NEW LEGISLATION > SPECIAL REPORT

Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Act 2021

Issued: 28 April 2021

|  |
| --- |
| Public Act 2021 No 8 |

This special report provides early information about some of the main changes in the new Act, ahead of comprehensive coverage of the new Act in an upcoming edition of the *Tax Information Bulletin*.

Contents

[Overview 3](#_Toc70509228)

[Land 4](#_Toc70509229)

[Feasibility expenditure 18](#_Toc70509230)

[Purchase price allocation 33](#_Toc70509231)

[Unclaimed money 51](#_Toc70509232)

[Mycoplasma Bovis tax issue 65](#_Toc70509233)

[Research and development 75](#_Toc70509234)

[Ability to transfer tax refunds to an amount borrowed under the Small Business Cashflow (Loan) Scheme 93](#_Toc70509235)

[Portfolio investment entities – remedial amendments 95](#_Toc70509236)

[COVID-19 tax relief for donations of trading stock 101](#_Toc70509237)

[Temporary loss carry-back remedial – loss grouping 105](#_Toc70509238)

[About this document 107](#_Toc70509239)

Overview

The Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill was introduced into Parliament on 4 June 2020. It received its first reading on 25 June 2020, second reading on 11 March 2021, and the third reading on 23 March 2021 (under urgency). This was followed by Royal assent on 30 March 2021.

Land

Extending the bright-line test

*(Sections CB 6A, CZ 39, EL 20, FB 3A, FM 18, FO 10, FO 17, GB 52, GB 53, and YA 1 of the Income Tax Act 2007; sections 54C, 54D and 54E of the Tax Administration Act 1994)*

The bright-line test has been extended from 5 years to 10 years.

Background

Housing unaffordability is caused by a number of supply and demand-side factors. The extension to the bright-line test is part of the Government’s response to reduce investor demand for property. Decreasing the tax advantage that property investors can receive will reduce the amount investors are prepared to pay for a given house and the number of houses they will buy. The measure is intended to support first home buyers and help lift New Zealand’s home ownership rates.

Key features

Extended bright-line test (new section CB 6A)

The bright-line test, which taxes gains from residential property acquired and sold within a specified timeframe, has been extended from 5 years to 10 years. Income arising under the bright-line test is taxed at a person’s marginal income tax rate.

The other policy settings for the bright-line test remain the same, except for the changes to the main home exclusion in section CB 16A and the business premises exclusion in the definition of “residential land”, as outlined further in this special report.

Therefore, the following features of the 5-year bright-line test will continue:

* The rules that determine when the property is acquired and disposed of, and when the bright-line period is counted from.
* The definition of “residential land” covered by the bright-line test includes land that has a dwelling on it, land where the owner has an arrangement to build a dwelling on it, and bare land that may be used for erecting a dwelling under the relevant operative district plan. “Residential land” does not include farmland or land used predominantly as business premises (subject to changes to ensure property used to provide short-stay accommodation is treated as residential land and not excluded as business premises – see below).
* The current exclusions and other forms of relief will continue to apply – that is:

– the main home will continue to be excluded (subject to changes to ensure the exclusion only applies for the periods the property was used as a main home – see below),

– transfers upon death, and any subsequent disposal by the beneficiary will continue to be exempt,

– transfers under a relationship property agreement will continue to be treated as a disposal at cost, so the transferor will not be taxed under the bright-line test on any gain, and

– those who receive land under a relationship property agreement will continue to take on the bright-line start date (the date from which the bright-line period is counted) of the transferor.

* The main home exclusion is available to properties held in trust. However, people cannot use the main home exclusion for multiple properties held through trusts.
* The main home exclusion cannot be used if it has already been used twice in the two year period preceding the date of sale, and also cannot be used by a person, or group of persons, who has a regular pattern of buying and selling their main home.
* Residential land withholding tax will apply to taxable bright-line sales by anyone who is an “offshore RLWT person” (defined in section YA 1 of the Income Tax Act 2007) – in short, a vendor who is living or established outside New Zealand.
* Specific anti-avoidance rules remain, to counter companies and trusts being used to circumvent the bright-line test.
* Vendors will continue to be allowed deductions for property subject to the bright-line test according to ordinary tax rules (subject to amended deductions as a result of changes to the main home exclusion – see below).
* Losses arising from a sale under the bright-line test will remain ring-fenced so they may only be used to offset taxable gains from other land sales.

Application date

The extended bright-line test applies if a person has acquired an estate or interest in the land on or after 27 March.

Detailed analysis

When an estate or interest in land is acquired

In a typical land purchase, the purchaser will first acquire an interest in the land when a binding contract to purchase the land is formed (even if some conditions – like getting finance or a building report – still need to be met). There is further discussion of when land is acquired in QB 17/02.[[1]](#footnote-2)

While the date a person acquires property determines whether the 5-year or 10-year bright-line applies, it should be noted that the 5 or 10-year period is then typically counted from the date the land is transferred to the purchaser (generally the settlement date).

Irrevocable offer carve-out

The 10-year bright-line test does not apply to property acquired on or after 27 March as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

An irrevocable offer is one that cannot be withdrawn before a certain time. For example, it is common as part of the tender process to sign a tender document that states the person cannot withdraw their offer until 5 working days after the tender has closed.

Table 1 outlines some scenarios and whether the 5-year or 10-year bright-line applies.

**Table 1: Extended bright-line test application date examples**

| Example | What bright-line test applies? |
| --- | --- |
| **The following scenarios deal with revocable offers** | |
| Purchaser offers on 21 March 2021, seller accepts on 24 March. Sale and purchase agreement (ASAP) signed 24 March. | 5-year test applies. |
| As above, but the seller accepts the offer and signs the ASAP on 27 March. | Extended 10-year test applies. |
| Purchaser offers on 18 March 2021, seller verbally accepts on 24 March, but does not sign ASAP until 27 March. | Extended 10-year test applies (for property transactions a verbal contract is not binding, and the purchaser does not have an equitable interest in the property at that point). |
| Purchaser offers on 19 March 2021, seller counter-offers on 24 March, purchaser accepts on 25 March. | 5-year test applies. |
| As above, but the purchaser accepts the counter-offer on 27 March. | Extended 10-year test applies. |
| **The following scenarios deal with irrevocable offers** | |
| Purchaser submits offer as part of tender process that closes on 22 March 2021. The tender document states that the offer cannot be withdrawn until 28 March. Seller accepts offer on 27 March and ASAP is signed. | 5-year test applies.  Although the purchaser acquires the land on 27 March and therefore is prima facie subject to the extended test, the carve-out for offers made on or before 23 March applies. |
| Purchaser submits an offer as part of a tender process that closes on 16 March 2021. The offer cannot be withdrawn until 22 March. Purchaser does not withdraw the offer, seller accepts on 27 March and ASAP is signed. | Extended test applies.  The carve-out does not apply because the purchaser was able to revoke their offer before 27 March. |
| **The following scenarios deal with conditional offers[[2]](#footnote-3)** | |
| Purchaser submits an offer subject to a building report on 18 March 2021. The vendor accepts the offer and the ASAP is signed on 24 March. On 2 April, the purchaser informs the vendor that the condition is satisfied and the agreement goes unconditional. | 5-year test applies.  The purchaser acquired the land when the binding agreement (subject to conditions) was entered into on 24 March, not on 2 April when the conditions were satisfied. |
| As above, except the purchaser and seller agree on a reduced price on 2 April, each signing the change in the agreement. | 5-year test applies. The binding agreement was entered into on 24 March, which is before 27 March. |

Nominees

Where a sale and purchase agreement has been entered into before 27 March but the purchaser is “and/or nominee”, then that person must have been nominated before 27 March to remain subject to the 5-year bright-line test, otherwise they will be subject to the 10-year test. This is because the nominee does not obtain an “estate or interest” in the land until they have been nominated as purchaser.

|  |
| --- |
| **Example 1: Trust nominated as purchaser**  Melissa’s offer on a property is signed and accepted on 26 March 2021. She lists the purchaser as herself “and/or nominee”. She intends for the property to be owned by her family trust, which is yet to be set up. She sets up the family trust and nominates the trustees as the purchaser on 1 April. Because the nomination is made on 1 April (after 26 March) the property is subject to the 10-year bright-line test. |

|  |
| --- |
| **Example 2: Additional purchaser added as nominee**  James’s offer on a property is signed and accepted on 26 March 2021. He lists the purchaser as himself “and/or nominee”. He intends to purchase the property with his brother Will, but Will wasn’t available to sign the agreement when he put the offer in. James nominates Will as the other owner of the property on 28 March 2021. Because Will is nominated after 26 March 2021, he will be subject to the 10-year bright-line test for his share of the property. James will be subject to the 5-year test for his share. |

The 5-year bright-line test (s*ection CZ 39)*

The 5-year bright-line test continues to apply in limited circumstances to residential land acquired on or after:

* 29 March 2018 but before 27 March 2021,
* 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, if the offer could not be revoked before 27 March 2021.

The income charging provision for the 5-year bright-line test has been shifted from section CB 6A to section CZ 39.

The main home exclusion that applies for the purposes of the 5-year test has been shifted from section CB 16A to section CZ 40.

Residential land withholding tax

*(Section RL 1 of the Income Tax Act 2007 (ITA) and sections 54C–54E of the Tax Administration Act 1994 (TAA))*

Residential land withholding tax (RLWT) applies to sales of residential land made by an “offshore RLWT person” if the sale occurs within five years. This is provided for in section RL 1 of the ITA and section 54C of the TAA.

With the extension of the bright-line test from five years to ten years, sections RL 1 and 54C have been updated so that RLWT also applies to sales of residential land made within ten years of acquisition (where the 10-year bright-line test is relevant).

Section RL 1(2)(a) has been amended to include references to new sections CZ 39 and CZ 40, so that a five-year test is still relevant for properties acquired before the application date of the 10-year test.

Section 54E of the TAA provides that the Commissioner is able to issue an RLWT exemption certificate in limited circumstances – including where a seller is in the business of developing land, dividing land into lots, or erecting buildings; and where the property was the seller’s main home.

RLWT exemption certificates will continue to be available where a property is used as a main home:

* For properties acquired before 27 March 2021 (or subject to the irrevocable offer carve-out), this is where it was the owner’s main home for more than 50 percent of the bright-line period (new section CZ 40).
* For properties acquired on or after 27 March 2021 (excluding where the irrevocable offer carve-out applies), this is where it is used as the owner’s main home for the whole bright-line period, including days within the 12-month buffer that are counted as main home days (provided for in new section CB 16A).

Section 54E of the TAA has been amended to refer to both section CB 16A and new section CZ 40 of the ITA (that is, both versions of the main home exclusion).

Where RLWT has been withheld, section 54D of the TAA and section RL 6 of the ITA permit a taxpayer to file a form for their land transactions to obtain a refund if too much RLWT has been paid relative to their overall income tax liability for their land transactions. Section 54D has been amended to refer to both CB 16A and new CZ 40.

Amendments to the main home exclusion

*(Sections CB 6A, CB 16A, CZ 40, DB 23C and YA 1 of the Income Tax Act 2007)*

The “main home exclusion” from the bright-line test has been amended so that it no longer applies on an all or nothing basis, but rather applies only for the period the property is actually used as the owner’s main home. A 12-month buffer applies to allow the property to not be used as a main home for up to 12 months without tax implications.

Background

A person’s main home is not taxed under the bright-line test. Prior to this amendment, a property was either fully in or fully out of the main home exclusion. For example, a person could qualify for the main home exclusion where the property was rented out for some of the time it is owned, provided it was used as the owner’s main home for more than 50 percent of the bright-line period. This all-or-nothing approach made sense in the context of a shorter bright-line period. However, it is not appropriate with a longer bright-line test as much more income could be involved. For example, without any changes to the way the main home exclusion works, a person would not have to pay tax under the bright-line test for a property that was rented out for four years if it was used as the taxpayer’s main home for five years.

Key features

* The main home exclusion has been amended so that it no longer applies on an all or nothing basis. Instead, it only applies for the period(s) the property is actually used as the taxpayer’s main home. To be within the exclusion, there is still a requirement that the property has been used predominantly (on a floor area basis) as the taxpayer’s main home.
* The legislation provides that a property is excluded from the bright-line test if it is the owner’s main home for the full bright-line period. Days when the property is not used as the main home will be treated as main home days if:

– the non-main home days are in a period of non-main home days of 365 days or less (the counted period), and

– the counted period is immediately before or after a period where the property is the person’s main home.

The effect of this is that there is a 12-month buffer, within which a change of use of a property to or from being the taxpayer’s main home does not need to be accounted for. In other words, the main home exclusion still applies if the property was not used as a main home for periods up to 12 months at a time. If the period that the property was not used as a main home exceeds 12-months, the main home exclusion does not apply.

* If the full main home exclusion in new section CB 16A does not apply, the amount the person derives from selling the property is income under section CB 6A. However, if the property has been used as the main home for some of the time it was owned, the legislation provides that the taxpayer is required to pay tax only for periods where the property was not used as their main home, or not counted as their main home. Periods of 12-months or less that are within the buffer discussed above, where the property is not used as a main home, are counted as main home days for the purposes of the calculation. The legislation provides for this as follows:

– New section CB 6A(6) provides that if the person has excluded days (that is, main home days) in the bright-line period, the amount of income the person derives from disposing of the land is reduced by reference to the formula in section CB 6A(7).

– New section CB 6A(7) provides that the person’s income is reduced by the amount calculated by subtracting the value attributable to the period the property was used as a main home or counted as a main home (that is, the proportion of days the property was used/counted as a main home multiplied by the sale price) from the sale price. This ensures that the taxpayer only has income attributable to the days the property was not their main home (or counted as their main home).

– New section DB 23C reduces the deduction the taxpayer can claim for the cost of the property (which includes the acquisition cost and any capital improvements). The deduction is reduced in proportion to the time the property was used (or counted as) as the main home. This ensures the proportion of the cost of the property that is deductible reflects the extent to which the property was not used as the main home (as this is the period in respect of which the gain is taxed).

Application date

The amended main home exclusion applies to property subject to the 10-year bright-line test, that is, property acquired on or after 27 March 2021. However, it does not apply to property acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021. The existing main home exclusion continues to apply for such properties, as well as properties acquired before 27 March 2021.

Detailed analysis

Main home exclusion (new section CB 16A)

The main home exclusion has been amended so that it no longer applies on an all-or-nothing basis in relation to residential land acquired on or after 27 March 2021 (subject to the carve-out for irrevocable offers). The existing main home exclusion continues to apply to properties acquired before 27 March (or after that date but subject to the irrevocable offer carve-out). This has been shifted to new section CZ 40. Table 2 outlines the previous law and the new law.

**Table 2: Previous law and new law**

| Previous law | New law |
| --- | --- |
| CB 16A: Section CB 6A does not apply to a person who disposes of residential land if, for **most of the period** [the bright-line period],[[3]](#footnote-4) the land has been used predominantly for a dwelling that was the main home for the person… | New section CB 16A: Section CB 6A does not apply to a person who disposes of residential land if, for **all of the days** [in the bright-line period], the land has been used predominantly for a dwelling that was the main home for the person… |
| Section YA 1 definition of main home: means, for a person, the one dwelling –   1. That is **mainly** used as a residence by the person…. | Section YA 1 definition of main home: means, for a person, the one dwelling –   1. That is used as a residence by the person… |

|  |
| --- |
| **Example 3: Main home exclusion**  William purchased a property in 2023. He lived in it for five years and rented it for four years before selling it in 2032.  William would qualify for the main home exclusion if the current settings for the exclusion were not changed because for most of the bright-line period (that is, more than 50 percent) the house was used as William’s main home. As a result, previous section CB 6A would not apply and William would have no tax to pay (though other aspects of the land sale rules, including the intention test, may still apply).  Under the change, the main home exclusion does not apply as it was not William’s main home for the full bright-line period. Instead, William is subject to section CB 6A, but his income is reduced to reflect the period for which the property was used as his main home (see quantification section below). |

|  |
| --- |
| **Example 4: Main home exclusion**  Erica purchased a property in 2022. She lived in it with a flatmate until she sold it in 2027.  Under both the previous and current law, the main home exclusion would apply. This is because for all of the bright-line period the property was used predominantly as Erica’s main home. The “predominantly” test looks at whether, on a floor area basis, the property was used at least 50 percent as the person’s main home. |

12-month buffer (new section CB 16A(6))

Despite the requirement that the property must be used as the person’s main home for “all of the days” in the bright-line period, a 12-month buffer applies under which any period of up to 12 months that the property is not used as the person’s main home is counted as a main home period, provided the period is immediately before or after a period during which the property was used as their main home. Therefore, the property will still qualify as the person’s main home if it was vacant or rented out for a period of less than 12 months before or after main home use.

This is intended to provide leeway for moving in or out of a property (for example, there may be vacant periods between settlement and moving in, or between moving out and sale). It also covers periods of up to 12 months where the taxpayer is not using the property as their main home (for example, if they rented the property out while overseas and it was no longer their main home for that period).

If a period of non-main home use exceeds 12 months, the entire period for which the property was not used as a main home is subject to tax.

If the main home exclusion does not apply to take the property completely outside the bright-line test (that is, because there was a non-main home period that exceeded 12 months), any non-main home period exceeding 12 months will need to be taken into account in working out a taxpayer’s income. See quantification section below.

|  |
| --- |
| **Example 5: 12-month buffer does not apply**  Catherine purchased her home in 2023. She lived in it until she went on her OE from 2025 to 2027. When she returned, she lived in her home again until she sold it in 2030.  The 12-month buffer does not apply here as the single period that the property was not used as Catherine’s main home (2025 to 2027) exceeds 12 months. As a result, the main home exclusion does not apply and Catherine must calculate her income under section CB 6A(6) (see quantification section below). |

|  |
| --- |
| **Example 6: 12-month buffer applies**  Gerald purchased his home in January 2022. He did not move in until six months later as he was overseas. He sold the property in 2026.  The 12-month buffer applies as the period Gerald was overseas and not using the property as his main home was less than 12 months, and it was immediately followed by a period where Gerald used the property as his main home. Therefore, the main home exclusion applies despite Gerald not actually using the property as his main home for a 6-month period. |

|  |
| --- |
| **Example 7: 12-month buffer applies**  Deb and Greg are retired and live in Dunedin. They acquired the property in March 2022 and sold it in January 2031. Every year they go to Brisbane for 3 months over winter. While they are in Brisbane, they stay in an apartment that they own.  Deb and Greg’s Dunedin property is likely to be their main home – as they typically live there, it is likely the home with which they have the greatest connection. When someone has two homes, the particular facts and circumstances need to be considered to determine which one they have the greatest connection with. This would include considering factors such as the extent to which they live in each property, and their family, social, employment and other ties to each of the locations. Regardless, in Deb and Greg’s situation, if the Dunedin property was not considered their main home when they are in Brisbane, the 12-month buffer would apply for the periods they are in Brisbane (as each period is less than 12 months). Therefore, either way the main home exclusion applies and Deb and Greg do not need to pay any tax on the sale. |

Quantification (new section CB 6A(6))

New section CB 6A(6) applies if a person has used their property as their main home for some but not all of the time it is held. Under section CB 6A(6), the person’s income from the disposal of the property is reduced by the excluded adjustment amount that is the amount calculated under subsection (7):

This formula only needs to be used if the property is used as the person’s main home for some of the time it is owned. If the property is never used as the person’s main home, the person’s income from disposal is simply the amount they derive from disposing of the property. They are not required to apply the formula as it does not impact them.

Quantification formula (CB 6A(7) to (11))

The formula for the excluded adjustment amount in section CB 6A(7) is:

***Adjustment days*** is the total number of days during the bright-line period where the property was used as a main home. It also includes days that are counted as main home days because the 12-month buffer applies.

***Total days*** is the total number of days in the bright-line period.

***Unadjusted amount*** is the amount of income the person derived from disposing of the property.

The effect of this formula is to evenly apportion the sale proceeds from the property over the period it is held. The amount attributable to the period the property was not used as the taxpayer’s main home then becomes income for tax purposes. There is no option to pay tax based on the actual valuations of the property at the start and end of the period the property was not the taxpayer’s main home. The following examples illustrate how the formula works:

|  |
| --- |
| **Example 8: Apportionment following change of use**  Everly bought a property for $1 million. It was transferred to her on 13 March 2030. She sold the property on 31 December 2037 for $1.8 million. She lived in the property and it was her main home from 13 March 2030 until 28 June 2035. Everly then rented it out until 31 December 2037. Her income is calculated as follows:  Excluded adjustment amount in subsection (7):  Under subsection (6):  Therefore $578,954.75 is Everly’s gross income from the sale. A portion of the acquisition cost needs to be deducted to determine the net amount of income from the sale that is subject to tax (see below). |

|  |
| --- |
| **Example 9: Apportionment and the 12-month buffer**  Shanti bought a property for $700,000. It was transferred to her on 20 May 2025. She lived in it from then until 2027, when she went overseas for nine months. While Shanti was overseas, the property was not her main home. When she returned, she lived in the property until 22 March 2029. Tenants moved in a few weeks later and Shanti rented the property out until 9 November 2033 when she sold it for $1 million.  The days in the 9-month period when Shanti went overseas are counted as “main home” days, even though the full main home exclusion does not apply to her because she exceeded the 12-month buffer period when she no longer used the property as her main home (from the day after she moved out (23 March 2029) until the date she sold the property – 9 November 2033).  The total number of days between 20 May 2025 and 9 November 2033 (inclusive) is 3,096. Her main home days total 1,403 (between 20 May 2025 and 22 March 2029, inclusive). For the purposes of the formula, total days is 3,096 and adjustment days is 1,403. The unadjusted amount (the amount derived on the sale) is $1 million.  Shanti’s bright-line income is calculated as follows:  Excluded adjustment amount:  Gross income from the sale per CB 6A(6):  Shanti’s gross income from the sale is $546,834.63. A portion of Shanti’s acquisition cost needs to be deducted to determine the net amount of income subject to tax (see below). |

Cost of some residential land reduced (DB 23C)

A person can claim a deduction under section DB 23 for the cost of property subject to the bright-line test.

Where new section CB 6A(6) applies, new section DB 23C reduces the deduction that can be claimed under section DB 23 as follows:

Adjustment days and total days have the same meaning as in CB 6A. Cost means the cost of the residential land.

|  |
| --- |
| **Example 8 continued: Cost of residential land reduced**  Continuing with Example 6 (Everly), Everly bought the residential land for $1 million, and it was transferred to her on 13 March 2030. Her total days is 2,851 and her adjustment days is 1,934.  Using the formula in section DB 23C(2), Everly’s excluded adjustment amount is:  Under DB 23C(1), Everly’s deduction for the cost of revenue account property under section DB 23 will be: |

Combined impact of sections CB 6A and DB 23C

The Income Tax Act 2007 operates on a gross basis and the structure of income charging and deduction provisions in different subparts does not allow for the provision of one single mathematical formula. However, it is possible to mathematically simplify the formula as follows:

|  |
| --- |
| **Example 8 continued: Combined effect of CB 6A and DB 23C**  Continuing with Example 6 (Everly), Everly’s income under section CB 6A is $578,954.75 and her deduction for the cost of revenue account property under section DB 23 (and DB 23C) is $321,641.53. Her net income from the sale is therefore:  Everly would therefore pay tax at her marginal rate on $257,313.22.  Alternatively, using the mathematically simplified formula from above and the original information from Example 6: |

Treatment of short-stay accommodation

*(Section YA 1 of the Income Tax Act 2007)*

The “business premises exclusion” from the definition of “residential land” has been amended to ensure that residential property used to provide short-stay accommodation, where the accommodation is provided in a dwelling that is not the owner’s main home, is subject to the bright-line test. The amendment also ensures short-stay accommodation is subject to the residential rental deduction ring-fencing rules in subpart EL of the Act.

Background

The bright-line test and residential rental deduction ring-fencing rules apply to “residential land” as defined in section YA 1. The previous definition of “residential land” had a carve out for land used predominately as business premises. Because there was no qualification to this carve out, residential property used to provide short-stay accommodation via predominantly digital platforms as part of the sharing economy was potentially able to qualify for the business premises exclusion and therefore be out of scope of the bright-line test and residential rental deduction ring-fencing rules. This was not intended.

