"2020 Hindsight"

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As taxpayers and their advisers limp towards the end of a remarkable but difficult year, it is time to look back on the significant developments from the past 12 months. Given time is valuable and space is short, a quick summary of the highpoints is below. This article by Mark Keating, tax barrister of Auckland, explains the new policy proposals, major legislative reforms, and significant cases during a year that many of us will be happy to put behind us.

COVID-19 reforms — the unforeseeable became the norm

The COVID-19 crisis that broke in March 2020 gave rise to an avalanche of tax reforms. Most of those changes were taxpayer-friendly concessions hurriedly rushed through Parliament in order to assist taxpayers cope with the sudden shutdown of the economy and the collapse of certain sectors.

The first changes, enacted by the COVID-19 Response (Taxation and Social Assistance Urgent Measures) Act 2020, included the following:[1]

- *A new power granted to Inland Revenue to remit UOMI on the sudden inability of many taxpayers to pay their tax liabilities by the due date.* The lockdown hit terminal tax payments for the 2019 year, the final provisional tax payment for 2020, and GST periods for all taxpayers, so Inland Revenue was given additional powers to excuse temporary defaults in making tax payments. However, while Inland Revenue basically applied an honesty system for taxpayers who claimed to have been severely adversely impacted by the COVID-19 crisis, as circumstances changed and taxpayers' businesses reopened, it was notable that Inland Revenue's credulity evaporated and a flintier approach became more apparent.
- *After not increasing for 2 decades, the provisional tax threshold of $2,500 was lifted to $5,000 for the 2021 and subsequent income years*, absolving approximately 95,000 very small businesses and individuals from the provisional tax burden (both with the timing of tax payments and reduced compliance), although calls for a general suspension of the provisional tax regime for all taxpayers were rejected.

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- *The low-value asset threshold of $500, which allows for an immediate deduction for purchases of assets, was increased* in 2 parts:[2]

  — a temporary increase to $5,000 for assets purchased during the 2021 income year (intended to stimulate the economy during the recovery phase after the crisis), and
  — a permanent increase thereafter to $1,000 for assets purchased in the 2022 and subsequent income years.

(As a result of the general election in October, the National Party’s proposal to increase the temporary low-value asset threshold to $150,000 for both the 2021 and 2022 income years never arose.)[3]

- *Depreciation on commercial buildings (but not residential buildings) was reinstated from the 2021 income year*.[4] The depreciation rate for a building with an estimated useful life of 50 years or more is 2% diminishing value or 1.5% straight line.

After those initial reforms, the more ambitious COVID-19 Response (Taxation and Other Regulatory Urgent Measures) Act 2020 enacted a number of reforms devised directly to combat the severity of the COVID-19 crisis, and therefore involved a number of sudden and unpredicted reforms. Those changes included a temporary loss carry-back regime and the small business cashflow scheme.

Temporary loss-carry-back regime

A temporary loss carry-back regime to cover the 2020 and 2021 income years for those affected by the COVID-19 shutdown was implemented on 15 April 2020.[5]

A permanent measure for subsequent years is expected to be enacted by 1 April 2021. This new rule permits taxpayers that suffer a net loss during the 2020 or 2021 years to carry that loss back to offset against any taxable profit in the immediately preceding income year, and thereby receive a refund of the surplus tax paid. Unfortunately, it appears the regime was poorly targeted and contained a number of deliberate restrictions that limited its application for most SMEs. The 2 most significant restrictions were:

- *2020 as the “blocker year”*: Under the new loss carry-back rules, a loss may only be offset against the immediately preceding year, meaning a 2021 loss *cannot* be offset against a 2019 profit. Unfortunately, 2020 “blocks” the full benefits of the loss carry-back rule. The timing of the crisis is unfortunate, given that only a few weeks remained in the 2020 income year for its full financial impact to be felt by most taxpayers in the 2020 year, so the resulting losses will generally arise in the 2021 income year.
- *Shareholder salary/beneficiary income*: The new loss carry-back rules apply only if the taxpayer had a profit in the first year and paid tax in that profit year; not if that profit was derived by a company that allocated its profit as shareholder salary to the proprietor/s in that year. The same problem arises with respect to profits derived by a trading trust that had previously distributed its profit by way of beneficiary income. There is no statutory mechanism by which companies and shareholder-employees/trustees and beneficiaries can attempt to reverse previous allocations of shareholder salary or beneficiary distributions.

The refusal by Inland Revenue to accommodate taxpayers in these circumstances effectively negated what was obviously intended to be a concession in response to extraordinarily difficult circumstances.