Key features

Bright-line changes (paragraph (b) of the definition of “residential land”)

The definition of “residential land” has been amended to include land with a dwelling on it if it is used predominantly for a business of supplying accommodation and the dwelling is not the main home of the owner.

This is intended to ensure the bright-line test applies to short-stay accommodation properties (including a property that is rented out as part of the sharing economy on digital platforms, or a bach that is sometimes rented out when the owner does not use it) unless it is an accommodation facility that is also the owner’s main home and they rent out rooms for short-stay accommodation such as a bed and breakfast. This ensures that the treatment is the same between a person who rents out a property on a long-term basis (that is, has tenants) and a person who rents out a property on a short-term basis – that is, both are subject to the bright-line test. The carve-out for bed and breakfast type properties that are the owner’s main home ensure they are treated the same as a homeowner who rents spare rooms to flatmates – that is, neither are subject to the bright-line test. This is necessary because in a bed and breakfast situation the property may not be used predominantly as the owner’s main home.

Residential rental deduction ring-fencing (paragraph (b) of the definition of “residential land”)

The amendment to the definition of “residential land” discussed above also ensures that residential properties used to provide short-stay accommodation are subject to the residential rental deduction ring-fencing rules.

Hotels, motels and other commercial accommodation

Hotels, motels and other similar commercial accommodation are not “residential land” and are therefore not subject to the bright-line test or the residential rental deduction ring-fencing rules. This is because they are specifically excluded from the definition of “dwelling” in the Income Tax Act.

Feasibility expenditure

*(Sections CH 13, DB 66 and DB 67 of the Income Tax Act 2007)*

The Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Act 2021 contains changes codifying when businesses can deduct expenditure over five years related to completing, creating or acquiring property (business assets) that is later abandoned. Immediate deductions are also available for such expenditure that in total is $10,000 or less in an income year. Together, the changes are intended to set out the circumstances when expenditure can be deducted for property that but for abandonment would have been depreciable property or revenue account property.

The rules complement the current tax depreciation rules in situations when property is abandoned and not completed.

Deductions for expenditure in relation to abandoned property are clawed back as taxable income if the property is subsequently completed, created or acquired. This effectively puts a taxpayer in the position that they would have been in if they had never abandoned the property.

Taxpayers may be able to obtain certainty on the tax treatment of feasibility expenditure (including for abandoned and completed property) incurred in particular arrangements by applying for a ruling from Inland Revenue’s Tax Counsel Office.

Background

From a policy perspective, the economic value of business expenditure that is expected to decline in value should be either immediately deductible or, when it provides an enduring benefit, deductible over time if that benefit declines over time. When the tax system does not provide for that treatment, an economic distortion is created.

An example of this distortion arises with feasibility expenditure incurred by taxpayers to determine the practicability of a proposal to acquire or create property that will decline in value over time. The Income Tax Act 2007 generally denies immediate deductions for expenditure when it has a connection with property that has the potential to yield future economic benefits beyond the current income year. If the expenditure is required to be capitalised and the property is not completed, the expenditure is not recognised for tax depreciation purposes and is unable to be deducted for tax purposes, resulting in what is referred to as “black hole” expenditure. This creates an incentive for businesses to complete capital projects that would otherwise be abandoned.

The non-deductibility of this expenditure effectively raises the cost of risky investments in new property (where the chance of a viable outcome is uncertain) and therefore can act as a barrier to businesses committing resources to developing new property – which is important to innovation and driving productivity improvements.

The new rules are intended to sit alongside the Income Tax Act’s rules for tax depreciation and Inland Revenue’s interpretation statement IS 17/01[[4]](#footnote-5) for businesses that regularly incur feasibility expenditure.

The amendments respond to private sector concerns following the 2016 decision by the Supreme Court in *Trustpower Limited v Commissioner of Inland Revenue*,[[5]](#footnote-6) which limited the deductibility of expenditure incurred on property that is subsequently abandoned. The rules reduce tax barriers for businesses seeking to invest in new property, by providing greater deductibility of expenditure where it relates to property that is abandoned.

The amendments do not give tax deductions for expenditure related to property that is not expected to decline in value, such as land, goodwill and shares. While property that is not expected to decline in value sometimes does, it would only be appropriate to provide deductions for this expenditure if the tax system taxed gains in property that appreciated.

The amendments do not alter the rules that exist for:

* tax depreciation (although the rules do allow immediate deductions in some circumstances if the expenditure is less than $10,000 – this is explained in more detail below)
* company administration costs
* costs incurred in the course of abandoning property
* research and development
* resource consents
* unsuccessful software projects
* patents
* plant variety rights.

The amendments also do not affect the application and effect of the general permission test relating to deductions. This is explained in more detail below under ‘Detailed analysis’.

Key features

Section DB 66 allows taxpayers to deduct expenditure incurred in relation to making progress towards completing, creating or acquiring property if:

* the property would be:
  + depreciable property, including depreciable intangible property, or
  + revenue account property
* progress on the property is abandoned with the outcome that the property is not completed, created or acquired, and
* no deduction for the expenditure is allowed under any other provision in the Act.

The deduction does not apply to expenditure on certain items, such as land, shares and goodwill.

Deductions meeting the conditions above can be spread in equal proportions over a five-year period starting in the income year the property was abandoned (section DB 66(2)). However, there is no entitlement to any remaining portions of the deduction if the abandoned property is completed, created or acquired within the five-year spreading period.

Section DB 67 allows an immediate deduction in the income year for expenditure incurred in relation to making progress towards completing, creating or acquiring property if the total expenditure incurred in an income year that could be subject to this provision is $10,000 or less and:

* the expenditure is related to depreciable property or revenue account property, and
* no deduction for the expenditure is allowed under any other provision in the Act.

As is the case with section DB 66, new section DB 67 does not allow a deduction for certain items, such as land, shares or goodwill.

Given that section DB 67 allows immediate deductions if the expenditure is less than $10,000 (even if the property has not been abandoned), this rule will in some circumstances override the general depreciation rules. This is explained in more detail below under ‘Detailed analysis’.

The expenditure under both sections must be incurred in relation to making progress towards completing, creating or acquiring the property.

The amount of the available deduction is equal to the expenditure the taxpayer incurs related to making progress towards completing, creating, or acquiring property.

For abandoned property that is later completed, created or acquired, new section CH 13 claws back the deductions allowed under section DB 66 by treating the amount deducted as income. The property may then be subject to the tax depreciation rules in subpart EE, or the revenue account property rules in section DB 23.

New sections DB 66 and DB 67 override the limitation for expenditure of a capital nature.

Application date

The amendments apply to qualifying expenditure incurred in the 2020−21 and later income years.

Detailed analysis

Spread deduction rule for feasibility expenditure

New section DB 66 is directed at expenditure incurred by taxpayers in relation to making progress towards completing, creating or acquiring property that is subsequently abandoned. The term “property” is defined by reference to property that if completed would be depreciable property, including certain types of intangible property, and/or revenue account property.

Progress will, generally, be considered to be abandoned when a decision has been made that no further progress will be undertaken to complete, create or acquire the property. For larger projects, such a decision will likely be documented by the taxpayer. However, for small businesses a decision to not proceed with the property may be reflected in that no further money has been applied to completing, creating or acquiring the property.

The available deduction is equal to the expenditure the taxpayer has incurred in relation to the abandoned property, which is not otherwise deductible under any other provisions of the Act. The intention is to permit a broad range of expenditures to be deducted, including direct costs that would ordinarily be considered to be the “cost” of depreciable or revenue account property, and expenses that have an indirect relationship with the property, such as administration or general overhead costs.

A deduction is not available for expenditure on acquiring property such as land, shares and goodwill in the course of developing another asset that is abandoned. This is because expenditure on such items is not typically associated with feasibility type activity but could potentially otherwise fall within the broad wording of the feasibility rules.

Deductions for the expenditure are spread in equal proportions (one-fifth) over a five-year period, starting in the year of abandonment. However, as discussed below, there is no entitlement to any remaining portions of the deduction if the abandoned property is subsequently completed, created or acquired before the five-year spreading period has expired.

|  |
| --- |
| **Example 10: When the new sections apply – wind studies**  Company A, an electricity generator, is exploring the practicability of establishing a new wind farm. It incurs expenditure in the 2020–21 income year associated with measuring wind frequency and speeds (anemology) relevant to the local geography. At the end of the 2021–22 income year, the studies regarding the site are inconclusive as to reliability of wind supply and the project is abandoned.  ***Tax impact***  The anemology expenditure relates to the possibility of expanding the capital structure of the business and, as such, is capital expenditure. Regardless of whether or not this expenditure would have been included in the cost of the property for depreciation purposes had the property been completed, created or acquired, it will be deductible under section DB 66 to the extent that it does not relate to land or other property that is not depreciable property or revenue account property. This is because the expenditure was incurred after section DB 66 came into effect and made progress towards creating or completing property that, if it were created or completed, would have been depreciable property (wind turbines). The relevant expenditure will be deductible in equal parts over five years. |

|  |
| --- |
| **Example 11: When the new sections apply – nanotechnology study**  Company B, a water management company, is working on ways to meet demand in times of low-aquifer inflows and drought, to prevent water restrictions. It is exploring the viability of desalination. The company carries out a number of studies on the practicability of building and operating a desalination plant, and researches how water from the plant could be connected to the wider network. Work on the project is abandoned after an assessment determines it is uneconomic, in terms of energy needs and water output, for the plant to meet forecast demand. The project is shelved pending future advances in desalination nanotechnology.  ***Tax impact***  Under section DB 66, the collective desalination study expenditure will be deductible as the expenditure was incurred in relation to making progress towards creating property that, if it were completed, would have been depreciable property (water treatment plant and reservoir). The expenditure will be deductible in equal parts over five years. |

|  |
| --- |
| **Example 12: When the new sections apply – design property rights**  Company C, an aeronautics company, has plans to redesign the cockpit and airframe canopy for a model of small single propeller aircraft. The redesign is intended to improve flight performance and pilot visibility for such purposes as aerial crop dusting.  The company incurs expenditure in costing the project and scoping initial airframe designs. The multi-year project is shelved when a competing overseas company brings a comparable (and cheaper) improved aircraft to the market.  ***Tax impact***  The design expenditure would be deductible under section DB 66 except to the extent the expenditure is deductible under another provision (for example, if some of the design expenditure resulted in depreciable intangible property). |

|  |
| --- |
| **Example 13: When the new rules will not apply – acquisition of shares**  Company D is seeking to diversify the range of products it provides to commercial clients. It initially considers either directly acquiring the products or acquiring the shares in another firm that is offering comparable products. However, a decision is made to explore acquiring the shares in the firm in order to retain the firm’s existing staff, management and the client list built up by the firm. Company D subsequently incurs legal and other consulting expenditure in undertaking a due diligence of the firm. However, Company D’s bid to acquire the firm is unsuccessful.  ***Tax impact***  The expenditure connected with Company D acquiring the shares in the firm is not deductible under section DB 66 as it relates to the acquisition of shares (which are specifically excluded from the scope of section DB 66 as excepted financial arrangements). |

|  |
| --- |
| **Example 14: When the deduction starts**  The finance team at Company E is considering the expenditure debited in its work in progress account after balance date for the 2020–21 income year. The expenditure includes a study directed at improving the energy efficiency of the company’s plant. The finance team decides not to make any further progress on the energy efficiency work due to cash flow constraints. The abandoned work related to a potential refit of the company’s premises for lighting and heating. Had the work been completed, the completed property would have been depreciable property (fitout). No further amounts had been spent on the project after balance date and the decision is made in 2021–22 income year to abandon the project.  ***Tax impact***  The expenditure would be deductible under section DB 66 given its relationship with depreciable property. A deduction of one-fifth of the expenditure can be made in the 2022 income tax return, being when a decision was made to make no further progress on the property, with the remaining deductions spread evenly over the next four years. |

Application of general permission

The new rules override the capital limitation, but not the general permission requirements. The general permission requires that the expenditure must have a connection to an existing business or income-earning process of the taxpayer in order to be deductible under the rules. In situations where the expenditure is incurred before any decision is made to enter into the business or income-earning activity, the expenditure will have been incurred too soon and will not be deductible. Similarly, where a business already exists, feasibility expenditure incurred in relation to a new business will still need to have sufficient nexus to the existing business. However, feasibility expenditure that is recurrent and incurred as part of the ordinary income-earning process of a business is likely to be deductible under the new provisions (if not already deductible under existing law in line with the principles in Inland Revenue interpretation statement *IS 17/01: Income tax – Deductibility of feasibility expenditure*).

The correct time for considering whether the expenditure satisfies the general permission is when the expenditure is incurred, not when the relevant property is abandoned.

|  |
| --- |
| **Example 15: Expenditure does not satisfy the general permission**  After being made redundant from her job as an architect, Willow decides to investigate starting her own architecture business. She spends $3,000 on market research, a consultant to put together a business plan, brochures and contacts former clients to compile a client database.  ***Tax impact***  The expenditure incurred by Willow is not deductible under section DB 66 because it does not satisfy the general permission. The expenditure is merely preliminary to establishing a business or income-earning activity. At the time of incurring the expenditure, a business had not yet commenced. |

|  |
| --- |
| **Example 16: Expenditure does not satisfy the general permission**  Company F, an operator of a coal mine, is considering becoming involved in a project to construct an aluminium smelter to which it can supply coal. Company F forms a consortium with two other companies and conducts a feasibility study to determine the construction and operating costs and to assess the environmental consequences of building and operating an aluminium smelter. The company also undertakes its own feasibility study of the project and engages various consultants to advise on matters such as industrial relations, finance, environmental issues and negotiating a joint venture agreement. However, the development does not proceed because the other two consortium participants withdraw from the project.  ***Tax impact***  The feasibility expenditure incurred by Company F is not deductible under section DB 66 because it does not satisfy the general permission. No nexus exists between Company F’s existing business and the smelter feasibility expenditure. The latter was incurred in creating a new business structure. |

Apportionment

Expenditure will be deductible under the rules only to the extent that it is connected with making progress towards depreciable or revenue account property. Where an amount of expenditure relates to a mixture of, for example, depreciable and non-depreciable property, then only a portion of the expenditure will qualify for a deduction under the rules.

The legislation does not specify a particular approach or methodology for how expenditure needs to be apportioned in these circumstances. This provides some flexibility to taxpayers in how they approach the apportionment exercise. Any fair and reasonable method of apportionment may be used.

Whether an apportionment is fair and reasonable will depend on the relevant facts and circumstances related to the expenditure. It is not necessary that the apportionment method applied be the most accurate, but it must reflect what an objective person would consider to be fair and reasonable in the circumstances. The method should reflect the contribution of the expenditure towards the relevant item of property. A method that could be considered fair and reasonable in some instances may be one based on estimates by qualified professionals of the values of respective in-scope and out-of-scope property at the time the property was abandoned. There may equally be other methods that can be applied that will provide a fair and reasonable apportionment.

Records that taxpayers would be expected to hold in support of their chosen apportionment method would include (but are not necessarily limited to) the following:

* Any records detailing what their plan was, in terms of what property they were looking to complete, create or acquire.
* Details of categories of expenditures that can be directly attributed to depreciable property, revenue account property, or property that is excluded from the scope of section DB 66.
* Categories of expenditures that relate to both depreciable property/revenue account property and property that is excluded from the scope of section DB 66.

The Inland Revenue interpretation statement *IS 17/01: Income tax – Deductibility of feasibility expenditure* notes that expenditure that is not directed towards a specific project or which is so preliminary as to not be tangibly progressing or materially advancing such a project will be on revenue account and therefore immediately deductible if the business regularly carries out feasibility studies. This being the case, it is expected that, by the time that tangible progress has been made on a specific capital project, the taxpayer will likely have a better understanding of the share of remaining costs between depreciable property and revenue account property, and property that is specifically excluded.

|  |
| --- |
| **Example 17: Deduction needs to be apportioned**  Company G, a manufacturer of various cleaning products, is seeking to acquire the intellectual property for an outdoor cleaning product produced by a competitor that is going out of business, along with any remaining stock of that product. After engaging a law firm to provide legal advice on the transaction, Company G makes an offer of $10 million for the intellectual property, including brand rights and the formulation or “recipe” for the product, and an additional $5 million for the remaining trading stock. However, Company G’s offer is rejected as the manufacturer of the product receives a higher offer from a different competitor. Company G paid $33,000 for the legal fees.  ***Tax impact***  A deduction for the legal fees is not available under section DB 62 (deduction for legal expenses) because the total amount of the expenditure on legal fees in the income year exceeds $10,000. Company G considers that a fair and reasonable allocation approach would result in a deduction of $11,000 (33 percent of the $33,000 it paid on legal fees related to the transaction) under section DB 66. This apportionment method is fair and reasonable in the circumstances because a third of the value of the transaction, had it been successful, would have been in relation to revenue account property.  A deduction is not allowed under section DB 66 to the extent that the expenditure relates to acquiring property that is not depreciable or revenue account property, such as intellectual property that is not fixed life intangible property.  An alternative apportionment methodology could be chosen by Company G if it was also fair and reasonable. |

|  |
| --- |
| **Example 18: Company unsure whether it would have bought shares or underlying business assets**  Company H is considering purchasing either the shares in a competitor company or the underlying business assets of the company, 40% of the value of which comprises depreciable property and revenue account property. Company H incurs due diligence expenditure totalling $55,000 before committing to a decision as to whether to buy the shares or the underlying assets.  Based on the information gathered from the due diligence exercise, Company H determines that the respective prices the vendor is asking for the shares and for just the business assets are both too high, and so decides during the 2020–21 income year not to proceed with either option.  ***Tax impact***  As Company H does not know whether it would have purchased the shares or the assets at the time it incurred the due diligence expenditure, a fair and reasonable apportionment method could involve 50% of the expenditure potentially within scope of section DB 66. This proportion is further reduced by 40% to reflect the proportion of assets within scope of the rules (that is, depreciable and revenue account property) to those outside the scope of the rules. As a result, Company H claims $11,000 ($55,000 × 50% × 40%) of expenditure under section DB 66 over a five-year period, commencing in the 2020–21 income year.  An alternative apportionment methodology could be chosen by Company H if it was also fair and reasonable. |

Partial abandonment

It is possible that a capital project may produce a number of distinct items of property that together achieve the overall objective of the project. In the process of developing the overall project, it is possible that some smaller items of property may be considered and abandoned even though the project as a whole is completed. Guidance on how to identify the relevant property can be found in Interpretation Statement *IS 12/03: Deductibility of Repairs and Maintenance – General Principles.*

If the costs that were incurred in exploring the viability of the abandoned property cannot be capitalised to the cost of depreciable or revenue account property resulting from the project and are otherwise not deductible, a deduction for the expenditure relating to the abandoned option may be available under section DB 66. As discussed above under ‘Apportionment’, any deduction would be limited to the extent the expenditure relates to depreciable property or revenue account property, had it been completed.

|  |
| --- |
| **Example 19: Partial abandonment**  Company I needs to add a line to its network to transport power from Point A to Point F. The company incurs expenditure in investigating three different potential routes for the power line (A to B to F; A to C to D to F; A to E to F). The expenditure includes resource consent costs and legal fees of more than $10,000 for negotiations with landowners to acquire access rights to the land on the alternative routes via points B, C, D and E.  As a result of its investigations, Company I decides to proceed with a route from A to E to F and the two alternative routes (from A to B to F and from A to C to D to F) are abandoned.  ***Tax impact***  Company I cannot take a deduction under section DB 66 for the resource consent costs. This is because a deduction for the resource consent costs is already available under section DB 19. Whether or not a deduction can be taken under section DB 66 for the legal fees relating to negotiations with landowners will depend on whether the access rights would have been fixed life intangible property and therefore depreciable property. If the access rights would have been fixed life intangible property if acquired and no deduction is otherwise available, Company I is entitled to a deduction under section DB 66 for the legal fees. Otherwise, a deduction is not allowed. |

Immediate deduction for feasibility expenditure

Section DB 67 works in a similar way to section DB 66, with modifications to reflect that section DB 67 is a compliance cost saving measure. That is, feasibility expenditure can be immediately deducted by the taxpayer if the total expenditure incurred is $10,000 or less in an income year. There is no requirement that the property be abandoned.

However, like the requirements of section DB 66, the expenditure must satisfy the general permission provisions and not be deductible elsewhere under the Act. Section DB 67 is not a replacement for tax depreciation for low-value assets. This means that a person who acquires an item of depreciable property must apply the depreciation rules from the year the property is actually acquired. A deduction for the cost of the property is not available under section DB 67 in this situation.

If the person had incurred expenditure in merely looking into purchasing the property, or started to make or construct the property but did not complete it within the income year so that it could then be depreciated, then a deduction for the expenditure would be available under section DB 67. In this situation, if the property is completed (resulting in an item of depreciable property), then any expenditure relating to the property that has previously been deducted under section DB 67 is excluded from the cost of the completed property for tax depreciation purposes.

|  |
| --- |
| **Example 20: When the deduction cannot be immediately claimed – depreciable property**  Retailer J acquires a secondhand vehicle to assist with deliveries. The vehicle and associated expenditure incurred during the income year totals $8,000.  ***Tax impact***  The cost of the vehicle is not deductible under section DB 67 as the cost of the vehicle is deductible under the tax depreciation rules. |

Only one deduction is allowed for the relevant expenditure

Once a deduction is claimed under section DB 66 or section DB 67, no further income tax deduction is available for this expenditure. This is a function of the income tax rules, which do not allow more than one deduction for the same item of expenditure.

However, if expenditure has been effectively denied by the application of the clawback in section CH 13 (discussed below), it is intended that the expenditure may be subsequently deductible if it otherwise satisfies the requirements to be part of the cost of depreciable or revenue account property.

Clawback of deductions

The feasibility expenditure rules include an integrity measure (referred to as the “clawback”) that applies where previously abandoned property is subsequently created, acquired or completed.

The clawback is directed at situations where taxpayers may be incentivised to prematurely abandon work on property. For example, property may be partially abandoned to take advantage of the five-year deduction if this would accelerate the deductions that would have been allowed had the property been completed and depreciated. A further example is where the deductions under the feasibility rules would be greater than would otherwise be available under the tax depreciation rules if the property was completed.

The clawback applies in the income year that the abandoned property is completed, created or acquired. This also applies in the situation where the taxpayer subsequently acquires property that is similar to the abandoned property.

The effect of this measure is to put taxpayers into a similar tax position to where they would have been had they never abandoned the property.

The clawback in new section CH 13 deems an amount of income equivalent to the deductions previously taken under section DB 66 in relation to the property. The requirement to include as income amounts that were previously deducted does not apply to expenditure that has been immediately deducted under the $10,000 de minimis rule.

To minimise compliance costs and provide greater certainty to taxpayers, a seven-year time limit applies to the clawback. The seven-year time limit aligns with the general business record retention requirements in the Tax Administration Act 1994, starting in the year immediately following the income year for which the fifth and final deduction was taken under the rules. This means that the deductions are not clawed back if abandoned property is subsequently created or completed more than seven years after the income year to which the last deduction relates, or if the property or similar property is acquired more than seven years after that income year.

|  |
| --- |
| **Example 21: Previous deduction clawed back**  Company K, an electricity generator, regularly undertakes studies to determine the practicability of different power generating options. Following the initial study process many of the options will be shelved. However, some of these options may be reconsidered in the future and result in the creation of electricity generation assets.  One of these studies involves the creation of a wind farm in Gusty Hills, with work on the project abandoned in Year 1. Prior to abandonment, $10 million was expended on various fees. The $10 million incurred by Company K is deductible over a five-year period, starting in the year the project is abandoned. This results in equal deductions to Company K of $2 million in Years 1 to 5.  In Year 7 Company K decides to reinstate the wind farm project in Gusty Hills, with the property being completed in Year 9 using the information from the previous studies.  ***Tax impact***  The clawback provision is triggered in the year that the relevant property is subsequently created, acquired or completed, being Year 9. In this case, the property was completed within seven years from the final year of deduction (that is, Year 5) under section DB 66. This means that Company K is required to return clawback income of $10 million in its Year 9 tax return. However, some of this expenditure may be deductible if it forms part of the cost base of depreciable property. |

|  |
| --- |
| **Example 22: Previous deduction not clawed back – example 11 continued**  A decade after Company B’s decision not to proceed with a desalination plant, population growth in the region and the need for greater water infrastructure has led Company B to restart its earlier work on nanotechnology. Development of the plant and reservoir begins and seven years later it is operational and connected to the wider water supply network.  ***Tax impact***  The earlier deduction taken for the previous study is not clawed back as the property is completed more than seven years after the end of the income year in which the final deduction was taken under section DB 66. |

Abandoned property subsequently created, acquired or completed

In order to apply the clawback, taxpayers need to identify and monitor whether any property subsequently arises from the expenditure that has been deducted under section DB 66.

In many situations a taxpayer will simultaneously abandon work on multiple items that, if completed, acquired or created, would have been depreciable or revenue account property. This may be due to the abandonment of all or part of a project being undertaken by the taxpayer.

In determining whether the clawback applies, the rules require an analysis of each separate piece of property that is subsequently created, completed or acquired. In other words, the relevant assessment is not in relation to the wider project, but to individual items of depreciable or revenue account property for which a deduction was allowed under section DB 66.

This will require an understanding of what property the expenditure relates to, which is an exercise that is likely to have been undertaken as part of the process of claiming a deduction under section DB 66 (for instance, in claiming a deduction there needs to be an apportionment between depreciable/revenue account property and other property).

It is possible that expenditure could relate to multiple potential items of depreciable or revenue account property, of which only some is subsequently created, acquired or completed. In this case, it will be necessary to make an apportionment of this expenditure on a fair and reasonable basis for the purpose of applying the clawback.

|  |
| --- |
| **Example 23: Restart of hotel development**  Company L is constructing a hotel on the Auckland waterfront as part of a larger development that includes residential apartments and retail space. Progress on the project stopped and was put on hold indefinitely in 2021 because overseas tourists stopped coming into the country. However, work on the hotel resumes in 2023 (but not the rest of the development) as international travel picks up again, with completion of the hotel in 2025. The design of the hotel is modified from its original design and includes a gym and larger swimming pool. However, the hotel is located on the same site and serves the same purpose (hotel accommodation) as was originally planned. The previously abandoned property was simply finished off (with some adjustments) when the project restarted.  ***Tax impact***  Although there are some differences between the completed hotel and the original construction plans for it, the property is based on the original design, performs the same function and is in the same location and as such is considered to be the completion of the abandoned property. Section CH 13 will apply to claw back any expenditure that was deducted under section DB 66 in relation to the hotel after it was abandoned. However, it will not be necessary to claw back any expenditure to the extent it relates to part of the project that has not been completed (the residential apartments and retail space). |

Similar property

A feature of the clawback is that it also applies to property acquired that is “similar” to the property that was abandoned. The need for the rules to apply where similar property is acquired is to protect against the clawback being ineffectual if the acquired property has even a slight modification or difference to the abandoned property.

It is important to note that the “similar property” requirement only attaches to property that is acquired by a taxpayer, rather than property that is created or completed by the taxpayer. This is because taxpayers will have greater opportunity to acquire property that is similar to (but not the same as) the original property that was abandoned. However, this is not expected to hold true for property that is created or completed by a taxpayer. In this case, the created or completed property is likely to be a continuation of the property that was abandoned.

The term “similar property” is not defined in the legislation. Acquired property is likely to be similar to abandoned property where it has a resemblance in appearance, character, function, purpose or quantity to the property that was abandoned. In determining the appearance, character, function, purpose or quantity of the property, regard may be had to any project and design plans relating to the abandoned property, which may include details of the assets required to be acquired for the project and their respective specifications.

|  |
| --- |
| **Example 24: Acquisition of non-similar property**  In order to expand its vegetable handling operations, Company M seeks to develop a new facility that will include an additional potato washing facility. After considering a number of options, Company M decides on a preferred option of a flatbed potato washer and incurs engineering and design costs for integrating the new machine into the existing processes and facilities. Due to a new form of fungal disease that reduces potato crops, Company M decides to abandon the project and does not acquire the potato washing plant. Company M claims a deduction under section DB 66 for the engineering and design costs.  Two years later, new fungus resistant potato varieties have been planted resulting in increased crop yields. As a result, Company M decides to acquire a new potato washing plant. However, instead of acquiring a flat bed washer, it acquires a barrel washer, which is able to wash more potatoes and is able to clean a wider range of vegetables. The original engineering and design work relating to the flat bed washer cannot be used for the barrel washer due to differing specifications.  ***Tax impact***  The barrel washer and flatbed washer have similar functions in that they both wash potatoes. However, the specifications between the two different washers are significantly different. This is reflected in that the barrel washer can clean a larger quantity of potatoes and can also clean other types of vegetables, as well as the engineering and design work for the flatbed washer not being able to be directly applied to the acquired barrel washer. Accordingly, the barrel washer is not similar to the flat bed washer and the clawback does not apply to the engineering and design expenditure deducted under section DB 66. |

No further deductions once clawback is triggered

In some situations, abandoned property may be reinstated and completed before the five-year spreading period has ended, resulting in the clawback being triggered before all the deductions available under section DB 66 have been claimed. In this situation, all the previously claimed deductions are clawed back as taxable income. There is no entitlement to the remaining deductions under s DB 66 once the relevant property is completed, created or acquired. As noted above, clawed back expenditure may be deductible under the depreciation or revenue account property rules, subject to meeting the relevant deductibility criteria.

|  |
| --- |
| **Example 25: Interaction between deduction provision in section DB 66 and clawback**  Company N is undertaking a capital project that, if completed, will result in depreciable property. Work on the project is abandoned in Year 1 but is subsequently resumed and then completed in Year 3.  The clawback in section CH 13 applies to the expenditure deducted in Years 1 to 2, meaning that Company N is required to return the deduction portions for Years 1 to 2 as taxable income in Year 3. Company N has no entitlement to the remaining deduction portions for Years 3 to 5. |

Purchase price allocation

This special report explains the new purchase price allocation rules in sections GC 20 and GC 21 of the Income Tax Act 2007 (the Act), inserted by the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Act. The rules reinforce and extend existing provisions requiring parties to a sale of business assets with different tax treatments to adopt the same allocation of the total purchase price to the various classes of assets for tax purposes.

Background

Sales of business assets are often subject to more than one tax treatment. These sales are sometimes referred to as ‘mixed supplies’. For example, a sale of commercial property will normally include depreciable buildings and fitout, and land held on capital account (non-taxable/non-deductible). The vendor and purchaser will agree a total price for the transaction, but may or may not allocate the price between the different assets. For tax purposes, however, the parties are usually required to make an allocation, to determine the vendor’s tax liability and the purchaser’s basis for deductions. This is referred to as a ‘purchase price allocation’.

Allocations must reflect market values for the various assets, but market value is a range rather than a single figure. Current law requires a purchaser of trading stock in a mixed supply to treat the trading stock as acquired for the same value as the vendor treats it as sold for (section EB 24(3) of the Act). Trading stock for the purposes of section EB 24 is broadly defined, to include livestock, land held on revenue account, and timber. Section DP 10(1) reinforces this rule for timber. However, these rules do not contain a mechanism for the vendor’s allocation to be communicated to the purchaser, if the allocation is not stated in an agreement. Also, there is no explicit consistency requirement for depreciable property or financial arrangements. As a result, under prior law there were many cases where the vendor and the purchaser in mixed supplies ascribed different market values to the same assets often with the effect that their aggregate reported income was lower than if they had applied consistent valuations.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Example 26**  Shark Attack Commercial Limited (Shark) is a commercial property owner with a number of buildings in the Auckland CBD. It wishes to sell one of its prime buildings, the Waiata Centre, to Corroboree Properties Limited another commercial lessor. The assets being sold comprise the land, building and fitout of the Waiata Centre. Shark and Corroboree agree on a purchase price of $150 million but they do not allocate that purchase price between the land, building and fitout.  When Shark files its tax return it allocates the purchase price as follows:   |  |  | | --- | --- | | **Item** | **Amount** | | Land | $100m | | Building | $40m | | Fitout | $10m | | **Total** | **$150m** |   However, Corroboree obtains a valuation of the building and applies that valuation to determine the values in its tax return:   |  |  | | --- | --- | | **Item** | **Amount** | | Land | $80m | | Building | $50m | | Fitout | $20m | | **Total** | **$150m** |   This results in a tax mis-match between the two taxpayers over the same assets giving Corroboree a higher tax depreciation base than the amount returned by Shark in determining its depreciation recapture income. |

The purchase price allocation rules address this lack of consistency and of information, applying to agreements for the disposal and acquisition of property entered into on or after 1 July 2021. An agreement is entered into once it is binding on the parties, whether or not there are conditions (for example, a standard finance condition for the benefit of the purchaser) that remain to be met and which if not met will mean the transaction does not proceed.

Key features

* Purchase price allocations are to be made at the level of the following classes of ‘purchased property’:

i) trading stock, other than timber or a right to take timber

ii) timber or a right to take timber

iii) depreciable property, other than buildings

iv) buildings that are depreciable property

v) financial arrangements, and

vi) purchased property for which the disposal does not give rise to assessable income for person A (the vendor) or deductions for person B (the purchaser).

**Agreed allocations**

* If the parties agree an allocation to the classes of purchased property and record it in a document before the first tax return for the year in which the transaction occurs is filed, they must both follow that allocation in their returns. This agreed allocation over-rides any prior unilateral allocation that may have been made (see below).

**Unilateral allocations meeting timeframes**

* If the parties do not agree an allocation and record it in a document before the first tax return for the transaction is filed, the allocation will be determined by a notification made by one of the parties, or the Commissioner. However, a unilateral allocation does not need to be notified if the total consideration for the purchased property is less than:

a) $1 million, or

b) $7.5 million, if the only purchased property is residential land (which includes residential buildings) together with its chattels.

* The vendor has three months after the change in ownership of the property to notify an allocation to the purchaser and the Commissioner, which then binds the vendor and the purchaser.
* If the vendor does not notify an allocation within three months, the purchaser has three months (that is, until six months after the change in ownership) to notify an allocation to the vendor and Commissioner, which then binds the purchaser and the vendor.

**No unilateral allocation meeting timeframes**

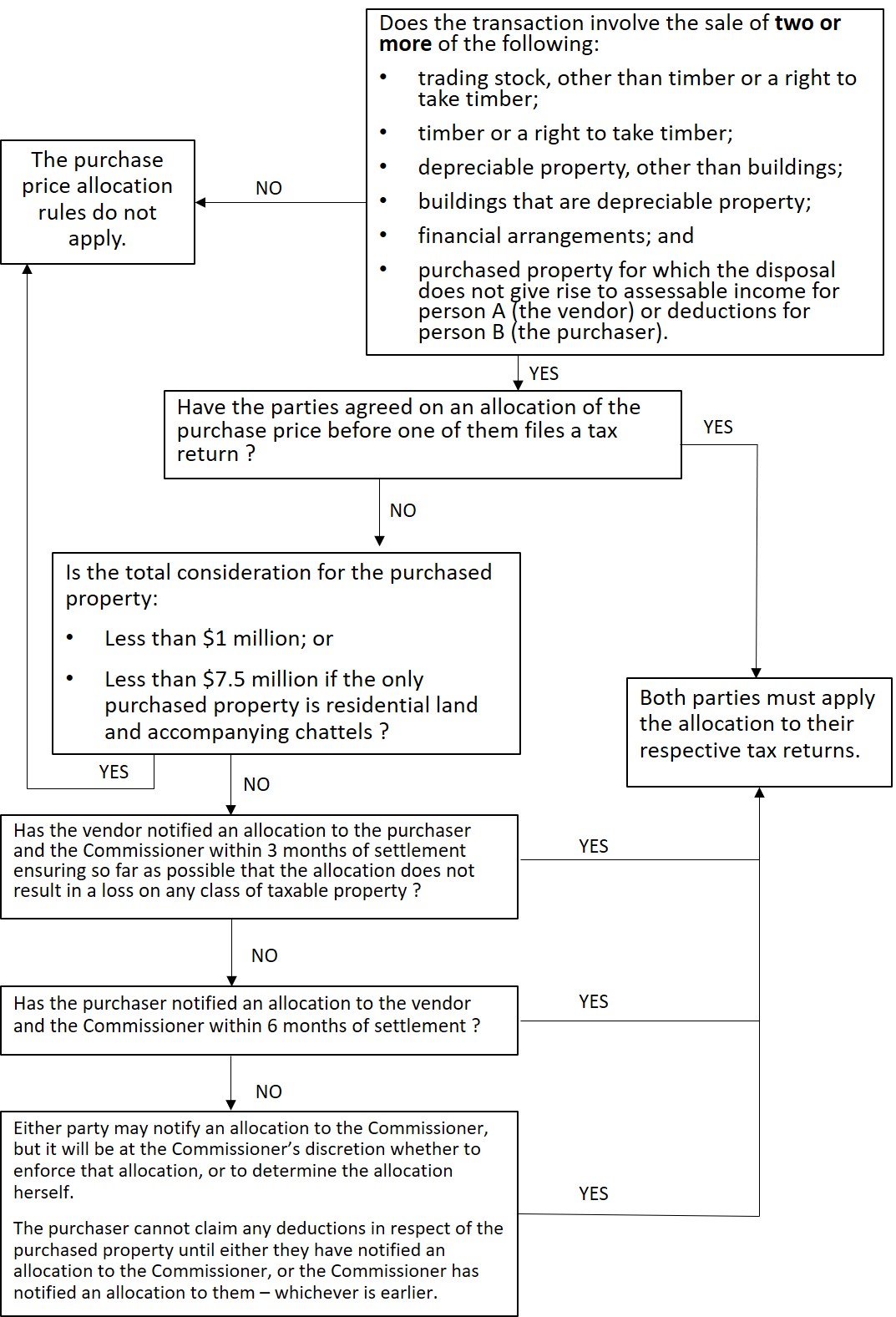
* Where the parties have not agreed an allocation, and neither party notifies a unilateral allocation (filing of a return containing an allocation is not notification of an allocation):
  + - * the Commissioner may determine the allocation,
      * the purchaser is not entitled to any deductions for the purchased property until the Commissioner notifies an allocation to the purchaser.

**General market value requirement and exceptions**

* Allocations must be based on the relative market values of the assets, except when the tax book value minimum on a unilateral vendor allocation applies to make the value allocated to a class of assets higher than market value, or the low-value depreciable property exception applies (see third bullet point below).
* The Commissioner can dispute an allocation that she considers is not based on relative market values.
* However, the Commissioner cannot challenge an allocation to an item of depreciable property if its original cost is less than $10,000, the total amount allocated to the item and any identical items is less than $1 million, and the amount allocated to the item is no less than its tax book value and no greater than its original cost.

Figure 1 illustrates the application of the purchase price allocation rules.

**Figure 1: Application of the purchase price allocation rules**



Application date

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

Detailed analysis

Effect of purchase price allocation agreement

Generally, parties to a sale and purchase agreement who agree an allocation of the transaction price to specific assets will follow that agreement when filing their tax returns. However, sometimes, purchasers have agreed an allocation in a sale and purchase contract and then argued that they are entitled to use a different figure in their tax return, on the basis that the agreed figure is less than market value. New section GC 20 requires parties who have agreed a purchase price allocation in writing to file their income tax returns on the basis of that allocation, even if they do not think it reflects market values. This is achieved by section GC 20(2)(a).

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Example 27**  Dizrythmia Consultants Limited (DCL) enters into negotiations to sell its commercial office building to Double Happy Properties Limited (Double Happy). The sale consists of land (class (vi)), building (class (iv)), and building fit-out (class (iii)). DCL asks a price of $10 million, but states that this price is contingent on Double Happy agreeing to the following purchase price allocation:   |  |  | | --- | --- | | **Item** | **Amount** | | Land | $4m (valuation) | | Building | $4.5m (tax book value) | | Fitout | $1.5m (tax book value) | | **Total** | **$10m** |   Double Happy is convinced that the cost base for the building fit-out is too low – and has a valuation to support that view – but nevertheless agrees to the allocation because it considers $10 million to be an acceptable price for the whole bundle of assets.  DCL and Double Happy must file their respective returns of income on the basis of the agreed allocation. |

If the Commissioner considers that the agreed amount does not reflect the relative market value of the class of property, the Commissioner can treat the class of property as disposed of and acquired for a different amount. This is achieved by section GC 20(2)(b). Relative market values should be determined either at the time the parties enter into their agreement or, if later, when they agree their allocation.

Section GC 20(3) is an exception to the Commissioner’s ability to challenge an agreed allocation. The Commissioner cannot challenge an allocation to an item of depreciable property if:

a) the original cost of the item for the vendor is less than $10,000, and

b) the total amount allocated to the item and to any identical items is less than $1 million, and

c) the amount allocated to the item is no less than its tax book value and no greater than its original cost.

This exception is primarily included to give certainty to vendors taking a low compliance cost approach to allocating to low-value depreciable assets.

Condition (a) of the exception sets the de minimis ceiling of a single item at $10,000.

Condition (b) is a caveat to condition (a). If there is a large number of identical low-value assets with an aggregate allocated value under the transaction of $1 million or more, the exception does not apply.

|  |
| --- |
| **Example 28**  Matinee Idyll Property Limited (Matinee) is selling a commercial building with 600 identical office desks. Matinee has agreed with the purchaser an allocation to depreciable property which is based on an aggregate allocation to the desks of $2 million – their tax book value. The desks were entered as one item on the vendor’s depreciation register. While the value of each individual desk is low, the aggregate value of the set is high, and any aggregate discrepancy between tax book value and market value could be material. Therefore, the Commissioner will retain the right to challenge an allocation in respect of these assets. |

Condition (c) sets the range of unchallengeable values. The allocation must be no lower than tax book value and no higher than original cost. The rationale for this range is that the immediate effect of an allocation within it will be either revenue neutral or positive, and symmetrical. However, an allocation below tax book value would give the vendor a loss, and an allocation above original cost would give the vendor an untaxed capital gain but a higher cost base for the purchaser’s deductions.

Purchase price allocation required: no agreement

New section GC 21 provides a hierarchy of unilateral allocation rules that apply where the vendor and purchaser do not agree an allocation to the classes of property before the first tax return for the year of the transaction is filed. The purpose of these rules is to give parties a mechanism to file on the basis of a single allocation in cases where they are unable to agree one.

De minimis

Section GC 21(2) sets out two thresholds below which the unilateral allocation rules do not apply. A unilateral allocation does not need to be notified where the total consideration for the purchased property is less than:

a) $1 million, or

b) $7.5 million, if the only property in the disposal is residential land (which includes residential buildings) together with its chattels.

‘Consideration’ encompasses both the purchase price and the value of any vendor liabilities assumed by the purchaser (such as warranty obligations).

|  |
| --- |
| **Example 29**  Amy is selling her small software business – ‘Twelfth Dimension Software’ – to Titus. The business assets include software (class (iii)) and goodwill (class (vi)). Titus offers Amy $950,000 for the business, which Amy accepts. They do not agree a purchase price allocation between the software and goodwill, but because the total price is less than $1 million, and section EB 24 does not apply to the software or goodwill, they are not subject to any consistency rules. Therefore, they are able to adopt their own allocations in their tax returns, based on their own respective assessments of market value.  Suppose the facts are varied so that Titus also agrees to take over certain obligations to customers, which the parties value at $60,000 (in addition to the $950,000 cash payment). The consideration is now above the de minimis, and section GC 21 applies. The amount allocated to the business assets will of course be increased by the $60,000. |

‘Residential land’ is defined in the Act and includes residential buildings. Chattels are any items sold with the residential building that do not form part of the building.

The vast majority of residential property sales will be below the $7.5 million threshold. Residential sales data for 2018–2021 shows there were only 115 sales at or above $7.5 million over the period – 0.03% of total sales. Of these, some are likely to have been sales of a house by one owner-occupier to another, which are not affected by the purchase price allocation rules, since all the property is outside the tax base for both parties. The residential transactions that are likely to be caught are sales of high-end rentals, or multi-dwelling buildings such as apartment blocks.

A higher threshold for residential property transactions is justified on the basis that residential buildings are non-depreciable, so the scope for tax manipulation in these transactions is low.

|  |
| --- |
| **Example 30**  Hermit McDermitt owns a number of high-end rental properties. One such property is located in a prime area in Nelson and Hermit has decided to sell the property. Sandy Allen has been looking for a property she can rent out to wealthy tourists once the borders have opened for travel and puts in an offer for the property of $7.2 million which is $1.5 million over the RV of the property and Hermit accepts this.  They do not allocate the purchase price between, land (class (vi)), house (class iv)) and chattels (class (iii)). Because the consideration is less than $7.5 million and the only property being sold is the land, house and chattels, the purchase price allocation rules do not apply. Section EE 45(10) requires Hermit McDermitt to allocate market value to the chattels.  If Hermit has been occupying the property as his main home, the sale will be non-taxable for him, and he will not need to make an allocation. |

Vendor allocation

Section GC 21(3) provides that, if the vendor uses different income tax treatments for two or more of the classes of property (and is thus required to make an allocation), the vendor may notify the Commissioner and the purchaser of an allocation within three months of the change in ownership of the property. The amount allocated to each class of property must be the greater of the relative market value and the tax book value of the class. ‘Tax book value’ is defined in subsection (13) as: ‘the total amount that person A uses or would use, for purchased property in the class of property, in calculating person A’s tax position for their income year in which the change in ownership of the purchased property occurs.’

The tax book value minimum protects the purchaser from an unreasonably low allocation to taxable/deductible property by the vendor, which the Commissioner may not wish to challenge.

The vendor will not be able to comply with the tax book value floor where the aggregate tax book value of all the classes of taxable property plus the relative market value of the class of non-taxable property exceeds the total purchase price. This could be the case in a distressed sale where the vendor is making a genuine loss. Section GC 21(4) provides a mechanism to deal with the excess of the amount required to be allocated by the previous subsection above the total purchase price. The excess is applied:

a) first, to reduce any amount allocated to the class of non-taxable property (for example, goodwill, or non-taxable land)

b) second, to reduce, pro rata, any amounts allocated to the other classes of property.

Therefore, where the amount allocated to the class of non-taxable property is higher than the excess, the excess can be eliminated entirely by reducing the allocation to that class. Where the amount allocated to that class is already zero – whether by virtue of having been reduced by the first step, or of there being no non-taxable property in the transaction in the first place – the tax book values of the classes of taxable property must be reduced proportionately until they collectively equal the purchase price.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Example 31**  Frenzy Fabrics Limited (Frenzy) is selling one of its factories to Poor Boy Pastels Limited (Poor Boy). The sale consists of land (class vi)), building (class (iv)), factory fit-out, and machinery (both class (iii)). During negotiation, Frenzy and Poor Boy try to reach agreement on an allocation, but Frenzy is adamant the fitout and machinery are worth $4 million less than tax book value of $7 million but that the land has appreciated significantly. Poor Boy claims the land has not moved much in value, but the machinery is worth closer to its original cost of $10 million. Frenzy has obtained a valuation for the underlying land that is much higher than Poor Boy’s assessment of the land value.  Despite not being able to agree an allocation with Frenzy, Poor Boy is committed to purchasing the factory, and the two companies complete the deal for $50 million.  Having not agreed an allocation with Poor Boy, Frenzy has the first allocation right under the new rules. Based on its valuation, Frenzy wants to make the following allocation:   |  |  | | --- | --- | | **Item** | **Amount** | | Land | $35m (valuation) | | Building | $12m (tax book value) | | Fitout & machinery | $3m (own assessment of market value) | | **Total** | **$50m** |   However, the aggregate tax book value of the fit-out and machinery is $7 million. Because Frenzy is making a unilateral allocation, it is required to allocate at least tax book value. Three weeks after settlement, it therefore notifies the following allocation to Poor Boy and to the Commissioner of Inland Revenue:   |  |  | | --- | --- | | **Item** | **Amount** | | Land | $31m (valuation less additional allocation to fitout and machinery) | | Building | $12m (tax book value) | | Fitout & machinery | $7m (tax book value) | | **Total** | **$50m** |   The allocation binds Poor Boy, and both companies file their returns on the basis of it, as required by the new rules. The Commissioner may only dispute the allocation of $7 million to fitout and machinery if she believes it is less than market value. |

Purchaser allocation

In some cases, the vendor may not make an allocation. For example, if the vendor is a dealer (taxable on all the property), or tax exempt, they are not able to make one.