Small business cashflow scheme — Bank of IR

The hastily enacted[6] small business cashflow scheme permitted Inland Revenue to make interest-free loans to SMEs with fewer than 50 staff that suffered the required 30% drop in revenue due to the COVID-19

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crisis.[7] Applications, which were initially only accepted for one month from 12 May 2020, but which have subsequently been extended,[8] provided:

- up to a maximum of $10,000 per business
- an additional $1,800 per employee, up to a maximum of 50 employees
- up to a total maximum loan of $100,000.

These loans will be interest free if repaid within 2 years (up from the initial one year) and subject to 3% interest if repaid thereafter (which is well below the current UOMI rate on funds owed to the Commissioner). No repayment is required for the first 2 years, but the loan must be repaid in full within 5 years, and the terms contain a number of unwelcome fish-hooks.[9] Nevertheless, Inland Revenue confirmed that more than 78,000 SMEs applied for more than $1.3 billion in loans under the scheme.[10]

COVID concessions

Due to the need to act quickly to resolve unexpected administrative and timing issues, the Commissioner was granted a new discretion to suspend the operation of the tax laws to enhance the effective administration of the tax regime. That power grants the Commissioner:[11]

> “a discretionary power to extend a due date, deadline, time period, or timeframe set out in an Inland Revenue Act or to vary a procedural or administrative requirement of an Inland Revenue Act, to apply in certain circumstances and for a limited time.”

The Commissioner has used this new power to extend filing dates, suspend taxpayer obligations or waive normal administrative requirements. For those worried about the possible abuse of that discretion, the power clearly records that any changes are optional and not binding on taxpayers, who may continue to apply the Act as written by Parliament.[12]

Conclusion on COVID-19

Desperate times called for desperate measures. The Government recognised the need to provide urgent relief for business taxpayers, even if most of those changes had little to do with the COVID-19 crisis itself. While somewhat piecemeal and disparate, and sometimes unfortunately restrictive, all of those reforms were welcomed.

Back to the future — the 39% top tax rate

One of the few clear tax proposals from the 2020 election was the increase by the Labour Government of the top margin tax rate on individuals to 39% on income over $180,000. From 1 April 2021, there will again be a disparity between the highest personal tax rate and the flat tax rate of 33% on trustees and 28% on companies, thereby creating the opportunity for tax arbitrage by ensuring income above that amount is derived by those other entities.

The last time the highest personal tax rate was at 39% was under the previous Labour Government.[13] In response, taxpayers routinely moved assets generating passive income into companies, and especially trusts, so that income did not suffer the higher individual tax rate. While this was generally unobjectionable, some taxpayers also diverted their personal services income through either a trust or a company owned by a trust, so that henceforth that entity derived the income, while they personally received a lower salary to reduce the tax otherwise payable on their personal services income.

That structure was considered by the Supreme Court in the leading case of *Penny and Hooper*.[14] That case involved orthopaedic surgeons who restructured their businesses into companies owned by their family trusts and then became employees on annual salaries of approximately $120,000 (a significant and inexplicable drop from their former self-employed profits of approximately $500,000). Despite a win for the taxpayers in

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the High Court, and a split decision in the Court of Appeal, the Supreme Court unanimously found in favour of Inland Revenue and ruled the arrangement constituted tax avoidance.

Based on long-standing case law the Supreme Court ruled that individuals cannot assign their personal services income or interpose entities to derive that income. But it also recognised a number of exceptions to that rule, including that it does not apply:

- to non-personal services income such as the sale or rent of goods
- where the entity is making losses, so cannot afford to pay market salary
- where the entity needs to accumulate capital/fixed assets for commercial use.

Revenue Alert 11/02 considered the application of *Penny and Hooper* and indicated that interposed entities were permitted to retain only 20% of the net profits, while at least 80% must be paid out to the individual service provider. But will Inland Revenue still apply that arbitrary rule? That question has not been relevant since the top tax rates were re-aligned in 2011, but will become relevant once again. It will therefore require the proper consideration of several untested issues:

1. The situation where an individual is paid a market salary for their personal services less than the required 80% of profits. Must taxpayers always allocate themselves any super-profit above market rates for their services?
2. The application of the 80% threshold to businesses involved in the sale of mixed services and goods. Inland Revenue’s focus was on professionals providing personal services, but will it turn its attention to skilled tradespeople?
3. Pre-existing *Penny and Hooper*-style structures that have operated for the past decade which have not given rise to tax benefits for the parties. Given the re-introduction of the highest personal tax rate, will those structures automatically become tax avoidance, or will the new tax benefits be viewed as merely incidental given they pre-dated that change?