Section GC 21(5) provides that if the vendor does not notify an allocation within the three months, the purchaser may notify the Commissioner and the vendor of an allocation within six months of the change in ownership of the property. An allocated amount must reflect the relative market value of the relevant class of property proportional to the other classes of property. There are no other constraints on the purchaser’s allocation.

Parties must notify each other following the requirements of sections 14A to 14G of the Tax Administration Act 1994. This means that in the case of a purchaser allocation, so long as they do this it will not matter that the vendor may no longer exist at the time the purchaser notifies their allocation (for example, where the vendor has wound up or liquidated after settlement).

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Example 32**  Time and Tide Financing Limited (TnT) is selling its finance business as a going concern to Charlie. The business’s assets are receivables (financial arrangements class (v)), goodwill (class (vi)), and software (class (iii). TnT claims most of the business’s value is in the goodwill, and that the receivables should be significantly discounted because there has recently been an economic downturn and some of TnT’s clients have been laid off and had to enter into special debt repayment plans.  Charlie believes that the economy will soon recover and that the clients will pay quickly and in full and wants the receivables to be allocated their tax book value. They claim the goodwill is worth substantially less than TnT’s assessment.  The parties do not agree an allocation, but Charlie wants to go ahead with the transaction and buys the finance business for $8 million.  After settlement, the owners of TnT start focusing on their next business venture and neglect to notify a purchase price allocation to Charlie and the Commissioner. Three months pass, and Charlie – having received no allocation – notifies their own allocation, based on their assessment of market values, to the owners of TnT and to the Commissioner:   |  |  | | --- | --- | | **Item** | **Amount** | | Receivables | $5m | | Goodwill | $2m | | Other intangibles | $1m | | **Total** | **$8m** |   The allocation binds both parties and they file their respective tax returns on the basis of it, in accordance with the rules. The Commissioner may challenge this allocation, if satisfied it was not made on the basis of relative market values. |

No timely notification

If no allocation is notified on a timely basis – that is, within six months of settlement – the power to determine the allocation passes to the Commissioner.

If the vendor or purchaser notifies an allocation after the six months, it will be at the Commissioner’s discretion whether to bind both parties to it, or to instead notify her own allocation in accordance with market values, which both parties must then adopt.

Where neither party notifies an allocation at any stage, they will still have to make allocations in filing their tax returns. Such allocations will be subject to adjustment by the Commissioner. The Commissioner may require a party to allocate, to the classes of purchased property:

a) the amounts allocated by the vendor to the classes of purchased property, or

b) the amounts allocated by the purchaser to the classes of purchased property, or

c) amounts that reflect the relative market value of the relevant class of purchased property, proportional to the other classes of purchased property.

The Commissioner will notify the required allocation to both the vendor and the purchaser, either for them to use in filing their respective tax returns, or – if they have already filed returns – in an amended assessment for one or both parties.

Allocated amounts enforced

Subsection GC 21(7) provides that a class of purchased property is treated as disposed of and acquired for the amount allocated under subsections (3) to (6). In effect, a unilateral vendor, purchaser, or Commissioner allocation is binding on the parties, with no right for a party to contest the allocation by filing a notice of proposed adjustment or to take any other proceedings to challenge the allocation. The Commissioner retains the right to dispute an allocation by one of the parties that is not market value, unless it is an allocation made in accordance with section GC 21(3)(b) and is higher than market value, or it is an allocation to low-value depreciable property protected by the exception (see section GC 21(11)).

No deductions for purchaser until allocation

To incentivise the purchaser to notify an allocation when they have the allocation right, sections GC 21(8) to (10) provide that the purchaser is not entitled to any deductions in relation to the purchased property until the first income year for which they file a return of income on a timely basis after the earlier of the following:

* The purchaser’s notification of their allocation to the Commissioner, and
* The Commissioner’s notification of her allocation to the purchaser.

The purchaser should therefore notify their allocation to the Commissioner and the vendor as soon as possible to ensure they can claim deductions in their next tax return, and not have them deferred. Any deductions that are deferred will be able to be claimed in the return that is filed on a timely basis after an allocation is notified to or by the Commissioner. This will result in the claiming of deductions for more than one year in a single return.

|  |
| --- |
| **Example 33**  Missing Person Detective Agency Limited (MPDA) a very successful private investigation firm has decided to sell its business to I Hope I Never Security Limited (IHNS) in the 2023–24 income year. The assets being sold are the building premises (class (iv)), fit out (class (iii)), customer database and goodwill (both class (vi)). MPDA and IHNS agree on a purchase price of $28m but don’t agree on an allocation.  Time moves on and neither MPDA nor IHNS notifies an allocation to the other party or the Commissioner. Both parties file tax returns for the 2023–24 income year recognising the transaction, with different allocations. MPDA allocates tax book value to its fit out, while IHNS allocates a greater amount.  In early 2026, when reviewing the 2023–24 tax return for IHNS, the Commissioner realises that no allocation has been notified by the parties. She determines that IHNS’s allocation is the more reasonable. She therefore issues an amended assessment to MPDA increasing its income in the 2023–24 year by the additional depreciation recovery implied by IHNS’s valuation. She also issues an amended assessment to IHNS denying a deduction for depreciation of the premises and fit out altogether for the 2023–24 year. These assessments trigger an obligation to pay UOMI, and shortfall penalties may also apply. IHNS will be able to claim the denied deductions in its next tax return, along with the deductions for that year. |

Exception for low value depreciable property

The low value depreciable property exception in section GC 20(3) is replicated in section GC 21(11).

Relationship with other provisions of the Act

Several existing provisions in the Act deal with amounts allocated to property sold in a mixed supply.

Section EB 24 provides that when trading stock is disposed of together with other business assets, the sale proceeds must be apportioned between the trading stock and the other assets in a way that reflects their respective market values. Also, the purchaser must use the vendor’s allocation to the trading stock. Section DP 10 contains rules consistent with section EB 24 that relate solely to disposals of timber.

Section EE 45(10) provides that when depreciable property is sold with other items, the amount allocated to the depreciable property is its market value.

Section GC 21(12) provides that any such existing provision of the Act that expressly requires the use of market value for purchased property is overridden by the purchase price allocation rules to the extent to which the amount allocated to that property is determined under the purchase price allocation rules.

This override serves two main purposes. First, it prevents parties from attempting to use two different market values for an item or class of property on the argument that one value is determined under the purchase price allocation rules and another is determined under a different provision of the Act. Second, it allows the tax book value floor on a unilateral vendor allocation to operate correctly; where the relative market value of a class of property is lower than its tax book value, the tax book value is used.

|  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Example 34**  Parrot Fashion Pines Ltd (PFP) is selling one of its forests, which comprises trees (timber, class (ii) and freehold land (class (vi)), along with depreciable equipment (class (iii))with a cost of $73,000 and a book value of $20,000. PFP has incurred expenditure on the land within various categories described in schedule 20 Part G of the Income Tax Act 2007. The original amount of such expenditure was $150,000, and it has been depreciated down to $85,000 at the end of the year before the sale, using the rates provided for in Part G.  PFP and the buyer, Bold as Brass Ltd have agreed a price and an allocation of:   |  |  | | --- | --- | | **Item** | **Amount** | | Depreciable Property | $20,000 | | Land | $1,800,000 | | Trees | $180,000 | | **Total** | **$2,000,000** |   PFP will recognize $180,000 income from the sale of trees, no depreciation recapture, and no other income. Bold as Brass will have a cost of trees of $180,000, depreciable property of $20,000, and an amortisation deduction in the year of sale of the appropriate percentage of the $85,000 of unamortised land related costs under section DP 3 (provided PFP gives Bold as Brass a record of this expenditure). There is no requirement for an allocation of the purchase price to the unamortised land related costs – these costs will generally be reflected in the value of land or other improvements. The allocation to timber is subject to the Commissioner’s right to dispute it if she considers it is not in accordance with relative market value (section GC 20(2)(b)).  ***First variation***  Assume that:   * PFP bought the forest by way of an asset purchase 2 years before the sale to Bold as Brass and paid $300,000 for the trees (log prices have declined significantly since then). PFP has not incurred any other expenditure which has had to be added to the cost of timber, and * PFP and Bold as Brass have not agreed an allocation.   If PFP makes an allocation under section GC 21(3), it must treat itself as selling the trees for $300,000 for tax purposes. This will also be Bold as Brass’s cost for the trees. This will reduce the allocation to land to $1,680,000.  ***Second variation***  Assume that Bold as Brass and PFP are associated parties, and that they have agreed the $180,000 allocation to the timber. In this case, the sale price will be respected for tax purposes (subject to the Commissioner’s ability to challenge it as not in accordance with relative market values). However, PFP will only be entitled to deduct $180,000 as cost of timber (section DP 10(4)) and Bold as Brass will add the “missing” $120,000 to its cost of timber (section DP 10(5)), giving it a cost of $300,000. |

When a mixed supply involves an acquisition of depreciable property by a person (purchaser) from an associate (vendor), sections GC 20 and GC 21 operate in conjunction with section EE 40(7), which limits the amount of depreciation that can be claimed in such a case. The person’s depreciation claim is based on the lesser of the cost to the person and the cost to the associate. While the cost to the person is determined by sections GC 20 or GC 21 if the acquisition from the associate was a mixed supply, if this amount is greater than the cost of the item to the associate, the person’s depreciation claim is based on the lesser amount.

Definitions

Section GC 21(13) provides definitions for three terms used in the purchase price allocation provisions.

The term ‘allocation notification’ is used in sections GC 21(9) and (10), which defer a purchaser’s deductions. ‘Allocation notification’ means the earliest of the following:

i) the time when the purchaser’s notification of their allocation is provided to the Commissioner in the form prescribed by the Commissioner, and

ii) the time when the Commissioner’s notification of her allocation under subsection (6) is provided to the purchaser.

The term ‘pre-allocation deduction’ is also used in sections GC 21(9) and (10). It means the purchaser’s deductions for purchased property that, ignoring sections GC 21(9) and (10), would be allocated to an income year before the income year in which allocation notification occurs. In effect, pre-allocation deductions are the deductions that are deferred.

The term ‘tax book value’ is used in sections GC 20(3)(c)(ii), GC 21(3)(b) and GC 21(11)(c)(ii). ‘Tax book value’ means the total amount that the vendor uses or would use, for purchased property in the class of property, in calculating their tax position for their income year in which the change in ownership of the property occurs.

For trading stock, the tax book value is the value of the stock on hand at the time of the transaction as calculated under the valuation method used by the vendor for the income year in which the transaction takes place.

For depreciable property, the tax book value is the amount the property has been written down to at the end of the year before the transaction, less a pro rata portion of the depreciation for the vendor in the year of the transaction.

For financial arrangements, the tax book value is the consideration that would give an amount of income or expenditure under section EW 31 (base price adjustment formula) equal to the income or expenditure the vendor would have for the purchased property in the year of the transaction, for the part-year period before the transaction, using the relevant spreading method for the property for the part-year period, pro-rata.

Subsection (b) of the trading stock definition in section YA 1 is amended to include sections GC 20 and GC 21. This means that in the purchase price allocation rules, trading stock:

i) includes anything produced or manufactured

ii) includes anything acquired for the purposes of manufacture or disposal

iii) includes livestock

iv) includes timber or a right to take timber

v) includes land whose disposal would produce income under any of sections CB 6A to CB 15 (which relate to income from land)

vi) includes anything for which expenditure is incurred and which would be trading stock if possession of it were taken

vii) does not include a financial arrangement to which the financial arrangement rules or the old financial arrangement rules apply.

This is the broad definition of trading stock used for the purposes of section EB 24 and several other sections.

Notifications by vendor or purchaser

Notification to the Commissioner of an allocation should be made online via MyIR, or via a letter. This notification should include the phrase “Purchase Price Allocation” in the subject line and contain the following information:

* The names, IRD/GST numbers and contact details of the vendor and purchaser
* The date of agreement to the transaction
* The date on which the property was transferred (that is, settlement/change in ownership)
* The total consideration (including the value of any liabilities assumed)
* The amounts allocated to each of the following classes of property sold, allocating zero to any class of property not sold:

i) trading stock, other than timber or a right to take timber

ii) timber or a right to take timber

iii) depreciable property, other than buildings

iv) buildings that are depreciable property

v) financial arrangements, and

vi) purchased property for which the disposal does not give rise to assessable income for person A (the vendor) or deductions for person B (the purchaser)

* A statement that the amounts have been allocated in accordance with section GC 21
* If desired, supporting documents such as the sale and purchase agreement and the notification provided to the other party.

Practical variations

Nominees

In some transactions the acquirer of the purchased property will be a nominee of the purchaser, rather than the purchaser named in the contract. If the vendor agrees an allocation with the purchaser, and the agreement also allows for nomination, the vendor should include a provision in the sale and purchase agreement to ensure that any nominee is bound to that agreed allocation. If the vendor makes a unilateral allocation under section GC 21, that allocation will bind the purchaser or the nominee without the need for any special contractual provision.

Mortgagee sales

The purchase price allocation rules may apply to a mortgagee sale, where the vendor is a bank or other lender (mortgagee) recovering funds by selling the property of an owner (mortgagor) who can no longer meet their repayment obligations. Neither the mortgagee nor the mortgagor is likely to be engaged on the issue of allocation, but if the purchaser wants to agree an allocation with the mortgagee, they should ensure that the mortgagee has been authorised by the mortgagor to agree an allocation.

Auctions and tenders

In competitive bid processes such as auctions and tenders, purchasers may often have to submit bids without the opportunity to agree a purchase price allocation. The outcome of the initial bidding process could be influenced by whether particular bidders have specified a potential purchase price allocation, since the allocation could impact on the vendor’s returns.

Parties may navigate these commercial realities in a number of ways. For example, in a tender, purchasers may express bids as being conditional on a specified allocation. Or the vendor in an auction may specify an allocation, to ensure that all bids are made on an even footing.

Purchase price adjustments

When an agreement provides for contingent payments to be made, the amount of those payments will often not be known before the parties agree an allocation or make a unilateral allocation. However, the parties may agree, or in the case of a unilateral allocation, specify, the “in principle” allocation of those payments to particular categories of assets. For example, earn out payments may be allocated to goodwill. If the allocation is agreed or specified in that way, sections GC 20 and GC 21 should apply to that allocation in the same way as they apply to non-contingent payments. If the non-contingent amounts have not been allocated in that way, their allocation will be dealt with under existing law.

Dealers and tax-exempt parties

In some transactions the vendor or purchaser may treat the entire amount of the consideration in the same way. This will be the case if the party is a dealer or an exempt entity.

A dealer or exempt party is not able to make an allocation. If the other party to the transaction is required to make an allocation because they use two or more different tax treatments for the purchased property, then as a practical matter that other party will be able to determine the allocation. Whether the formal mechanism for this is agreement or a unilateral allocation should not be significant, since the dealer or exempt party will not be applying the allocation in any event.

Where both parties to a transaction are dealers or exempt entities, the purchase price allocation rules do not apply.

Unclaimed money

The Taxation (Annual Rates for 2020–21, Feasibility Expenditure and Remedial Matters) Act 2021 (“ARFERM Act”) was passed on 23 March 2021 and received the Royal assent on 30 March 2021. This Act amends the Unclaimed Money Act 1971 (“UCM Act”). The amendments modernise the unclaimed money regime with the aim of simplifying the process of reporting and transferring unclaimed money to the Commissioner of Inland Revenue. The reforms also recognise that customers are increasingly interacting with their accounts in new ways (for example, online or using institution specific software such as an “app”).

Background

Unclaimed money refers to money which has become detached or somehow disconnected from its owner for a given period. A common example is money which has been left untouched in a bank account by its owner for several years. That is, the owner of the account has not made any withdrawals or deposits, or provided written instructions to the bank. Once the money has been left in an account for a given period, it will become unclaimed under the UCM Act. It is then passed from the holder (for example, bank or service provider) to Inland Revenue, who will hold the money until the owner claims it.

The unclaimed money regime had not been reviewed substantially since its enactment in 1908. Accordingly, the administrative procedures required by the UCM Act were reflective of an era in which the use of paper and postage dominated administration. Inland Revenue’s ongoing transformation programme provided an opportunity to modernise the administration of unclaimed money. The reforms make the administration of unclaimed money more efficient by lowering compliance costs for holders of unclaimed money and make it easier for owners to be reunited with their money.

Key features

The reforms to the UCM Act include the following:

* Reducing the amount of time which must pass before money is deemed unclaimed by replacing the previous deeming periods of 6 and 25 years with a single period of five years for all funds.
* Expanding the forms of account interaction which will prevent money from becoming unclaimed to include new forms of account activity (for example, online banking).
* Allowing holders to, in limited circumstances, transfer money to the Commissioner before it is unclaimed.
* The repeal of the requirement for a holder to keep and maintain a register of unclaimed money.
* A quarterly reporting regime (which will allow holders to transfer unclaimed money to Inland Revenue on a quarterly basis).
* Transitional provisions to assist holders who will require further time to update their systems to align with the reforms.

Application date

The amendments apply from the date of Royal assent, with the exception of section 178 of the ARFERM Act, which took effect on 1 March 2021.

Detailed analysis

The Amendment Act amends the Tax Administration Act 1994, the Unclaimed Money Act 1971, and the KiwiSaver Act 2006. These amendments support the administration of unclaimed money.

The definition of unclaimed money (section 4 of the UCM Act)

This section refers to money that is more than $100. This is intended to refer to money in the traditional sense. The UCM Act is not intended to apply to other stores of value such as units in Portfolio Investment Entities (PIE). Money covered by the Public Finance Act 1989 is excluded by section 5(3) of the UCM Act.

Inland Revenue is aware that some PIE fund managers choose between transferring unclaimed money to the Commissioner under the UCM Act or to the Crown under the new section 149 of the Trusts Act 2019. There is merit in allowing the flexibility to transfer unclaimed money under both Acts. As noted, units in PIEs are not included within the definition of unclaimed money. Therefore, although Inland Revenue will not accept units in PIEs, it will remain possible for fund managers to transfer the redeemed units (in money) to the Commissioner once it has remained in the holder’s possession for the required deeming period (or where the holder wishes to transfer the money earlier).

|  |
| --- |
| **Example 35**  B&E Limited is a PIE fund manager which administers several PIE funds. Natisha is an investor in the Ultra risky fund which has high volatility. Each year Natisha is contacted by an employee of B&E to see if she is happy with her investment mandate. Over the last two years B&E has not received any reply from Natisha and some letters have been returned to B&E as undeliverable.  Three years later B&E decides that Natisha’s investment is effectively unclaimed money. B&Es terms and conditions provide that if they cannot contact a client after four years, they can convert the investment to cash, which they do for Natisha’s investment. At this point the unclaimed money deeming period starts. However, B&E decides that it has made reasonable efforts to contact Natisha and decides to pay the funds to Inland Revenue as unclaimed money before the five-year deeming period has ended. |

Monetary threshold (section 4 of the UCM Act)

Amounts of $100 or less are not unclaimed money for the purposes of the UCM Act. However, the UCM Act retains the alternative use provision in place under the previous UCM Act, which allows fund holders to transfer amounts of $100 or less to the Commissioner as unclaimed money. Holders have a choice between paying these amounts to the Commissioner or putting them to another purpose (such as donating them to charity). Money applied for the benefit of the holder, or another use, will cease to be unclaimed money. However, this does not affect any claim that the owner of the money may have against the holder for repayment. Amounts which are retained by a holder which are not unclaimed money will be income in the hands of the fund holder.[[6]](#footnote-7)

|  |
| --- |
| **Example 36**  Crimson Permanent Assurance Limited (Crimson) is a life insurance company that provides life insurance for pets at very low premiums (with very low pay outs). Over the last few years Crimson has received many claims from clients but have been unable to locate the owners after the claim has been made. There are 24 claimants and all the claims are under $100. Despite trying to contact the claimants through multiple channels, Crimson has received no reply from any of them.  Crimson holds the money for five years and then decides these claimants are never going to claim the funds and so decides to donate them to a charity that finds homes for former greyhound racing dogs. As the money does not meet the definition of unclaimed money (being $100 or less) Crimson can do whatever it wishes with it, although they will need to return the amount as taxable income for the year and a donation credit for the donation. |

Under the former section 4(1), any amounts owed to the same owner were combined to determine whether the value of the unclaimed money was $100 or less. This was designed to avoid amounts which were individually $100 or less but collectively more than $100 being applied to some other purpose rather than transferred to the Commissioner. This approach is preserved under section 4(3) of the amended UCM Act.

Length of time until money is unclaimed (section 4 of the UCM Act)

Previously, the length of time which was required to pass before money was deemed unclaimed was either 6 or 25 years from the date of the owner’s last interaction with the holder, depending on the type of funds.

The reforms consolidate the prior two deeming periods into one uniform deeming period of five years. In other words, the standard deeming period of five years will apply to all amounts of money.

To avoid engaging the deeming period, an owner must request information or provide instructions to the holder about the money or another matter, within five years. If owner does not do so, the money will be deemed unclaimed. The deeming period will commence from the date of the owner’s last interaction with the money.

A common issue for some holders arises from money which is discovered during a routine financial remediation process. These amounts can now be paid to the Commissioner immediately where there is little prospect of reuniting them with their owner (see “Transfer of money to the Commissioner before it becomes unclaimed” below).

Account activity (section 4(3)(a) of the UCM Act)

To recognise modern forms of account interaction which will prevent money from becoming unclaimed, section 4(3)(a)(i) and (ii) now refer to owners “requesting information” or “providing instructions” to the holder. This includes, for example, customer interaction through internet banking (for example, where a customer views their account balance online). This broadens the 1970s definition of forms of account activity from making a deposit, withdrawal or providing instructions in writing.

Institutional approach to account activity (section 4(3)(a) of the UCM Act)

The reforms apply a customer’s account activity on one account to all accounts the customer holds with the same institution. This is reflected in the wording of section 4(3)(a)(i) and (ii) which refer to the owner requesting information or providing instructions to the holder about “another matter”. This is intended to avoid money at the same institution from becoming unclaimed while the owner remains engaged with their funds. Account activity will also include an owner’s interaction with a joint account or another product held with the same institution (for example, an account holders’ cash-PIE investment).

|  |
| --- |
| **Example 37**  Sabena has $1,000 in a savings account with Money Bags Bank (MBB). She is keen to save the money, so she decides to leave the $1,000 untouched and doesn’t withdraw any money for ten years. She also holds an on-call account with MBB which she accesses frequently for her everyday purchases.  The institutional approach to account activity means that Sabena’s interaction with her on-call account will prevent the funds in either account from becoming unclaimed. |

The broad wording of this section gives banks and other holders the ability to determine for themselves whether customers have been interacting with another of their accounts at that institution. Holders are expected to apply their best judgement when determining account interaction, as the nature of account interaction may vary between institutions.

Transfer of money to the Commissioner before it becomes unclaimed (section 4(3)(b) of the UCM Act)

Historically there was no ability for holders to pay unclaimed money to the Commissioner before the expiry of the six or 25-year holding periods specified under the previous regime.

In some circumstances, however, Inland Revenue appreciates that there is little to be gained by requiring holders to retain amounts owed to former clients where they have identified that the owner is unable to be contacted.

To assist holders, section 4(3)(b) allows holders to choose to pay money which has not yet become unclaimed to the Commissioner where they have made reasonable efforts under section 5B and have been unsuccessful in locating the owner. There is no requirement that a holder first contact the Commissioner before transferring such money to Inland Revenue.

Allowing holders this option is intended to increase the chances of an owner being reunited with their money. This may assist holders who owe, for example, amounts identified during a routine remediation process or backdated holiday pay.

|  |
| --- |
| **Example 38**  Really Big Bank (RBB) conducts a financial remediation process and identifies that it has overcharged their client (Mr. Bach) $105 in account fees. However, before RBB realises its error, Mr. Bach closes his accounts with RBB and moves to a remote location in the Northern Territory.  Once its process is complete, RBB seeks to contact Mr. Bach to return the funds and apologise for the error. However, despite its best efforts, Mr. Bach cannot be located. While the refund of fees owed to Mr. Bach will become unclaimed money five years from when the error first arose, RBB takes the view that there is little sense in it retaining the funds any longer.  To increase the chances of reuniting Mr. Bach with his money, RBB chooses to pay the $105 to the Commissioner as unclaimed money before the five-year deeming period has expired. |

Treatment of renewing term deposits (section 4(6)(b) of the UCM Act)

The reforms recognise that it is common for term deposits to be automatically reinvested on similar terms and conditions upon maturity. The amended section 4 refers to these as “renewing-term arrangements.” The definition in section 4(6)(b) is intended to cover a deposit which contains an option for repayment but is treated as reinvested where the option is not exercised.

There may be situations in which a term deposit is the only investment which a customer has with a financial institution. In such a situation, the standard deeming period would conventionally apply five years from the date the customer last provided instructions to the bank.

To ease the administrative burden on institutions and depositors, section 4(3)(a)(ii) provides an exception to the usual deeming period. Where the deposit is the only investment which the customer has with an institution, the five-year deeming period will not commence until the second term (that is, first rollover) of the renewing term arrangement.

Once the deeming period starts and five years has passed with no interaction, the money will be deemed unclaimed money. However, to avoid breaking a deposit mid-term, section 4(3)(a)(ii) prevents a deposit becoming unclaimed money before the end of a term.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Example 39**  Josh is a customer of Conservative Cash Bank (CCB) but he decides to try his chances at investing in a one-off account with Money Bags Bank (MBB). He invests $1,500 in a two-year term deposit with an option for repayment, but which is treated as reinvested where that option is not exercised. This is his only investment with MBB. Provided Josh does not exercise the option for repayment, the timeline looks as follows:   |  |  |  | | --- | --- | --- | | **Investment period** | **Period of investment** | **Total length of time unclaimed** | | Period one | Two years | N/A | | Period two | Two years | Two years | | Period three | Two years | Four years | | Period four | Two years | Six years |   Josh’s first period of two years does not engage the unclaimed money regime. The UCM Act views the first period of investment as a free period. Once the term deposit rolls over for another two years, the unclaimed money deeming period begins. However, Josh does not have any linked accounts with MBB and does not check his balances over this time.  Period two represents years one and two of the deeming period. Without any directions from Josh, the money rolls over into period three, which represents years three and four of the deeming period.  When the money rolls over into period four of the renewing term arrangement, Josh has completely forgotten about the money and does not interact with MBB. The unclaimed money deeming period stops at five years, but the money will not be deemed unclaimed until the end of period four. This removes the need for the bank to transfer a deposit before the end of the fourth term. In this example, the money will become unclaimed once six years have elapsed since the first roll-over. |

Holder (section 5(2) of the UCM Act)

The reforms allow a person, firm, body or institution which holds money:

* which is not unclaimed money under section 4(2) or 4(7) of the UCM Act, and
* if it excluded by section 4(5), it meets the requirements of section 4(7)

to elect to be a holder under the UCM Act.

Obligations of holders

Reasonable efforts (section 5B of the UCM Act)

The reforms require a holder to make “reasonable efforts” to locate an owner of unclaimed money. Section 8(1) of UCM Act requires that holders have met this requirement within one month and 20 days of the end of their reporting period (see below, “Payment and transfer of unclaimed money.”) However, for some holders, the requirement to make “reasonable efforts” to locate the owner of the money may already have been met owing to past attempts to contact the owner having been unsuccessful.

The obligation on a holder to make reasonable efforts is intended to encourage holders to use their resources and the information they hold efficiently. This is a move away from the formalistic process for contacting owners prescribed by the previous legislation. Holders are required to pursue the avenues of contact which they consider will be most productive. This will require holders to exercise reasonable judgement.

However, this is not intended to impose additional compliance costs upon holders and does not require them to pursue avenues of contact which they know will prove unproductive. For example, a holder is not required to attempt to contact an owner using a phone number or email address which is considered or known to be no longer current.

|  |
| --- |
| **Example 40**  Fantastic Filing Bank Ltd (FFB) has many customers who hold renewing term arrangements. Every so often, FFB reaches out to account holders to provide an account update. FFB has tried to update Baz who holds a single account with the bank.  Baz does not interact with the account for three years. During this time, FFB sends two emails to update him on his account but they both “bounce back” as undeliverable. FFB decides to send a letter to his last recorded physical address, but the letter is returned to sender as Baz no longer resides at that address.  As FFB’s attempts to contact Baz using known avenues prior to the conclusion of the deeming period are reasonable, FFB will not have to repeat its efforts to contact Baz once the five-year deeming period has elapsed. |

The obligation to make reasonable efforts simply requires holders to use the information available to them in each situation. To optimise the customer experience, holders may wish to develop their own guidelines to be applied in accordance with the contact options available to the holder in each case.

Inland Revenue would expect most holders would, in providing good customer service, make multiple attempts to contact the customer before the deeming period ends. The holder may, at its discretion, send a final notice to the customer once the funds become unclaimed, but this is not required.

|  |
| --- |
| **Example 41**  Another Institution Ltd (AIL) is not up to speed with the unclaimed money rules. An employee of AIL notices that one account of $625 has just become unclaimed money. AIL’s internal system has three avenues of contact recorded for the account owner: an email address, a cell phone number, and a physical address. Standard practice at AIL is to send a pre-formatted letter to the owner’s physical address because this saves time.  However, in this case, the letter is returned as the customer no longer resides at that address. AIL does not attempt to contact the owner by cell phone or email, although it has no reason to believe they are not current.  The Commissioner would not consider AIL’s actions satisfy the standard of reasonable efforts required by section 5B. Ideally, AIL would attempt to contact the customer using the other avenues of contact which it has available to it. |

Information collection and transfer (section 5B(2) of the UCM Act)

This section requires holders of unclaimed money to provide the Commissioner with any information in their possession or control relating to the owner of the money and the amount. Section 8(1) of the UCM Act requires holders to provide this information to the Commissioner within 1 month and 20 days of the end of their reporting period (see below, “Payment and transfer of unclaimed money”). Information which holders should provide to the Commissioner includes (in summary):

* how the money came to the holder
* the identity and whereabouts of the owner (if known
* why the money belongs to the owner, and
* any identifying data (for example, the owner’s IRD number).

For example, a bank which submits information to Inland Revenue using the relevant schedule could categorise money as arising from a range of sources including bonds, credit cards, investments or bank charges. The bank could also use the space within the schedule to note any particulars associated with the owner (such as the owner’s name, date of birth, contact details and IRD number). A detailed guide to the transfer of unclaimed money may be obtained from Inland Revenue.

However, this is not intended to impose any added information collection requirements on holders of unclaimed money. Rather, holders should provide the Commissioner with any readily available information which they hold relating to the owner or the money. This will assist the Commissioner in verifying the owner.

Inland Revenue will provide holders with an electronic template to facilitate the transfer of relevant information from the holder to Inland Revenue. To send the template, holders will need to register as a holder in myIR and submit their schedule online.

Maintaining a register (section 6 and 7 (register sections) of the UCM Act repealed)

A holder is no longer required to maintain a publicly available register of unclaimed money. Holders are instead encouraged to maintain internal records which align with the information collection requirements of section 5B. Inland Revenue will supply holders with appropriate electronic schedules for submitting information.

Payment and transfer of unclaimed money (section 8 of the UCM Act)

The reforms institute a reporting and transfer regime. This, in summary, allows holders to combine all the money which became unclaimed during a reporting period and transfer it to Inland Revenue within one month and 20 days of the end of the reporting period.

Reporting period

Section 8(5) sets out the reporting periods available to a holder. Holders are expected to report quarterly. A quarter is defined in section 2 as a period of three consecutive calendar months ending on the last day of March, June, September, or December. Holders may apply to the Commissioner to seek a longer reporting period of two consecutive quarters either as a “one-off” or on an ongoing basis.

**Table 3: The UCM Act’s reporting and transfer periods**

| Reporting period | Transfer of money and information by |
| --- | --- |
| 1 January – 31 March | 20 May |
| 1 April – 30 June | 20 August |
| 1 July – 30 September | 20 November |
| 1 October – 31 December | 20 February |

|  |
| --- |
| **Example 42**  Really Big Bank (RBB) has noted that three deposits of money will be deemed unclaimed on the 1st of March. These will be reported as unclaimed for the quarter 1 January – 31 March.  RBB will have one month and 20 days from the end of the quarter to make reasonable efforts to locate the owners. However, as the money became unclaimed at the beginning of March, RBB can start seeking the owners in early March. If the owners cannot be located, it must transfer any relevant information and the deposits to the Commissioner by 20 May. |

Transitional periods

Due to the change in timelines from the old deeming periods to the new five-year deeming period, transitional provisions are necessary. To assist in explaining the money that will be affected by the reforms, it is helpful to distinguish between the “flow” and “stock” of unclaimed money.

Flow

For present purposes, “flow” refers to money which becomes unclaimed (that is, satisfies the five-year deeming period) the day on which the Amendment Act receives Royal assent, and in the days which follow.

Holders of money that becomes unclaimed the day the Amendment Act receives Royal assent will be subject to the new reporting requirements unless they apply for the extended reporting period available to applicants in the new section 8(5)(c) of the Act. However, for most holders, the first reporting period will commence on 1 April 2021 (refer to table 3 above).

Where a holder requires more time to update its computer systems to comply with the reforms, the holder will need to apply to the Commissioner for an extension of the reporting period. Where a holder receives the maximum available extension, the relevant reporting and transfer dates are as follows:

**Table 4: Reporting timetable for money that becomes unclaimed on or after 30 March 2021**

| Amendment Act receives assent | Date money becomes UCM under the new definition | First reporting period end date | Date to transfer UCM and file return by | Maximum extension of first reporting period | Extension to transfer UCM and file return by |
| --- | --- | --- | --- | --- | --- |
| 30 March 2021 | 30 March 2021 | 30 June 2021 | 20 August 2021 | 31 March 2023 | 20 May 2023 |

Holders who are granted the full extension will be reporting on all amounts deemed unclaimed money over the preceding 24-month period.

Normal reporting requirements will then apply to these holders’ second reporting period.

This means that holders will be required to report quarterly unless the holder has applied for an alternative reporting period of two consecutive quarters (that is, six months) which has been approved by the Commissioner under section 8(5)(b).

Stock

The reforms also contain transitional provisions to deal with the large amount of money which will be rendered unclaimed money overnight once the reforms implement the five-year qualifying period.

The issue of “stock” arises because the prior regime had longer deeming periods of either six or 25 years depending on the category of unclaimed money.[[7]](#footnote-8) Once the reforms take effect, the five-year deeming period will apply “instantly” to the pool of money (“stock”) which had not yet qualified as unclaimed money under the previous deeming periods.

Money which falls into the category of “stock” must be transferred to the Commissioner within the period which is two years after the Amendment Act receives Royal assent. This is expressed in section 210(5) of the ARFERM Act 2021. As the reforms received the Royal assent on 30 March 2021, the “stock” of unclaimed money must be transferred to the Commissioner no later than 30 March 2023.This deadline applies irrespective of any extension in reporting period applied for under section 8(5)(c) of the Act.

Unclaimed money yet to be transferred under the previous regime

The previous regime imposed a reporting calendar upon holders. For the 2021 year, this ran from 1 June 2020 to 31 May 2021. If the UCM Act had remained unchanged, the required steps of a holder in 2021would have looked like this:

**Table 5: Due dates under the former regime**

| 01/06/2020– 31/05/2021 | 01/06/2021 | 30/06/2021 | 30/09/2021 | 31/10/2021 |
| --- | --- | --- | --- | --- |
| UCM accrues | Holders enter particulars of unclaimed money arising in the past year into their registers. | Holders write to owners of unclaimed money by post. | Holders send list of unclaimed money to the Commissioner. | Holders transfer any remaining unclaimed money to the Commissioner. |

Money deemed unclaimed between 1 June 2020 and the day prior to enactment would usually not have been transferred to Inland Revenue until 31 October 2021. However, as the reforms come into force mid-way through this reporting calendar, some holders will hold money which has become unclaimed but has not yet been transferred to Inland Revenue.

This category of money does not fit easily within the categories of “stock” and “flow” which we have described above. Therefore, to assist holders in managing the transfer of this unclaimed money, (section 210(7) of the ARFERM Act 2021) allows holders to transfer it over two years, along with the category of “stock” noted above. This means that holders must transfer such money within the period which is two years after the day the reforms receive Royal assent.

Capacity of trustees

The reforms insert a new section 11B which affirms the principle that a person acting in the capacity of a trustee of a trust acts in a capacity which is separate from the person’s other capacities. These other capacities include the person’s personal capacity, their capacity as a body corporate which is a legal person, or as a trustee of another trust.

Therefore, in applying the institutional approach to account interaction, holders should be mindful that a person’s interaction with an account of a trust of which they are a trustee cannot be taken as interaction with an account which they hold in their personal capacity, or in their capacity as trustee of another trust.

However, there will be situations in which a person’s interaction with an institution may establish interaction in more than one capacity. An example might be where a person is able to log into his or her online banking “portal” and view both personal accounts and any accounts of which they are a trustee. Accessing accounts in this way will constitute interaction with all the accounts accessed. The deeming period will therefore not commence in connection with any of the linked accounts.

Amounts no longer claimable under the reforms (sections 11(6) – (8) of the UCM Act)

The reforms make three categories of money received or held by the Commissioner unclaimable. These are amounts which:

* have been unclaimed money for 25 years or more
* have no identifying information, or
* are $100 or less.

Amounts that fall within these categories are removed from the list of unclaimed money by the Commissioner and may not be claimed by their owners. In each case, these amounts cease to be unclaimed money when they meet the requirements for delisting by the Commissioner. The Crown becomes the owner of this money.

Amounts aged 25 years or older

Previously there was no time limit on an owner’s ability to claim money held by the Commissioner. This meant an owner could make a claim for money which had accrued as long ago as the regime’s beginning in 1908. However, the longer the money remains with Inland Revenue, the less likely it is to be returned to its owner. This is typically due to incomplete information or a lack of eligible claimants.

The reforms introduce a time bar of 25 years upon an owner’s ability to claim money from the Commissioner. A time bar allows Inland Revenue to focus public resources on the amounts of unclaimed money which have the best chance of being reunited with their owners, while also allowing sufficient time for owners to claim their money.

Un-associated amounts

Amounts of unclaimed money which have no information associated with them are referred to as “un-associated amounts”. It is impossible for the Commissioner or the fund owners to establish an entitlement to these amounts.

Amounts $100 or less

Although holders are not required to pay amounts of $100 or less to the Commissioner, they may transfer such amounts to Inland Revenue if they choose.

Amendments to other Acts

Defining the UCM Act as an Inland Revenue Act (schedule 1 of the Tax Administration Act 1994)

The reforms amend the Tax Administration Act 1994 (TAA) to bring the Unclaimed Money Act 1971 within the Inland Revenue Acts included in Schedule 1 of the TAA. This will allow Inland Revenue to use the existing tax information which it holds in its system to assist in validating claims. This should increase the likelihood of owners being reunited with their money.

Disclosure permitted (schedule 7, part A, clause 13C of the TAA)

As the UCM Act will become an Inland Revenue Act, administrative matters will be covered by the general confidentiality provisions of the TAA in section 18. The amendment creates a specific exclusion from the confidentiality provisions of the TAA which will allow the publication of unclaimed money data.

This will allow the Commissioner to publish searchable information on Inland Revenue’s website and make it easier for owners to find and claim funds. This information will include the name of the owner and the amount, the name of the holder who sent Inland Revenue the unclaimed money, and broad physical location of where the money was located (for example, Christchurch).

Due to the inclusion as an Inland Revenue Act, the bespoke secrecy provision in section 12 of the UCM Act is no longer necessary and has been repealed.

Extension of binding rulings regime (section 91C(1)(db) of the TAA)

The TAA has been amended to include the UCM Act within the binding rulings regime. This allows Inland Revenue to make binding rulings in respect of matters affected by the UCM Act to offer certainty to taxpayers as to the Commissioner’s application of the UCM Act.

Alignment of the KiwiSaver Act 2006 with the reforms (section 83(1)(a) of the KiwiSaver Act 2006)

Section 83(1)(a) of the KiwiSaver Act 2006 deals with KiwiSaver contributions that the Commissioner is unable to administer in accordance with the UCM Act due to insufficient information. Inland Revenue acts as a holder for the purpose of these funds and is subject to the unclaimed money rules. This amendment aligns section 83 of the KiwiSaver Act 2006 with the new five-year deeming period.

Consolidation of deeming period under KiwiSaver Act 2006 (section 83(3)(ab) of the KiwiSaver Act 2006)

Previously, under the KiwiSaver Act 2006, different dates could apply to determine when employee and employer KiwiSaver contributions were deemed to be in the Commissioner’s possession. This could create administrative issues where it has not been possible to associate the contribution with a specific member. To simplify this process, the date the money is in the Commissioner’s possession will be deemed to be the last day of the month to which the employment income information applies for the purposes of unclaimed KiwiSaver contributions.

Allowing use of unclaimed money to offset a tax liability (section 173V of the TAA)

The reforms insert the new section 173V into the TAA. This section allows a taxpayer with a valid claim to an amount of unclaimed money held by the Commissioner to apply all or some of that amount to a liability the taxpayer owes to Inland Revenue. This option is available to taxpayers on a voluntary basis.

Mycoplasma Bovis tax issue

*(Sections CZ 37, EH 1, EH 5, EH 13, EH 35, EH 36, EH 61, EZ 4B, EZ 80, EZ 81, YA 1 of the Income Tax Act 2007)*

These amendments enable the taxable income arising from the culling of certain qualifying Mycoplasma bovis affected livestock to be spread over six income years.

Background

Some farmers have significant unexpected taxable income through their herds being culled following a primary sector and government decision to eradicate Mycoplasma bovis in New Zealand.

Federated Farmers requested an amendment to ensure there would be no income tax implications from culling and replacing dairy and beef cattle impacted by Mycoplasma bovis. They cited the special treatment given to depreciation recovery income on buildings damaged by the Christchurch and the Hurunui-Kaikōura earthquakes as a precedent.

The issue arises for farmers who have used a cost-based method (that is, national standard cost (NSC) and the self-assessed cost scheme)[[8]](#footnote-9) to value their breeding stock on hand for tax purposes. This is because the difference between the total proceeds received from the cull and the cost of the stock is income. This creates a cash-flow issue for those farmers who purchase replacement livestock after the cull. The replacement stock is valued at its purchase price and cannot, for tax purposes, be immediately written down to the homebred cost to offset the income.

To avoid this outcome, the legislative changes enable the proceeds from the cull to be transferred from the year of the cull and to be spread evenly over the following six income years. This ability to spread is optional.

Key features

The income can only be spread if:

* The business has been subject to Biosecurity Security New Zealand requiring a cull of Mycoplasma bovis affected stock.
* The business is a dairy or a beef breeding operation, with the breeding stock that is culled being valued under NSC or the cost price method. The expectation is that the breeding stock that is culled comprises mainly mixed-aged cows, in combination with any other class of breeding stock.
* The stock is substantially replaced through purchasing equivalent breeding stock by the end of the income year following the cull year.
* The replacement stock continues to be valued using, as relevant, NSC or the cost price method. This is to ensure that farmers cannot enter the herd scheme on more advantageous terms than those not affected by Mycoplasma bovis.

Given that a livestock owner might use a couple of valuation methods in combination,[[9]](#footnote-10) not all of the breeding stock might be valued at cost. However, only the income derived from the culling of the breeding stock valued under NSC or the cost price method can be spread. For this purpose, breeding stock includes immature female stock intended for future breeding in the business.

Owners of the affected livestock, including sharemilkers, are covered, that is, the ability to spread income from the cull is not be limited to just the owners of farmland with livestock.

The qualifying proceeds from the cull would comprise payments from the slaughterhouse, top-up compensation from the government for the difference between the normal market value for the stock and the payments from the slaughterhouse, and in some cases, further compensation to cover the additional cost of purchasing equivalent replacement stock.

The income arising from the culling of stock valued under another valuation method, or stock culled from a fattening stock business valued under NSC, do not qualify for this spreading provision. The Income Equalisation Scheme is available in those circumstances to mitigate the income implications of the cull.

Livestock owners who have previously made deposits into the Income Equalisation Scheme or the now repealed Adverse Events Income Equalisation Scheme to mitigate the impact of the additional income, can retrospectively switch to the income spread. In such cases, the tax effects of the deposit will be reversed.

Application date

The amendments apply for the 2017–18 and later income years.

Detailed analysis

The Act amends the Income Tax Act 2007.

Relevant current legislation

The livestock valuation rules are contained in subpart EC of the Income Tax Act 2007, including the requirements that apply when using multiple valuation options and the restrictions on switching between valuation options. These rules ensure that the cost of stock on hand is valued appropriately and that the cost of purchases is not deducted ahead of their being sold.

Precondition for the spread (section EZ 4B(1))

New section EZ 4B(1) sets out the following preconditions:

* A person needs to have, as part of their business, mixed-age cows on hand at the start of the cull year that they use for breeding and those cows need to be valued under either NSC or the cost price method at the end of the income year before the cull year. The cull year would need to be before the 2028–29 income year. (The focus on mixed-age cows is to ensure that the spread is provided to those who have sizeable additional income as a result of the cull given that female breeding stock make up a high proportion of a standard herd. The 2028–29 income year cut-off is in the expectation that Mycoplasma bovis should be less significant by that stage).
* In the cull year, some or all of the person’s cattle need to be destroyed, because of Mycoplasma bovis, using the powers in either sections 121 or 122 of the Biosecurity Act 1993 that enable Biosecurity New Zealand to examine organisms and give directions. (Normally the whole herd is destroyed but in some isolated cases only a portion needs to be destroyed).
* A significant portion of the culled stock need to be replaced by the end of the income year following the cull year. The expectation is that the culled livestock are replaced with purchased stock. Specifically, the requirement is that the number of mixed-age cows valued under the national standard cost scheme or the cost price method that the person has on hand (or expects to have on hand) at the end of the income year following the cull year is at least seventy five percent of the number of mixed-age cows valued under the national standard cost scheme or the cost price method that the person had on hand at the start of the cull year.

The spread (sections EZ 4B(2), (3) and (5) to (13))

There are two parts to the spread. Section EZ 4B(2) enables the income calculated under section EZ 4B(5) to be spread evenly over the six income years following the cull year. Section EZ 4B(3) spreads the deduction that the livestock owner would otherwise be able to claim under section EC 2 for the equivalent number of stock.[[10]](#footnote-11) Their combined effect is that the net income arising from the culling of the relevant livestock is spread.

For the income spread component, the formula in section EZ 4B(5) is:

*Σ(number × (sale proceeds + compensation) ÷ culled stock)*

This formula works on a livestock class basis, where:

* **Σ** is the summation of the amounts calculated using the formula for each of the following classes of each of the beef cattle and dairy cattle types of livestock:

(a) rising 1 year heifers

(b) rising 2 year heifers

(c) mixed-age cows; and

(d) breeding bulls.

* Number, for a class of livestock, is the number that is the lesser of:

(a) the number calculated using the formula in section EZ4B(12):

*valuation method breeding stock + culled stock − opening stock*

(b) the number of livestock of that class that:

(i) were breeding stock or stock that the person expected to be capable of, and intended be used for, breeding upon reaching maturity, and

(ii) the person valued under NSC or the cost price method in the income year before the cull year.

* **Sale proceeds**, for a class of livestock, is the amount of income the person derives from the disposal of the livestock of that class that are part of the destroyed cattle.
* **Compensation**, for a class of livestock, is the amount of compensation which the person is entitled to under section 162A of the Biosecurity Act 1993 and that the person receives by the end of the income year following the cull year for:

(a) the difference between the stock’s market value and the sale proceeds; and

(b) the cost of the replacement cattle of the same class being greater than the total amount received in relation to the stock it replaces.

* **Culled stock**, for a class of livestock, is the number of livestock of that class that are part of the destroyed cattle.
* **Valuation method breeding stock** is the number of livestock of that class that:

(i) were breeding stock or stock that the person expected to be capable of, and intended be used for, breeding upon reaching maturity; and

(ii) the person valued under NSC or the cost price method in the income year before the cull year.

* **Opening stock** is the number of livestock of that class that the person had on hand at the start of the cull year.

The formula takes into account the possibility that a livestock owner might be using more than one valuation method to value the stock and might reduce the number on NSC or the cost price method between the start of the cull year and the cull date. When all the stock are on NSC or the cost price method, stock numbers are constant and all stock is culled, then the formula simplifies to just the sales proceeds plus compensation.

If there is an increase in livestock numbers for a class over the cull year, those additional stock are excluded from the spread through section EZ 4B(8)(b) which caps “number” at the number of livestock of that class on hand at the beginning of the cull year and valued in the previous year under either NSC or the cost price method.

Person ceasing business (section EZ 4B(4))

Should a person cease carrying on the business in which they use the relevant livestock, section EZ 4B(4) requires any unallocated amount of spread income and deduction to be allocated to the cessation year.

In the case of a sole trader, the person would effectively cease business once probate has been granted, but with a company, the death of a shareholder would not automatically trigger an allocation of the remaining spread. In the case of a look through company or a partnership, the owner or partner who has died would effectively cease their proportion of the business which would trigger an allocation of their proportion of the remaining spread.

Notification (sections EZ 4B(14) to (16))

Those taking up the spreading option need to notify Inland Revenue in writing. This can be done electronically.

Section EZ 4B(14) requires an election to be made by the date of filing the taxpayer’s return of income for the 2020–21 income year, if the cull year is the 2020–21 income year or earlier, and by the date of filing their return for the cull year in any other case.

The additional compliance costs from this notification requirement would be small given the anticipated small number of farmers affected by Mycoplasma bovis. The amount of income and tax involved is significant for each affected taxpayer so knowing who has taken up this option will also be helpful from a compliance perspective.

The election is irrevocable, but under section EZ 4B(16) is treated as not being made if, at the end of the income year following the cull year, the number of mixed-age cows on hand that were valued under one of the cost schemes is less than seventy five percent of the equivalent pre-cull levels. This is to ensure that there has been material replacement of the culled stock.

Enabling switching from the Main Income Equalisation Account or Adverse Events Income Equalisation Account to the income spread

*(Sections CZ 37, EH 1, EH 5, EH 13, EH 35, EH 36, EH 61, EZ 4B, EZ 80, EZ 81)*

As culls began in 2017, some Mycoplasma bovis-affected farmers will by now have made deposits into the Main Income Equalisation Scheme (MIES) or the now repealed Adverse Event Income Equalisation Scheme (AEIES), to mitigate the tax consequences created by the cull. The legislation gives Mycoplasma-bovis affected farmers that made such deposits the option of retrospectively switching to the proposed six-year income spread provided the tax effects of the relevant deposits are reversed and the election is made by the date of filing their return of income for the 2020–21 income year. The spread is likely to be better at mitigating the income effects as in many cases the deposits will have needed to be withdrawn after a year to fund the purchase of replacement stock.

Under normal circumstances, a deposit into the MIES or AEIES results in a deduction for the livestock owner, for the amount of the deposit, and a withdrawal of a MIES or AEIES deposit results in equivalent income. However, deposits in any one year cannot exceed net income. If deposits in a year exceed this maximum, the excess needs to be refunded.

This concept is built upon in the new legislation to achieve the necessary reversals of the tax effects of deposits made in relation to the income that is now to be spread. It also means that the tax effects of deposits in relation to other income are not reversed.

Reversal of deduction for the deposit

Specifically, a retrospective amendment to section EH 35 (meaning of main maximum deposit) ensures that the spread is included in the calculation of the maximum deposit and, therefore, automatically leads to a reversal of the earlier deductions for the deposit, to the extent the maximum deposit is then exceeded. A comparable change has been made to section EH 61 to include the spread in the meaning of adverse event maximum deposit.

Reversal of income from withdrawal of deposit

Any such excess deposit is refundable. This is separate from any earlier excess deposit that arose under the standard provisions (respectively, sections EH 8 and EH 42) that require Inland Revenue to refund amounts that exceed the maximum deposit. Sections EZ 80 and EZ 81 treat this refund as excluded income (and therefore as not taxable) to negate any income that would have arisen when the deposit was withdrawn – see section EZ 80 (6)(b) and EZ 81(6)(b) in conjunction with section CZ 37(2).

Sections EZ 80(8) and EZ 81(8) stipulate that section EZ 80 and EZ 81 respectively override sections EH 8 and EH 42. This override is necessary to distinguish when Inland Revenue needs to repay any additional excess deposits arising from the spread, from any other excess deposit situation. Sections EH 8 and EH 42 envisage the automatic refund of an excess deposit soon after the end of the accounting year. They were therefore considered to be impracticable for an election to spread the income which is made retrospectively and may involve amounts that have already been refunded under other provisions.

To the extent that the excess deposit has not already been withdrawn, sections EZ 80(2) and EZ 81(2) require Inland Revenue to pay it out as soon as practicable after the election to use the spread is made. Practicably, the revised income tax returns outlining the spread amount will be necessary for Inland Revenue to calculate any remaining deposit amounts that need to be repaid.

Refunds are to first come from the deposits made for the accounting year in which the excess arose. In many cases an excess amount will likely have already been refunded through a standard withdrawal request, to pay for replacement livestock. Therefore, if there are insufficient remaining deposit amounts to fully refund the excess deposit, sections EZ 80(5) and EZ 81(5) provide ordering rules (starting with the earliest refunded deposits) to determine which, and how much, of the deposits for that accounting year that have been already refunded under other provisions (sections EH 13 and EH 15 but not EH 8), are instead treated as being refunded under sections EZ 80 and EZ 81. This means that those refunds change from being income to being excluded income.

Treatment of interest

Any interest paid or payable on the deposits, under sections EH 6 (interest on deposits in main income equalisation account) and EH 40 (interest on deposits in adverse event equalisation account), will still stand and be income. Interest on any excess deposits is calculated to the date the election is made (see sections EZ 80(7) and EZ 81(7) which respectively modify sections EH 6 and EH 40 to achieve this).

|  |
| --- |
| **Example 43**  A livestock owner deposits $200,000 into their MIES account in their 2018–19 accounting year. As the maximum deposit that they could make at that stage was $120,000, $80,000 was refunded under section EH 8 (and is excluded income).  With the passage of the new legislation, the person decides to take up the income spread option for the 2018–19 accounting year. This reduces their maximum deposit amount to $0, in which case Inland Revenue now needs to refund a further $120,000 (which is also treated as excluded income, and no deduction can be claimed for that deposit amount). $100,000 of deposits for 2018–19 have already been withdrawn (ignoring the $80,000 refunded under section EH 8). Those withdrawals are now treated as refunds under new section EZ 80. The remaining $20,000 not already withdrawn is also refunded under section EZ 80.  Interest on the $20,000 is still payable as those funds have been in the scheme for more than one year. The $100,000 withdrawn earlier did not meet this standard timing test to qualify for any interest. |

|  |
| --- |
| **Example 44**  A livestock owner deposits $150,000 into their MIES account in their 2018–19 accounting year, the maximum deposit that they could make. This comprises $100,000 for the additional net income arising from the cull of their herd in that year, plus $50,000 in relation to other income.  With the passage of the new legislation, the person decides to take up the income spread option for the 2018–19 accounting year. This reduces their maximum deposit amount to $50,000. As none of the $150,000 deposited for that year has been withdrawn, under section EZ 80 Inland Revenue now needs to refund $100,000 (which is treated as excluded income, and no deduction can be claimed that deposit amount).  Under section EH 6, interest is payable on the full $150,000. Interest is payable on the $100,000 up to the date of the election. Interest is payable on the remaining $50,000 up until the deposit is refunded, either because it has been withdrawn or the maximum deposit period has expired (whichever is earlier). The maximum deposit period ends five years after the end of the accounting year for which the deposit was made. |

Consequential changes

Consequential changes have been made to sections EH 1, EH 5, EH 13, EH 36, YA 1 and the former EZ 80 (now EZ 82) to update them for the new provisions.

Already filed income tax returns

Since the spread applies from the 2017–18 income year, taxpayers who take up the spread for a past year, can now request that the Commissioner of Inland Revenue amend their relevant past assessments, under section 113 of the Tax Administration Act 1994.

Previously, up to the enactment of the legislation, Inland Revenue had been allowing instalment arrangements to be entered into in relation to the tax due for the 2018–19 income year, to match the proposed spread.

**Table 6: Income spread**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| Opening numbers for cull year | | | | | | Cull numbers | | Income spread | | | | | |
|  | Total for class | Valued in cost | Held in herd scheme A − B | Held for breeding | Breeding in NSC D − C | Number culled | Valued in NSC E + F − A | Spread based on smaller of E or G | Cull proceeds per class | Compo per class | Gross cull income I + J | Cull income per head K ÷ F | Income to spread H × L |
|  | **A** | **B** | **C** | **D** | **E** | **F** | **G** | **H** | **I** | **J** | **K** | **L** |  |
| R1 heifers  cows | 0 |  |  |  |  |  |  |  |  |  |  |  |  |
| R2 heifers (AVO in use) | 20 | 5 | 15 | 20 | 5 | 19 | 4 | 4 | $15,200 | $7,600 | $22,800 | $1,200 | $4,800 |
| MA cows | 100 | 100 | 0 | 100 | 100 | 80 | 80 | 80 | $95,000 | $55,000 | $150,000 | $1,875 | $150,000 |
| Breeding bulls | 0 |  |  |  |  |  |  |  |  |  |  |  |  |
| **Total income spread** | | | | | | | | | | | | | **$154,800** |

Presumed that when the alternative valuation option (AVO) is in use, the herd scheme animals are the breeding or replacement animals.

**Table 7: Deduction spread**

|  |  |  |  |
| --- | --- | --- | --- |
|  | Spread based on smaller of  E or G H | Last year NSC per class  M | Spread H × M N |
| R1 heifers | 0 |  |  |
| R2 heifers | 4 | $845 | $3,380 |
| MA cows | 80 | $925 | $74,000 |
| Breeding bulls | 0 |  |  |
| **Total deduction spread** | | **$77,380** | |

Research and development

Amendment to definition of eligible R&D expenditure

*(Section LY 5 of the Income Tax Act 2007)*

This amendment modifies section LY 5 of the Income Tax Act 2007, which contains the rules regarding what expenditure is eligible for the R&D tax credit, to clarify that expenditure must be closely connected with conducting an R&D activity to be eligible for the R&D tax credit.

Background

Section LY 5(1), as previously written, defined R&D expenditure as being eligible to the extent to which it was:

* incurred on an eligible R&D activity in the relevant income year
* described in schedule 21B, part A (which lists the categories of expenditure that are eligible for R&D tax credits), and
* not described in schedule 21B, part B (which lists the categories of expenditure that are ineligible for R&D tax credits).

These tests did not specify how closely the expenditure had to be connected to an R&D activity to be eligible. To ensure that expenditure claimed has sufficient nexus with the eligible R&D being conducted, the amendment clarifies that expenditure is only eligible if it is *directly related to*, *required for*, and *integral* *to* the R&D taking place.

Application date

This amendment applies from the beginning of the R&D tax credit regime, which is the 2019–20 income year. The amendment is a simple clarification that expenditure must be directly connected with R&D to be eligible and is not intended as a change in policy, or to change the way the law currently operates. It should therefore not affect R&D tax credit claims already filed and should provide future claimants with more explicit legislative direction regarding what expenditure may be eligible for the credit.

Key features

The amendment adds new tests to the definition of eligible R&D expenditure for the R&D tax incentive, as prescribed in section LY 5 of the Income Tax Act 2007, to clarify that only expenditure directly connected with an eligible R&D activity is eligible. The amendment does this by adding in the following requirements, so that expenditure is only eligible if it is:

* **directly related** to conducting an R&D activity
* **required for** conducting an R&D activity, and
* **integral to** conducting an R&D activity.

The existing requirement that expenditure must be listed in schedule 21B, part A and not in schedule 21B, part B also applies.

All section references are to the Income Tax Act 2007 unless otherwise stated.

Detailed analysis

The amendment to section LY 5(1)(a) inserts a requirement that expenditure must be *directly related to*, *required for*, and *integral to* an eligible R&D activity to be eligible for the credit. These are in addition to the existing requirements in the section that expenditure must be listed in schedule 21B, part A and not described by schedule 21B, part B.

Directly relates to (new section LY 5(1)(a)(i))

The “directly relates to” requirement clarifies that expenditure must have a direct connection to an R&D activity to be eligible. A person must make a reasonable assessment of whether their expenditure has a sufficiently close connection to R&D to be eligible. If a person’s expenditure relates to an R&D activity, but also relates to another purpose, the person must apportion the expenditure accordingly.

This requirement is intended to ensure that expenditure that is too remote from the R&D activity to which it relates is not eligible for the credit. Requiring expenditure to directly relate to an R&D activity clarifies the policy intent, which is that only expenditure that closely relates to an R&D activity should be eligible.

|  |
| --- |
| **Example 45: Expenditure must directly relate to R&D to be eligible for the credit**  LiamCo operates a mixed-use facility in Auckland, where fifty percent of the facility is devoted to R&D, while the other fifty percent is used for HR for LiamCo’s operations across New Zealand.  LiamCo has an ongoing contract with a cleaning company to clean its Auckland facility. LiamCo’s payments to the cleaning company would be eligible expenditure where they relate to cleaning the R&D area of the facility (while used for eligible R&D), because they directly relate to performing eligible R&D. However, the costs of cleaning the HR work area would not be eligible, even though HR spends some time supporting R&D staff, because these costs have no direct connection with performing R&D. |

Required for and integral to (new section LY 5(1)(a)(ii) and (iii))

The “required for” requirement clarifies that expenditure is only eligible to the degree it is necessary to support an R&D activity. The “integral to” requirement clarifies that expenditure must be essential to an R&D activity to be eligible. That is, the activity could not be performed or completed without the expenditure.

Similarities with supporting activity limb

These two requirements are taken from the definition of supporting R&D activity in section LY 2(3)(a). A supporting R&D activity is an activity that contributes to and is necessary for a core R&D activity (a core R&D activity is one that resolves scientific or technological uncertainty, via a systematic method, in order to produce new knowledge or things). The policy intent is that supporting activities must be very closely connected to a core activity in order to be eligible, and the tests required by the supporting R&D activity definition are designed to necessitate this close connection.

The policy intent for R&D expenditure is likewise that it must be closely connected with an eligible R&D activity to be eligible for the credit. Replicating part of the supporting R&D activity tests for the definition of eligible R&D expenditure clarifies that there must be a close connection between expenditure and an R&D activity for the expenditure to be eligible. This ensures the legislation matches the policy intent.

|  |
| --- |
| **Example 46: Expenditure must be required for and integral to the R&D**  To the extent that their duties relate to eligible R&D, expenditure on the salaries of staff at LiamCo’s Auckland facility is eligible for the credit, as it is required for and integral to the R&D taking place. This includes the salaries of LiamCo’s R&D staff, but also the salaries of the HR staff inasmuch as their duties relate to the R&D staff, as this expenditure is considered required for and integral to R&D (it relates to the performance of R&D and the R&D could not be performed without it).  However, the HR staff at the Auckland facility also perform HR duties for LiamCo’s operations nationwide. The salaries of the HR staff cannot be claimed to the extent that their duties do not relate to R&D staff, as this expenditure is not required for R&D.  In addition to their salaries, staff at the facility receive a number of employee benefits, such as discounted gym subscriptions and on-site childcare facilities. These benefits are optional and are not factored into an employee’s remuneration package. While some R&D staff may use these facilities, they are not integral to the R&D taking place; R&D could still be performed even if these benefits were not provided. Expenditure on these benefits is therefore not eligible. |

"Only or main purpose” test not included

Not all of the supporting activity tests are included in the amended eligible expenditure definition in section LY 5. In particular, the “only or main purpose” requirement has not been included, as this test would go beyond the policy intent by requiring that expenditure be incurred only or mainly for the purpose of supporting an R&D activity to be eligible.

For example, a business does R&D in a lab, which forms part of a larger complex that also includes non-R&D facilities. The R&D portion of the total complex is twenty five percent. The policy intent is that twenty five percent of the rent be eligible for the credit; however, an “only or main purpose” test may completely exclude the rent. Therefore, the “only or main purpose” has not been included in the amendment.

Businesses not obligated to minimise expenditure

As with the supporting R&D activity tests, the new “required for” and “integral to” expenditure tests do not obligate a business to adopt the cheapest possible approach to its R&D. For instance, one business may want the highest possible quality for materials and equipment used in R&D, while another may be satisfied with a lower standard. In both cases the expenditure required for and integral to the R&D activity is eligible.

Similarly, businesses may go about their research in different ways. Expenditure that is required for an approach that a business has chosen is not disqualified simply because another business might have chosen a cheaper option.

|  |
| --- |
| **Example 47: Business not obligated to minimise expenditure**  Loud Co is performing eligible R&D to develop new drilling equipment for use in constructing tunnels. Their equipment emits noise at a volume damaging to human hearing, so, to protect its employees’ (and future customers’) health and safety, Loud Co incorporates noise-reducing technologies into the design of its drilling equipment.  At the same time, Equally Loud Co is performing R&D on similar equipment. Rather than altering the design of the equipment, Equally Loud Co addresses the problem more cheaply by buying noise-cancelling earmuffs for all of its employees working on the drill.  Both Loud Co’s expenditure on reducing the noise of the drill and Equally Loud Co’s expenditure on earmuffs are eligible for the credit. It does not matter that Loud Co could have taken a cheaper approach to solve the issue. |

Existing requirements in section LY 5(1)(a) and (b) still apply

Schedule 21B, part A

To be eligible, expenditure must be described in schedule 21B, part A, which provides a list of expenditure that may be eligible for the R&D tax credit (section LY 5(1)(a)). This requirement is not affected by the new amendment and continues to apply as before.

Schedule 21B, part B

If expenditure is described in schedule 21B, part B, it is not eligible for the R&D tax credit (section LY 5(1)(b)). This requirement is also not affected by the new amendment and continues to apply as before.

*“To the extent” test still applies*

The amendment removes the “to the extent” test (which ensures that expenditure is only eligible to the extent to which it is incurred on an R&D activity) from LY 5(1)(a). However, the test still applies to R&D expenditure because it is explicitly referred to in each of the clauses in schedule 21B, part A. Each of the clauses in this schedule stipulates that expenditure in that category is only eligible to the extent to which this expenditure relates to performing an R&D activity.

|  |
| --- |
| **Example 48: Eligible R&D expenditure under the new requirements**  GeneriCo is a company whose main business activity is performing R&D. It files its supplementary return for the 2020–21 income year.  GeneriCo can claim the costs of employees performing eligible R&D, as well as costs for other staff to the extent that their duties are required for and integral to performing R&D. For instance, GeneriCo can claim the cost of HR staff to the extent that they are supporting R&D staff, cleaning staff to the extent that they are cleaning facilities used for R&D, and payroll staff to the extent that they are paying R&D staff.  However, GeneriCo cannot claim expenditure with a less direct connection to R&D. For instance, it cannot claim the cost of payroll staff to the extent that they are paying HR staff who are supporting R&D staff, or cleaning staff to the extent that they are cleaning the offices of payroll staff who are paying R&D staff, and so on. This is because these costs do not directly relate to an R&D activity.  GeneriCo can claim rent, utilities, insurance, and other expenses necessary to operate its R&D-performing facility in Christchurch, to the extent that the expenses relate to the performance of eligible R&D activities. However, GeneriCo cannot claim the costs of its on-site cafeteria or grounds maintenance costs at the facility. These costs are not required for or integral to the performance of R&D – R&D could still take place at the facility even in the absence of these costs.  ***Variation of facts: Under the previous expenditure rules***  The legislation previously required that expenditure be on an activity but gave no direction as to how closely the expenditure must be connected to the activity. Without the clarification provided by this amendment, this could allow GeneriCo to claim costs that are only loosely connected with R&D, contrary to the policy intent (which is that only expenditure that closely relates to and is reasonably necessary for performing R&D should be eligible).  For instance, GeneriCo might interpret the law in a way that allows it to claim the full cost of its staff for the credit; as GeneriCo’s main business is performing R&D, all staff costs could be considered as necessary to support the performance of R&D activities. Likewise, as they are part of the costs of a facility used solely for R&D activities, GeneriCo might interpret the law in a way that allows it to claim the costs of the staff cafeteria or maintaining the grounds at its Christchurch facility. |

Exclusions in relation to miners

*(Schedule 21, parts A and B, and schedule 21B, part B of the Income Tax Act 2007)*

This amendment clarifies the treatment of capital assets used in the petroleum and mineral mining industries for the purposes of the tax credit regime and aligns it with the existing treatment of depreciable assets used in other industries.

Background

The intent is that the upfront cost of capital assets is not generally eligible for the R&D tax credit. This is achieved through a number of expenditure exclusions in schedule 21B part B of the Act (which lists categories of ineligible expenditure) that target various types of expenditure on depreciable property.

Most industries use the depreciation rules when amortising their assets for tax purposes, and their assets are therefore caught by the exclusions, as intended. However, assets used in the petroleum and mineral mining industries have their own tax treatments, set out in subparts DT and DU (respectively) of the Act. As these tax treatments are not technically depreciation, assets used in the mining industry are therefore not considered depreciable and are thus not covered by the existing expenditure exclusions in schedule 21B part B that relate to depreciable property. A taxpayer can thus claim the full upfront cost of these assets for the credit, contrary to the policy intent.

To ensure that the upfront costs of assets used in the mining industry are not inappropriately eligible for the credit, the amendment adds a new clause to schedule 21B part B that specifically excludes the cost of these assets from being eligible.

Key features

The amendment adds a new expenditure exclusion that excludes assets used in the petroleum and mineral mining industries, using language which aligns with the petroleum and mining tax regimes that already exist in the Income Tax Act 2007 (“the Act”). It achieves this by excluding expenditure or loss by a “petroleum miner” or “mineral miner” (as defined in section YA 1 of the Act). The new exclusion includes exceptions for labour costs that contribute to core R&D and for prototypes (parallel to the treatment of tangible depreciable property).

To ensure the exclusion covers the same range of industries as the existing activity exclusion on prospecting for, exploring for, or drilling for, minerals, petroleum, natural gas, or geothermal energy, miners of “minerals” (as defined in section YA 1 of the Act) and geothermal energy are explicitly covered by the exclusion. As its intent is covered by the new exclusion, the amendments also repeal the existing activity exclusion.

Application date

The amendment applies from the beginning of the R&D tax credit scheme, which is the 2019–20 income year (1 April 2019 for most taxpayers).

Detailed analysis

The amendment adds a new clause, clause 3B, to schedule 21B part B of the Act, which lists categories of excluded expenditure for the R&D tax credit. Clause 3B excludes expenditure or loss incurred by a petroleum miner, mineral miner, or a person who would be a mineral miner of geothermal energy and “minerals” (in the broader sense defined in section YA 1 of the Act).

Assets used in petroleum and mineral mining have their own tax regimes in the Act (subparts DT and DU). These regimes centre on the terms “petroleum miner” and “mineral miner,” as defined in the Act. These terms are linked to a number of expenditure-related defined terms, such as “mining development expenditure” and “petroleum development expenditure,” which provide for the alternative tax treatment of assets created and used by miners when undertaking mining activities. Anchoring the clause to the definitions of a petroleum miner or mineral miner thus excludes all expenditure that falls within these expenditure-related terms.

The petroleum and mineral miner definitions, and the expenditure-related terms that depend on them, only affect a taxpayer in their capacity as a miner. Any R&D activities performed by a business involved in mining that meet the other legislative requirements could therefore potentially be claimed for the credit, so long as it is not performed by the business in their capacity as a miner. This is in line with the policy intent, which is to exclude the cost of assets used in the mining industries from the tax credit while still allowing a credit for R&D performed in these industries.

As its intent and function is similar to existing exclusions on tangible depreciable property, clause 3B contains similar exceptions for labour costs that contribute to core R&D and for prototypes only used in R&D (refer to *Amendment to tangible depreciable property exclusion*, for a detailed analysis of how these exceptions work). This brings the treatment of expenditure on assets in the mining industries fully into line with the treatment of expenditure on depreciable tangible property in other industries.

The mining regimes in the Act include terminology that covers the intent of clause 5 of schedule 21 parts A and B (which excludes “prospecting for, exploring for, or drilling for, minerals, petroleum, natural gas, or geothermal energy” as an eligible activity). The amendments accordingly repeal clause 5 of schedule 21 parts A and B.

However, the term “mineral miner” and the terms associated with it in the Act (for example, “mining prospecting expenditure,” “mining exploration expenditure”) refer only to “listed industrial minerals,” rather than minerals in the broader sense. The definition of “listed industrial minerals” in the Act does not cover some minerals intended to be covered by the exclusion, such as coal. Geothermal energy, which is also covered by the present exclusion, would not be covered. To achieve the policy intent, clause 3B also deems miners of “minerals” (as defined in the Act) and geothermal energy to be “miners”.

Amendment to tangible depreciable property exclusion

*(Schedule 21B, part B of the Income Tax Act 2007)*

Schedule 21B, part B, clause 3 renders expenditure or loss that contributes to the cost of tangible depreciable property ineligible for the credit, other than expenditure or loss on developing prototypes. An amendment to clause 3 ensures the exception for expenditure or loss on prototypes is working as intended, while also allowing expenditure or loss in relation to labour on core R&D activities to be eligible (regardless of whether the property is a prototype).

Background

Schedule 21B, part B, clause 3 excludes expenditure or loss that contributes to the cost of tangible depreciable property. An exception exists for expenditure that contributes to the cost of property intended for use solely in performing an R&D activity. This prototype exception is intended to capture expenditure required to produce items created by and solely used in core R&D activities, such as prototypes. Expenditure on tangible depreciable property that meets this test is still eligible for the tax credit.

This amendment changes the exclusion in two ways. The first change amends the prototype exception. The second allows certain labour costs to be eligible, even if they contribute to the cost of tangible depreciable property.

Prototype exception

The policy intent of the prototype exception is to allow expenditure or loss on items of tangible depreciable property created through R&D and used solely in R&D throughout their lifetime to be eligible. However, as previously worded, the exception may have included a greater range of expenditure than was intended.

The amendment brings the legislation in line with the intent by requiring, in addition to the requirement that the property must only be used in performing R&D, that the property must only be intended for use in performing R&D in the future, and that creating the property must involve a core R&D activity.

Labour cost carve-in

The amendment also allows labour-related expenditure or loss on an item of tangible depreciable property to be eligible for the tax credit, regardless of whether it meets the above tests, to the extent to which it relates to performing core R&D activity. This means that a business can claim expenditure on employees or on contracted labour that contributes to the cost of an item of tangible depreciable property for the tax credit, even where the item of property is not intended as a prototype, to the extent that the employees or contractors are performing a core R&D activity. Usually this means an identifiable separate activity incidental to the creation of a larger item of tangible depreciable property.

This is consistent with the existing inclusion for labour costs for R&D undertaken in commercial production environments and recognises that it should be easier to identify whether labour costs directly relate to R&D compared with non-labour costs, such as electricity costs. The amendment allows more genuine R&D costs to be eligible while still ensuring any fiscal risk posed by R&D projects involving significant tangible depreciable assets is minimised.

Key features

This amendment makes two changes to the existing exclusion on expenditure or loss that contributes to the cost of tangible depreciable property (schedule 21B, part B, clause 3 of the Income Tax Act 2007).

First, it clarifies the scope of the exception for expenditure that contributes to the cost of property intended for use as a prototype (“prototype exception”), by adding further requirements that:

* the property must only be intended for use in performing R&D in the future, and
* creating the property must involve a core R&D activity.

This ensures that the provision operates consistently with the policy intent, which is for expenditure on tangible depreciable property to be ineligible unless it is on a prototype (property that is developed through R&D and is only used in R&D).

Second, it allows expenditure/loss on labour in relation to core R&D to be eligible for the credit, despite the exclusion for costs that contribute to tangible depreciable property (“labour cost carve-in”).

Application date

The amendment applies from the beginning of the R&D tax credit scheme, which is the 2019–20 income year (1 April 2019 for most taxpayers).

Detailed analysis

Clarifying the prototype exception

The amendment adds further tests into the clause that ensure the prototype exception is better targeted towards the concept of a prototype. In addition to the requirement that an item of property is only used in R&D, these tests require that the property’s sole intended future use is in performing R&D, and that the creation of the item involves a core R&D activity:

* **Sole intended future use is in performing R&D** means that a person’s intent must be that the item of property will only ever be used in performing R&D activities, and never be used for any other purpose.
* **Creation involves a core R&D activity** means that, for expenditure or loss on an item of property to be eligible, the expenditure or loss must also be incurred on performing a core R&D activity (that is, the creation of the item involves resolving a scientific or technological uncertainty via a systematic method).

For expenditure or loss on an item of tangible depreciable property to be eligible, all three tests must be met.

New exception for labour costs on core R&D activity

The amendment also allows expenditure or loss on an item of tangible depreciable property to be eligible for the tax credit, regardless of whether it meets the above tests, to the extent to which it relates to labour costs on core R&D activity. Labour expenditure can be claimed regardless of whether it relates to employees or to contracted labour.

Expenditure or loss on labour for an item of tangible depreciable property is ineligible to the extent to which the costs do not relate to performing a core R&D activity (unless the item of property meets the tests required by the prototype exception).

|  |
| --- |
| **Example 49: Tangible depreciable property exclusion and labour costs**  Claire’s Construction is experimenting with new construction materials that would allow the construction of lighter yet sturdier bridges. The construction of their first bridge involves some eligible R&D as it requires the resolution of scientific or technological uncertainty. Assuming the R&D is successful, Claire’s Construction intends that the bridge be used for commercial transport once it is complete.  Claire’s Construction contracts a local university to provide scientific expertise to help resolve the uncertainty. The university’s scientists work alongside engineers who are directly employed by Claire’s Construction. The company also hires workers to build the bridge, who are variously employed or contracted.  The cost of the scientists and engineers working to resolve the scientific or technological uncertainty involved in creating the bridge is eligible expenditure for the tax credit (as these costs relate to a core activity). However, Claire’s Construction cannot claim the cost of the workers building the bridge (as building the bridge is a supporting activity), nor any of the costs of materials or equipment. |

Other amendments to the schedule of excluded expenditure

*(Schedule 21B, part B of the Income Tax Act 2007)*

The Act makes a number of other amendments to schedule 21B, part B of the Income Tax Act 2007 clarifying what expenditure is excluded from the R&D tax credit.

Key features

The Act makes several additions or changes to the categories of expenditure ineligible for the R&D tax credit set out in schedule 21B, part B. These are:

* Amending the exclusion on expenditure to acquire depreciable property (clause 2) to clarify that “acquiring” depreciable property, for the purposes of the exclusion, does not include making depreciable property.
* Amending the exclusions on expenditure to acquire depreciable property (clause 2) and on expenditure that contributes to the cost of depreciable tangible property (clause 3) to exclude expenditure or loss on property which would have been depreciable in the absence of an election to treat it as non-depreciable under section EE 8 of the Income Tax Act 2007.
* Changing the word “purchase” in the existing exclusion on expenditure to purchase land (clause 10) to “acquire”.
* Changing the exclusion on professional fees incurred in determining a person’s entitlement to the tax credit (clause 13) to also cover in-house expenditure incurred in determining a person’s entitlement.
* Inserting new clause 13B, which excludes expenditure or loss incurred in performing corporate governance activities.
* Inserting new clause 20B, which excludes expenditure or loss incurred in decommissioning.
* Inserting new clause 20C, which excludes expenditure or loss incurred in remediating land.
* Changing the exclusion on expenditure or loss supported by or related to a government grant (clause 21) to allow amounts not directly supported by other forms of government funding to be claimed for the credit.

Application date

The amendments apply from the beginning of the R&D tax credit scheme, which is the 2019–20 income year (1 April 2019 for most taxpayers).

Detailed analysis

Clarifying that expenditure to make depreciable property can be eligible for the credit (clause 2)

An amendment to clause 2, which excludes expenditure or loss to acquire items of depreciable property, clarifies that this exclusion does not apply to expenditure or loss to make depreciable property. The policy intent is that expenditure on the upfront cost of large capital assets generally be ineligible for the credit. Instead, it is intended that depreciation loss on these assets over time be eligible (to the extent the assets are used in R&D), similar to the tax treatment of these assets.

As R&D can involve the creation of a capital asset, the original intent of clause 2 was to exclude expenditure on acquiring these assets through any means other than making them. It was intended that expenditure on making depreciable property be generally eligible, subject to the other exclusions in schedule 21B part B. However, the Income Tax Act 2007 defines “acquire” to include “make” in relation to depreciable property. Under the previous wording, taxpayers were thus prevented from claiming the tax credit for any costs of making depreciable property, giving the exclusion unintended overreach.

Treatment of items of property where election made under section EE 8 (clauses 2 and 3)

Amendments to clause 2 (which excludes expenditure to acquire depreciable property) and clause 3 (which excludes certain expenditure that contributes to the cost of depreciable tangible property) clarify that these exclusions also apply to expenditure or loss on acquiring an item of property that would have been depreciable in the absence of an election under section EE 8 of the Income Tax Act 2007. The policy intent is that expenditure on the upfront cost of large capital assets generally be ineligible for the credit. Instead, it is intended that depreciation loss on these assets over time be eligible (to the extent the assets are used in R&D), similar to the tax treatment of these assets.

Section EE 8 allows a taxpayer to elect that an item of property be treated as non-depreciable property (where, in the absence of this election, it would otherwise be depreciable property) upon acquisition or, in limited circumstances, a change in use. This could potentially allow taxpayers to bypass the exclusions for the upfront cost of depreciable property and claim the full upfront cost of their property as eligible expenditure, contrary to the policy intent. The amendments ensure the legislation better satisfies the policy intent by aligning the treatment of depreciable property and property that would have been depreciable absent an election under section EE 8.

Changing “purchase” to “acquire” (clause 10)

Clause 10 excludes expenditure to purchase land. It is not appropriate to give an R&D tax credit for land acquired for use in R&D for two reasons. The first is that it is difficult to apportion what cost of the land relates to R&D, given the land could be used for non-R&D purposes later. The second reason is that land generally increases in value and therefore can be sold to recoup the cost.

This amendment broadens the scope of clause 10 so that it excludes expenditure to acquire land, rather than merely to purchase it. This is consistent with the policy intent of the original exclusion, which is intended to exclude expenditure on obtaining land regardless of the method used to obtain it.

Excluding in-house costs on determining tax credit entitlement (clause 13)

Clause 13 excludes professional fees incurred in determining a person’s entitlement, or lack of entitlement, to an R&D tax credit. This exclusion covers fees paid to determine the eligibility of a person, activity, or amount of expenditure, such as amounts paid to an accounting firm to prepare a person’s R&D claim.

The amendment broadens the scope of clause 13 to cover all expenditure or loss incurred in determining a person’s entitlement to the tax credit by replacing the words “professional fees” with “expenditure or loss.” This is intended to exclude in-house expenditure on determining entitlements, as well as the fees currently targeted by the exclusion. These amounts should be ineligible under current legislation because they do not directly relate to R&D (they do not relate to resolving scientific or technological uncertainty), but the amendment to clause 13 provides explicit legislative guidance that these costs are not eligible for the R&D tax credit.

Exclusion of expenditure on corporate governance activities (new clause 13B)

New clause 13B excludes expenditure or loss on performing corporate governance activities. These costs should already be ineligible under current legislation, but the new exclusion provides certainty and clarity to firms that they cannot claim these costs. These amounts are excluded because they do not directly relate to R&D. They are costs that have to be incurred regardless of whether R&D takes place.

Exclusion of decommissioning expenditure (new clause 20B)

New clause 20B excludes expenditure on decommissioning. This exclusion is intended to cover expenditure involved in doing the following to assets (including land):

* dismantling, demolishing, disposing of, removing, or abandoning an asset
* preventing access to an asset
* converting an asset so that it can be used to conduct a different activity (unless it is being converted for use in R&D), and
* otherwise decommissioning an asset.

The exclusion is intended to apply to assets (including land) such as:

* structures
* plant and machinery, and
* any improvements or alterations to land.

Note that the above lists are not exhaustive.

This expenditure, in and of itself, should largely already be excluded from the credit as it is unlikely to relate to resolving scientific or technological uncertainty. The intent of this exclusion is to clarify that expenditure on decommissioning is not eligible for the credit.

Note that the exclusion only relates to expenditure on the act of decommissioning itself. Expenditure on R&D relating to decommissioning is potentially eligible for the credit, providing it meets the other eligibility criteria, is an identifiable separate activity, and is incidental to the decommissioning activity.

Exclusion of expenditure on remediating land (new clause 20C)

New clause 20C excludes expenditure on remediating land. This exclusion is intended to cover the costs of restoring or remedying a site or area of land ("site"), where a person's activities on the site have resulted in changes to the site. This also includes any monitoring or maintenance activities that relate to restoring/remedying a site.

This expenditure, in and of itself, should largely already be excluded from the credit as it is unlikely to relate to resolving scientific or technological uncertainty. The new clause clarifies this by explicitly excluding expenditure on remediating land from the credit.

Note again that the exclusion only relates to expenditure on the act of remediating land itself. Expenditure on R&D relating to remediation could still be eligible for the credit, providing it meets the other eligibility criteria, is an identifiable separate activity, and is incidental to the decommissioning activity.

Amending the exclusion of expenditure related to a government grant (clause 21)

Clause 21 excludes expenditure or loss that is related to a grant made by the Crown or a local authority. This is a broad exclusion introduced to avoid ‘double-dipping’ by preventing businesses from claiming multiple sources of government funding for expenditure relating to the same R&D activity. An amendment in the Act clarifies the scope of the exclusion to allow more expenditure unsupported by any other funding mechanism to be claimed for the credit, while maintaining the anti-double-dipping provision.

The broader policy intent of the tax credit is to incentivise and support businesses to increase their expenditure on R&D. However, as previously written, the exclusion applied very broadly, so that (for example) expenditure that relates to R&D funded by a Project Grant but is not directly funded by the grant, and beyond the specified co-funding, was excluded from the credit. This expenditure was thus supported by neither the Grant nor the credit, contrary to the intent of the credit.

Under a Project Grant, businesses can receive funding for up to 40% of a project’s estimated cost (and are required to contribute 60% as co-funding). However, the terms of the funding agreement specify that the business must spend any additional funding required to complete the project beyond the required 60% co-funding. This means that any additional expenditure by the business on the project is considered to be incurred in connection with expenditure that has already been subsidised through the grant and was therefore considered ineligible for the RDTI under schedule 21B, part B, clause 21 as previously written.

|  |
| --- |
| **Example 50: Current practice**  Company A undertakes R&D project X and applies for a Project Grant. At the time of application, the company estimates that Project X will cost $500k. Company A’s application is approved, and it receives funding from Callaghan Innovation of $200k (which is 40% of 500k). The company is required by its Project Grant funding agreement to complete the agreed R&D project and spend a minimum of $300k on top of the $200k funded by the grant.  After starting the project, Company A discovers that it will need to spend an additional $700k on the project. The $700k of additional expenditure is considered ineligible for the RDTI under schedule 21B, part B, clause 21 because it relates to expenditure supported by a Project Grant. |

The amendment narrows the scope of clause 21 so that it does not cover amounts over and above the estimated cost of the project (as specified in the Project Grant contract), allowing these amounts to be claimed for the credit provided they meet the other criteria. It also removes the words “or otherwise related to” from the exclusion, allowing for other amounts that are not directly supported by a government grant to be claimed.

Criteria and methodologies application due date change

*(Section 68CC of the Tax Administration Act 1994)*

This amendment brings forward the due date for submitting an application for criteria and methodologies (CAM) approval to six months before the end of a person’s income year.

Background

From the 2020–21 income year, businesses must obtain either general approval or criteria and methodologies (CAM) approval. Under general approval, a business must apply for approval of each of its core and supporting R&D activities. Businesses which expect to spend more than $2m on R&D in a given year can opt out of general approval and into CAM approval. Under CAM approval, a business instead applies for approval of the criteria and methodologies it uses to determine the eligibility of its R&D activities and expenditure.

Under the previous legislation, CAM approval applications were due after the end of the income year. The amendment changes the due date for applying for CAM approvals to six months before the end of the first income year to which a CAM relates (CAM approvals can be obtained for up to three income years). So, for a standard balance date (31 March) claimant in the 2021–22 income year, their year-end would be 31 March 2022, and their CAM approval application would be due on 30 September 2021 under the proposed new due date. This amendment does not require that the CAM approval process be completed by the above due date, only submitted.

This earlier due date ensures businesses have the correct R&D processes and methodologies in place when their R&D is actually occurring (during the relevant income year). This reduces the need for businesses to have to retrospectively amend their processes and methodologies to ensure their R&D claims are correct. In addition, an earlier due date means businesses have more time to seek general approval should their CAM approval application be declined (or only cover part of their R&D). This is important, because without general or CAM approval, a person is not eligible for the R&D tax credit regime from the 2020–21 income year.

|  |
| --- |
| **Example 51: Applying for CAM approval under the new rules**  Widgets-R-Us, a large company with a major R&D arm, is considering applying for the R&D tax incentive in the 2021–22 income year. Its balance date is 30 June. As Widgets-R-Us undertakes a wide variety of R&D projects, it elects to apply for CAM approval for the 2021–22, 2022–23, and 2023–24 income years (rather than seeking general approval for each project). The due date for applying for CAM approval is six months before the end of the first income year to which the CAM relates. As Widgets-R-Us’s balance date for the 2021–22 income year is 30 June 2022, its application is due on 31 December 2021.  The company submits its CAM application on 21 December 2021. The application takes six weeks to process and is completed on 1 February 2022. Most of Widgets-R-Us’s R&D projects are included in the CAM approval; however, the core team is not satisfied with the company’s systems for identifying eligible expenditure in two of its projects. These projects are not covered by the CAM approval. The core team advises Widgets-R-Us to apply for general approval for both projects.  The due date for applying for general approval for the 2021–22 income year is unchanged; applications are due on or before the 7th day of the 2nd month after the end of the first income year. For Widgets-R-Us, this is 7 August 2022. The company applies for general approval for both projects before the due date.  ***Variation of facts: Under the previous legislation***  Under the previous legislation, CAM approval applications were due on or before the 7th day of the 2nd month after the end of the first income year to which the CAM relates. As Widgets-R-Us’s balance date for the 2021–22 income year is 30 June 2022, its application would be due on 7 August 2022. The company submits its application on 28 July. As above, the CAM takes six weeks to approve (it is approved on 8 September 2022), and two projects are not covered.  The due date for applying for general approval is still 7 August 2022. Widgets-R-Us cannot apply for general approval for the two projects not covered by its CAM approval in time. The company cannot claim the credit for these projects in the 2021–22 income year. |

The amendment also contains a discretion for the Commissioner to accept and approve applications after the new due date, where the applicant has had a change in their balance date for the first income year to which the CAM relates. This ensures that taxpayers who have a transitional tax year due to a change in their balance date are not rendered unable to apply for CAM approval in a timely manner due to their balance date being brought forward.

The amendment applies prospectively from the 2021–22 income year (from 1 April 2021 for most claimants). This ensures that taxpayers (particularly those with early balance dates) intending to apply for CAM approval for the 2020–21 income year have sufficient time to plan for the new due date.

Application date

The amendment applies from the 2021–22 income year (1 April 2021 for most taxpayers).

Key features

The amendment brings forward the due date for applying for CAM approval applications in section 68CC(3) of the Tax Administration Act 1994, so that applications must be submitted on or before the last day of the 6th month before the end of the first income year to which the CAM applies (30 September for most taxpayers). Applications submitted after that date will not be considered for the relevant income year.

However, the amendment also provides the Commissioner with discretion to accept an application at a later time of her choosing where the applicant has changed the end date of their income year due to a change in their balance date.

More time to consider requests to increase R&D claims

*(Section 108(1E) of the Tax Administration Act 1994)*

This amendment provides the Commissioner with more time to consider section 113 requests to increase claims in a taxpayer’s favour. Previously, the legislation imposed a time bar that prevents the Commissioner from considering requests if more than a year has passed since a taxpayer’s income tax return due date for the relevant year.

Background

A person can only file a request to increase their R&D tax credit claim once for each R&D tax credit claim they make (section 113E of the Tax Administration Act 1994), whether through a section 113 request or a notice of proposed adjustment (NOPA). A time bar prevents the Commissioner from increasing a person’s R&D tax credit claim if the person fails to make the request to increase their claim within a year of their income tax return due date (section 108(1E)).

As previously drafted, the legislation required a section 113 request to increase an R&D tax credit claim to be initiated **and processed** within a year of the relevant taxpayer’s income tax return due date. This is contrary to the policy intent, which is simply that the person must initiate the disputes process within that timeframe. By requiring the request to be processed within that timeframe, the Commissioner may not have enough time to fully consider requests.

An amendment in the Act removes the requirement that the request be fully processed within that timeframe, while still requiring the request be initiated within a year of the relevant taxpayer’s income tax return due date. This makes the time bar which applies to section 113 requests consistent with the rules that apply for NOPAs, which were amended by the Taxation (KiwiSaver, Student Loans and Remedial Matters) Act 2020 in a similar way. The amendment ensures the Commissioner has enough time to consider requests consistent with the policy intent.

Key features

Section 108(1E) of the Tax Administration Act 1994 is amended to allow the Commissioner to adjust a person’s R&D tax credit claim upwards if the person has made a section 113 request within a year of their income tax return due date. Provided a request is initiated within this timeframe, the Commissioner can consider the request.

Application date

The amendment applies from the beginning of the R&D tax credit scheme, which is the 2019–20 income year (1 April 2019 for most taxpayers).

Ability to transfer tax refunds to an amount borrowed under the Small Business Cashflow (Loan) Scheme

*(Section 3 of the Tax Administration Act 1994)*

An amendment is made to the definition of “tax” in the Tax Administration Act 1994 to ensure that tax refunds owed to a recipient of a loan under the Small Business Cashflow (Loan) Scheme (SBCS) can be transferred by Inland Revenue to their outstanding loan balance at their request.

Background

The Small Business Cashflow (Loan) Scheme (SBCS) opened for applications on 12 May 2020 as a response to the economic impacts of COVID-19. Borrowers are able to access a loan of up to $100,000, with the amount depending on the number of full-time-equivalent employees employed by the business or organisation.

Previously, if a borrower was owed a tax refund, they were unable to request that Inland Revenue transfer this amount toward paying down their SBCS balance. This is because a loan under the SBCS was not included in the definition of “tax” for the purpose of Part 10B of the Tax Administration Act 1994, where transfers of excess tax can be made to another tax type or to another amount due. This meant that tax refunds had to be made to the borrower’s bank account, at which point the borrower had to make a manual repayment to repay their loan under the SBCS.

Key features

The Act provides for an amendment to section 3 of the Tax Administration Act 1994 to allow Inland Revenue to transfer a tax refund owed to an SBCS recipient to their outstanding SBCS balance at the recipient’s request.

Application date

The amendments apply from the date the Act received Royal assent.

Detailed analysis

The Act amends the Tax Administration Act 1994.

Section 3 of the Tax Administration Act 1994

The definition of “tax” in section 3 of the Tax Administration Act 1994 is amended for the purpose of Part 10B to include an amount payable in relation to a loan made under the SBCS. The amendment allows Inland Revenue to transfer a tax refund owed to an SBCS loan recipient to their outstanding SBCS balance at the recipient’s request. This simplifies the process for a loan recipient who wants to use a tax refund they are owed to pay down their SBCS loan balance.

The purpose of the amendment is to reduce compliance costs for loan recipients who want to offset a tax refund against their SBCS balance. Instead of a loan recipient receiving a refund before using it to make a manual repayment of their loan, the recipient may choose for a tax refund to be directly transferred to their outstanding SBCS balance. This amendment does not give Inland Revenue authority to make a transfer without the recipient’s permission.

Portfolio investment entities – remedial amendments

Changing the due dates for locked-in PIEs

***Sections 25E, 25J, 25K and 61 of the Tax Administration Act 1994***

The amendment brings forward the date to 15 May by which multi-rate portfolio investment entities (PIEs) that are a superannuation fund or retirement savings scheme are required to file detailed income information for their investors.

Background

Existing rules provide for a year-end square-up of the tax on income from multi-rate PIEs for natural persons. This PIE tax square-up happens alongside the year-end process for income tax. The outcome of the square-up is applied to the person’s end-of-year income tax position, resulting in one overall tax refund or bill, if any. However, currently the due date for filing of PIE information is not standardised which can result in delays in squaring up taxpayers PIE tax.

Key features

The amendment brings forward the filing due date by which multi-rate PIEs that are a superannuation fund or retirement savings scheme are required to file detailed income information for their investors to 15 May, to align with that of other multi-rate PIEs and enable the year-end square-up.

Application date

This amendment applies retrospectively from the 2020−21 income year to align with the application date of the new PIE rules. The first filing due date under the change is 15 May 2021.

Detailed analysis

For individuals who only have reportable income, (income that Inland Revenue receives regular information about, typically from third party payers such as employers), the year-end process for tax on PIE income is an automated process at the same time as the auto-calculation process for income tax.

Section 25K of the Tax Administration Act 1994 has been amended to require multi-rate PIEs that are a superannuation fund or retirement savings scheme (for example, a locked-in fund) to file the detailed income information for their investors by 15 May each year (previously 30 June), to align with other, non-locked-in funds.

This avoids delays to the year-end income tax automatic calculation process for a large number of individuals under the new PIE tax square-up.

Changes to the PIE schedular income year-end adjustment rules

*(Sections BC 7, DB 53, HM 36B, HM 52, HM 56, LA 6, LS 3, LS 4 and YA 1 (residual income tax) of the Income Tax Act 2007)*

Amendments have been made to the way in which the portfolio investment entity (PIE) year-end process works to clarify the rules, and to simplify and future proof the calculations.

Background

The Taxation (KiwiSaver, Student Loans, and Remedial Matters) Act 2020 introduced changes to allow for overpaid tax on PIE income of individuals to be refunded from the 2020/21 tax year. This is achieved through a year-end square-up comparing the amount of tax paid on PIE income during the year (by PIEs on behalf of their investors) with the amount of tax that should have been paid on a person’s PIE income for the tax year. This year-end square-up addresses any over- or underpayment of tax on PIE income during the tax year. Any resulting refund due or tax payable is added to the person’s end of year tax position and would either be refunded, payable, or would reduce the person’s tax payable or reduce the person’s tax refund.

These current amendments clarify the year-end adjustment process and better integrate it into existing income tax legislation and processes.

All references are to the Income Tax Act 2007 unless otherwise stated.

Key features

The key changes are as follows:

* The year-end adjustment calculation formula described in legislation is replaced with an outline of what the Commissioner needs to take into account when calculating the adjustment.
* PIE losses and loss tax credits attributable to a natural person investor are included when calculating the individual’s PIE schedular tax adjustment.
* Only taxpayers who have used the incorrect prescribed investor rate (PIR) or who have changed their PIR during the year will have additional tax to pay or a refund from a PIE schedular tax adjustment.
* Clarification that the year-end PIE schedular tax adjustment:
* applies only to natural person investors who are resident in New Zealand, and
* does not apply to a natural person who derives PIE income as beneficiary income from a trust that is not a PIE.
* Multi-rate PIE income is taxable income for the purposes of the calculation of the PIE schedular tax adjustment only. This limits the removal of PIE income from excluded income.
* The PIE schedular tax adjustment will form part of an investor’s residual income tax for provisional tax purposes.

Application date

The amendments apply retrospectively from 1 April 2020, when the new year-end PIE tax adjustments came into effect.

Detailed analysis

PIE schedular income year-end adjustment calculation

The year-end adjustment calculation formula described in subsections HM 36B(2) and (3) was overly prescriptive. This risked preventing the ability to include some types of attributed tax credits in the calculation for the benefit of the investor both in the 2020–21 year or in the future as more detailed information can be supplied by fund managers.

The prescriptive formula is changed to an outline of what the Commissioner needs to consider when calculating the adjustment. The recommended amendments are designed to future-proof the calculation and enable the Commissioner to incorporate any potential improved data reporting around credits in the future.

A PIE schedular tax adjustment is only required where a natural person investor resident in New Zealand has had tax deducted from their PIE income using an incorrect prescribed investor rate (PIR). This could occur when an incorrect PIR is provided by the investor, where they have changed their PIR during the year, or where a PIE has not applied the correct PIR or applied a zero rate to some or all of the PIE income. This change eliminates the charging of small amounts of tax payable to investors due to the timing of the calculation process.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Example 52**  Tim is an investor in the B&E PIE. Tim started the year on a 17.5% PIR, however, after filing his tax return for the prior year he works out that his PIR for the year should be 28% but he fails to change his PIR with the B&E PIE. At the end of the year the B&E PIE undertakes a tax calculation using the following information:   |  |  | | --- | --- | |  | **Amount** | | PIE income | $20,000 | | Tax on that @17.5% | $3,500 | | Tax to pay | $3,500 |   The B&E PIE redeems some of Tim’s units and pays the PIE tax liability.  At the end of the year Inland Revenue performs the PIE tax adjustment for Tim’s PIE income from the B&E PIE using the following information and Tim’s correct PIR:   |  |  | | --- | --- | |  | **Amount** | | PIE income | $20,000 | | Tax on that @28% | $5,600 | | *Less:* |  | | PIE tax paid | $3,500 | | Tax to pay | $2,100 |   Tim will have additional tax to pay of $2,100 to bring his PIE tax for the year up to the correct PIR. As Tim used an incorrect PIR and tax was deducted using that incorrect PIR during the year this amount will be charged to him. |

The PIE schedular tax adjustment is now included as part of residual income tax, which forms the basis for any provisional tax liability. This amendment reduces complexity for taxpayers and Inland Revenue’s systems in that the tax liability for the year will be the same as their residual income tax liability on which provisional tax is calculated.

|  |
| --- |
| **Example 53**  Noel is an investor in a KiwiSaver fund administered by Spoons Funds Limited (Spoons). When Noel opened his fund in the 2023–24 income year he gave Spoons his PIR at 10.5% thinking that he would get a good timing advantage from having his funds taxed at a lower rate than his correct PIR of 28%.  Noel is self-employed and he is a provisional taxpayer with residual income tax (before PIE schedular tax adjustment) in the 2023–24 income year of $26,000. Inland Revenue adds his PIE adjustment of $6,000 to his income tax liability for the year and his residual income tax for the 2023–24 income year will be $32,000 on which his 2024–25 provisional tax will be based. |

|  |
| --- |
| **Example 54**  Eddie, an employee of The Lost Cat Cattery Limited, is an investor in a PIE fund administered by Pioneer Phunds Limited (Pioneer). Eddie figures that it will be great timing advantage to delay paying as much PIE tax on his investment as possible and gives Pioneer a PIR of 10.5% even though he should be on the 28% PIR. Inland Revenue has notified Eddie that he is on an incorrect PIR but he does not notify the PIE.  At the end of the year Inland Revenue calculates his PIE schedular tax adjustment as $5,300 which he will have to pay but it will also mean that Eddie will be a provisional taxpayer for that year. He will be liable to pay provisional tax in the following year even though the rest of his income is taxed at source.  However, it is likely that cases such as the example of Eddie will be reduced, as Inland Revenue will be notifying investors that they are on an incorrect PIR to enable them to correct this and reduce the exposure to provisional tax liabilities. |

PIE losses and loss tax credits are incorporated when calculating a person’s PIE schedular tax adjustment

PIE schedular tax adjustments calculated under section HM 36B only referred to attributed PIE income. This amendment clarifies that attributed losses and resulting tax credits are included when calculating the PIE schedular tax adjustment.

The amendment will ensure that a natural person investor, who is resident in New Zealand, that is attributed a loss that has or is entitled to have a tax credit calculated on the loss using their prescribed investor rate (PIR), can also receive an adjustment where the rate used is not the investor’s PIR.

Clarification of whom the PIE schedular tax adjustment rules apply to

Specific rules apply to non-resident investors in a multi-rate PIE and to trustees of a trust investing in a multi-rate PIE. The new year-end PIE schedular tax adjustment rules were not intended to make changes to these rules.

The amendments clarify that the new year-end adjustment only applies to natural person investors who are resident in New Zealand, and that the new year-end adjustment rules do not apply to a person who is an investor in a multi-rate PIE and derives income as a beneficiary of a trust that is not a PIE.

Limiting the removal of the excluded income status for multi-rate PIE income

Prior to the new PIE schedular tax adjustment rules being introduced, income from a multi-rate PIE was largely excluded income of a natural person, meaning this income did not flow through to the person’s income tax assessment. To better incorporate the new year-end adjustment process into existing income tax processes, this excluded income status was removed entirely, meaning attributed income from a locked-in PIE (such as KiwiSaver) was included in a taxpayer’s PIE taxable income.

The excluded income status is reinstated for multi-rate PIE income attributed to a natural person who is resident in New Zealand except for the calculation of the PIE schedular tax adjustment. This avoids any unintended flow-on consequences that treating the adjustment as non-excluded income might have for loss offsets and any added complications for Working for Families tax credits, student loans, and child support.

|  |
| --- |
| **Example 55**  Iris works for Ghost Girl Comics Limited as an illustrator. She has a student loan obligation which is deducted from her salary each fortnight. She is also a member of KiwiSaver and has her fund held by One Step Ahead Funds Limited (OSA). When Iris started in KiwiSaver she made a mistake in calculating her PIR and gave OSA a PIR of 10.5% when she should have been on 17.5%.  At the end of the year Inland Revenue calculates a PIE schedular tax adjustment for Iris and because she was on an incorrect PIR she has additional tax to pay of $346.50. Although this amount is included in her income tax liability for the year it will be excluded income for the purposes of calculating her liability to repay her student loan. |

COVID-19 tax relief for donations of trading stock

*(Sections FZ 9, GZ 4, GZ 5, CZ 38 and YA1 of the Income Tax Act 2007; section 225ABA of the Tax Administration Act 1994)*

The new legislation provides tax relief for businesses that have made, or are contemplating making, donations (or supplies for less than market value) of trading stock during COVID-19.

Rules in the Income Tax Act 2007 impose tax on the market value of trading stock disposed of for no consideration or an amount that is less than the market value. The application of the rules can act as a significant disincentive to donate trading stock. As a COVID-19 relief measure, a temporary amendment has been made so that disposals of trading stock between 17 March 2020 and 16 March 2022 (inclusive) are not subject to these rules if the recipients are donee organisations, public authorities, or other persons not associated with the transferor.

The amendment requires trading stock deductions to be offset by an amount of deemed income in certain circumstances.

A new section authorises the making of an Order in Council to extend the period for which the new sections apply or to declare a later period for which the new sections apply.

Background

Trading stock is generally deductible in the income year it is purchased as a business expense. If it is not sold in the year of purchase, closing stock is included as income at the end of the year and then becomes deductible as opening stock the following year.

Deemed income rules in sections GC 1 and FC 2 apply when a person disposes of trading stock for less than market value or when it is transferred on the making of a gift. The rules deem the market value of donated trading stock to be assessable income. This means businesses are effectively taxed on a deemed profit margin for the donated goods, (that is, the difference between the deemed market value and the deduction obtained on purchase or in the opening stock adjustment).

The deemed income rules were introduced to counter tax avoidance, including situations where sole traders use their trading stock for private purposes. However, the application of the rules can act as a significant disincentive to donate trading stock. For example, a hand sanitiser business may be liable for tax if it donates some of its products to a hospital, or a farmer may be liable for tax if they donate livestock for meat to be sent to a foodbank.

In 2010–2011 an 18-month exclusion was introduced to provide relief for trading stock donations made in response to the Canterbury earthquakes. A permanent provision allows relief when trading stock is donated to a person not associated with the donor for the use in a farming, agricultural or fishing business that is affected by a self-assessed adverse event.

Key features

The following changes have been made to the Income Tax Act 2007 and to the Tax Administration Act 1994.

* Inserting new sections GZ 4 and GZ 5. Section GZ 4 provides an exclusion for disposals of trading stock to public authorities and donee organisations from section GC 1. Section GZ 5 provides an exclusion from section GC 1 for disposals of trading stock by a business to persons not associated with that business.
* Inserting new section CZ 38, which applies where a business disposes of trading stock to a person not associated with that business (other than a public authority and donee organisation) and there is no business purpose for making the disposal. In these circumstances, the deduction they have taken for the trading stock is offset by a deemed income amount.
* Amending the definition of trading stock in section YA 1 for the purposes of the new sections to exclude timber or a right to take timber or land whose disposal would produce income under any of sections CB 6A to CB 15.
* Inserting new section FZ 9, which provides an exception from the rule in section FC 2(1) that requires the transfer of property on the making of a gift to be treated as a disposal and acquisition at market value.
* Inserting new section 225ABA into the Tax Administration Act 1994. That section authorises the making of an Order in Council to extend the period for which the new sections in the Income Tax Act 2007 apply or to declare a later period for which the new sections apply.

Application date

The amendments to the Income Tax Act 2007 apply from 17 March 2020.

The amendment to the Tax Administration Act 1994 applies from the date of enactment.

Detailed analysis

Sections GZ4 and GZ 5 of the Income Tax Act 2007

Sections GZ 4 and GZ 5 both provide exceptions from the deemed income rule in section GC 1 for the period that starts on 17 March 2020 and ends on 16 March 2022.

Section GZ 4 provides an exception from section GC 1 where a business disposes of trading stock to a public authority or donee organisation. The exception applies even if the public authority or donee organisation is associated with that business. This exception recognises that public authorities and donee organisations exist for the public benefit, are subject to regulation and are publicly transparent, so it is appropriate to remove disincentives to donate to these organisations, particularly as a response to COVID-19.

Section GZ 5 provides an exception from section GC 1 where a business disposes of trading stock to a person not associated with that business (that is not a public authority or donee organisation). However, this provision includes a new offset rule, which applies when there is no business purpose for disposing of the trading stock. It ensures that if trading stock is disposed of to a person that is not a donee organisation or public authority for no business purpose (for example, by way of gift), a net deduction for the trading stock is not available to the business. The deduction the business would normally take for the trading stock, being either the cost or the value under section EB 3 at the end of the previous income year, is offset by a deemed income amount under section CZ 38. The deemed income amount is reduced to take into account consideration received for the trading stock (if any).

For the purposes of sections GZ 4 and GZ 5, trading stock has the meaning given in section YA 1 paragraph (b). However, it does not include timber or a right to take timber or land whose disposal would produce income under any of sections CB 6A to CB 15. This narrower definition of trading stock has been used because the temporary amendments are a COVID-19 relief measure and are not directed at significant disposals of this nature.

Section GC 1 will continue to apply where trading stock is disposed of to associated persons, which are not donee organisations or public authorities, for no consideration or an amount that is less than the market value of the trading stock at the time of disposal.

Section CZ 38 of the Income Tax Act 2007

When trading stock disposals are excluded from the deemed income rules in sections GC 1 and FC 2, the person disposing of the trading stock will typically qualify for a deduction. The deduction is available under section DA 1 if the stock is purchased in the year it is disposed of and section DB 49 if the disposal is from opening trading stock.

If section GZ 4 applies, the person disposing of the trading stock will not be required to offset the deduction by a deemed income amount.

If section GZ 5 applies, the person disposing of the trading stock may be required to offset the deduction by a deemed income amount under section CZ 38. The formula for the deemed income offset is contained in section GZ 5 and is explained above.

Section FZ 9 of the Income Tax Act 2007

Section FC 2(1) requires the transfer of trading stock, being revenue account property, to be treated as a disposal by the transferor at the market value.

There is some overlap between subpart FC and section GC 1 in the case of gifts. To have effect, any adjustment to section GC 1 must be accompanied by a corresponding adjustment to subpart FC.

Section FZ 9 provides an exception from the rule in section FC 2(1) in respect of trading stock, provided the transferee is not associated with the transferor or, if they are associated with the transferor, the transferee is a donee organisation or a public authority. The exception applies to transfers made in the period that starts on 17 March 2020 and ends on 16 March 2022.

For the purposes of section FZ 9, trading stock means property that is trading stock under section EB 2 as well as livestock not used in a dealing business and consumable aids to be used in the process of producing trading stock.

Section 225ABA of the Tax Administration Act 1994

Section 225ABA authorises the making of an Order in Council to extend the period for which the new sections in the Income Tax Act 2007 apply or to declare a later period for which the new sections apply.

The Minister of Revenue may only recommend extending the period if satisfied that people in New Zealand are likely to continue to be significantly adversely affected by COVID-19.

The Minister may recommend specifying a new application period if satisfied that there is an emergency event that significantly adversely affects people in New Zealand. The event must meet the requirements of paragraphs (a) and (b) of the definition of emergency in section 4 of the Civil Defence Emergency Management Act 2002.

Temporary loss carry-back remedial – loss grouping

*(Section IZ 8 of the Income Tax Act 2007)*

Background

Section IZ 8 of the Income Tax Act 2007 contains the temporary loss carry-back rules. The rules allow a company with net losses in the 2019–20 or 2020–21 income years to carry losses back to offset taxable income in the immediately preceding income year, in order to receive a tax refund.

Key features

The purpose of this remedial amendment is to ensure companies in non-wholly owned corporate groups are able to use the loss carry-back. A non-wholly owned corporate group (“group”) is a group of companies that have at least 66%, but less than 100%, common ownership.

Under previous rules, to be eligible for the loss carry-back, a company in a group was required to:

* have a net loss in the 2019–20 or 2020–21 income years (the “loss year”), and
* have taxable income in the income year immediately preceding the loss year (the “profit year”).

If a company had losses in both the profit and loss years, then the company was not able to use the loss carry-back under the previous rules, even if another group member had taxable income in the profit year against which the losses could be offset. This outcome was contrary to the policy intent expressed in the COVID-19 Response (Taxation and Other Regulatory Urgent Measures) Bill commentary.

The policy intent is for a company to be able to carry back and offset its losses against a group member’s taxable income in the profit year, even if the company has losses in both the profit and loss years. This remedial amendment amends section IZ 8 of the Income Tax Act 2007, so that the legislation now satisfies the policy intent.

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Example 56**  Mippy Co and Snowy Co are 80% commonly owned. In 2018–19, Mippy Co has net income of $100,000 and Snowy Co has $50,000 of losses. Snowy Co decides to offset its $50,000 of losses against Mippy Co’s income that year, so Mippy Co has taxable income of $50,000.  In 2019–20, Mippy Co has net income of $50,000 and Snowy Co has net losses of $75,000. After offsetting Snowy Co’s losses against Mippy Co’s net income,\* Snowy Co still has $25,000 of losses remaining. It decides to use the temporary loss carry-back so that it can offset its remaining $25,000 of losses against Mippy Co’s 2018–19 taxable income.  Snowy Co carries its remaining $25,000 of losses back to 2018–19, and offsets the losses against Mippy Co’s 2018–19 taxable income of $50,000. Mippy Co receives a tax refund of $7,000 ($25,000 × 28%, which is the corporate tax rate). After using the loss carry-back, Mippy Co still has $25,000 of taxable income remaining in 2018–19. Snowy has $0 losses remaining in 2019–20 after using the loss carry-back.   |  |  |  | | --- | --- | --- | | **2018–19 income year** | **Mippy Co** | **Snowy Co** | | Net income/(loss) *(before offsets and loss carry-back)* | $100,000 | ($50,000) | | Taxable income/(loss) *(after offsets but before loss carry-back)* | $50,000 | $0 | |  | | | | **2019–20 income year** | | | | Net income/loss *(before offsets and loss carry-back)* | $50,000 | ($75,000) | | Taxable income/loss *(after offsets but before loss carry-back)* | $0 | ($25,000) | |  | | | | **Temporary loss carry-back** | | | | 2018–19 taxable income/(loss) *(after loss carry-back)* | $25,000 | $0 | | 2019–20 taxable income/(loss) *(after loss carry-back)* | $0 | $0 | | Amount refunded under loss carry-back | $7,000 | $0 |   *\* In this example the two companies have chosen to offset losses within the group in the loss year before using the loss carry-back. This is not a requirement for groups that are not wholly owned.* |

Application date

This remedial amendment applies for the duration of the temporary loss carry-back scheme, so applies to two pairs of income years: the 2018–19/2019–20 and 2019–20/2020–21 profit/loss years.

About this document

Special reports are published shortly after new legislation is enacted to help affected taxpayers and their advisors understand the consequences of the changes. These are published in advance of a final article in the *Tax Information Bulletin*.

1. Available at <https://www.taxtechnical.ird.govt.nz/questions-we-ve-been-asked/2017/qb-1702-income-tax-date-of-acquisition-of-land-and-start-date-for-2-year-bright-line-test> [↑](#footnote-ref-2)
2. The date of acquisition (when the person first acquired an estate or interest in the land) is relevant for determining which bright-line test will apply (the 5-year or the 10-year test). As noted on page 4, in a typical land purchase, the acquisition date is generally when there is a binding agreement between the purchaser and the seller. This includes when the vendor accepts an offer with standard conditions to be satisfied (such as obtaining finance or a building report), not a later date when those conditions are satisfied or settlement occurs. [↑](#footnote-ref-3)
3. The bright-line period typically starts on the day the property is transferred to the owner and ends on the day the property is sold (when the sale and purchase agreement is entered into – not when the sale is settled). [↑](#footnote-ref-4)
4. Interpretation statement IS17/01: Deductibility of feasibility expenditure. Tax Information Bulletin Vol 29, No 3 (April 2017) available at <https://www.taxtechnical.ird.govt.nz/tib/volume-29---2017/download-tib-vol29-no3> [↑](#footnote-ref-5)
5. SC 74/2015 [2016] NZSC 91. [↑](#footnote-ref-6)
6. See Inland Revenue public rulings- BR Pub 17/01 *Income Tax – Treatment of unclaimed amounts of $100 or less* and BR Pub 17/02 *Income Tax – Treatment of unclaimed amounts of $100 or less- amounts held on trust*. [↑](#footnote-ref-7)
7. These two categories were described as fixed term deposits and renewing term deposits. In the case of fixed term deposits, the prior regime required the money to have been unclaimed by its owner for a period of 6 years. Conversely, in the case of a renewing term deposit, the prior regime required the money to have been left for a period of 25 years. [↑](#footnote-ref-8)
8. The NSC scheme values the animals at, if the animal is homebred, a standard cost (determined by the Commissioner of Inland Revenue) for the respective age and type of animal that reflects that animal’s average costs of production, or at its purchase cost if the stock is purchased.

   The self-assessed cost scheme involves farmers using their own farm costs rather than standard costs. It is a Commissioner approved “cost price method” under section EC 25. Its details are set out in *Tax Information Bulletin, Volume 4, No.7, March 1993, Appendix A*. [↑](#footnote-ref-9)
9. For example, an owner might use the herd scheme in conjunction with NSC (the alternative valuation option). [↑](#footnote-ref-10)
10. Section EC 2 provides a deduction at the beginning of the cull year for the value of stock on hand at the end of the preceding income year. [↑](#footnote-ref-11)