There was media speculation that the risk of tax avoidance would compel the Government to also raise the tax rate for trusts.[15] Certainly Inland Revenue is concerned about the intensive and burdensome task of auditing all high-income individuals to ensure they do not utilise trusts to avoid the new top tax rate. The rate change is forecast to generate $160 million in the first year, increasing to $550 million by 2024, raising an expected total of $2.2 billion over the forecast period. But officials have been clear, however, that this forecast is highly conditional on taxpayer behaviour.[16]

Accordingly, the package of reforms enacting the new tax rate includes additional wide-ranging disclosure requirements for all trustees, apparently regardless of the source or nature of their income.[17] Inland Revenue appears to be banking on the belief that its super-sized computer systems can sift through this avalanche of additional information to identify sudden changes in trust activities that may indicate the implementation of strategies to circumvent the new top rate.

The new disclosure requirements mean that financial accounting information must be provided by trustees on an ongoing basis, alongside annual income tax returns. This information includes:[18]

- financial information — statement of profit and loss and statement of financial position
- details of in-period settlements, including detailed personal information for each settlor
- information on distributions made in the period, including the amount of the distribution, and personal information of the beneficiary recipients
- information on those with the power to appoint trustees, including personal information for each appointer, and
- any other information required by the Commissioner per the Bill’s commentary — this may include, for example, information on any transfers to the trust by associated persons and information on loans to or by related parties.[19]

A further information-gathering power has also been enacted to allow the Commissioner to request detailed information for any trust returns prepared from the 2014 year onwards. This retrospective power is expected to support the Commissioner’s ability to compare past behaviour by trusts with their ongoing compliance in the 2022 and future income years.

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And despite the tax rates having been aligned for the past 10 years, Inland Revenue has not forgotten either how taxpayers acted or how it was forced to respond. For instance, the narrower "income attribution rules" that prevent taxpayers from using other entities to derive more than 80% of their personal services income from one source largely fell into dis-use over that period.[20]

But last year Inland Revenue released IS 19/02 "Income Tax – Attribution rule for income from personal services" explaining how those rules apply; and in November 2020 it released a draft follow-up policy in PUB00321 "Income tax – Calculating income from personal services to be attributed to the working person", which explains how Inland Revenue expects taxpayers to calculate their income under those rules. So, it is clear that Inland Revenue is preparing itself for what is coming.

Fewer cases in the courts

Given the interruption to court procedure caused by the lockdown, it is perhaps not surprising that fewer than normal cases were decided by the courts during 2020. However, a few decisions warrant mention.

Frucor

The High Court judgment in *Frucor* (in November 2018)[21] broke Inland Revenue's decade-long run of wins in tax avoidance cases.[22] That decision even called into question the correctness of Inland Revenue's long-standing approach to tax avoidance. The case was obviously welcomed by taxpayers and advisers who hoped the pendulum was starting to swing back in favour of taxpayers by redrawing the line between permitted tax planning and tax avoidance.

Not surprisingly Inland Revenue felt obliged to appeal that decision – and the Court of Appeal unanimously over-turned the High Court judgment. It ruled that, despite the commercial need for the borrowing by the taxpayer under the OCN funding arrangement, and actual cash payments of interest, the arrangement contravened s BG 1 of the Income Tax Act 2007. So, it's business as usual and the needle on tax avoidance has not moved, although there may be further developments. On 18 December 2020 the Supreme Court granted the taxpayer leave to appeal the Court of Appeal decision. The Commissioner was also granted leave to contest the ruling that shortfall penalties did not apply.[23]

Why does Inland Revenue hate charities?

Inland Revenue continues to be unaccountably hostile to charities and taxpayers that make charitable donations. Rather than encouraging philanthropic giving and taking a generous approach to those who fund public benefits, Inland Revenue repeatedly adopts a narrow, technical and niggardly approach.

First, in *Church of Jesus Christ*,[24] the Court of Appeal ruled that donors who gifted funds to the church to help fund the missionary work of friends and relatives were still entitled to a tax credit.[25] Any private benefit enjoyed by the missionaries was not consideration received by the donor in return for the payment, such that it did not constitute a gift. The Supreme Court rejected the Commissioner's appeal:[26]

> "The question at issue in this case, namely whether the alleged benefit derived by the donors was such that it meant the payments should not be categorised as gifts, was an intensely fact-specific question and the facts in this case were relatively unusual."

Second, in *Roberts*,[27] the Commissioner alleged that the forgiveness of debt owed by a charity was not a "gift of money"[28] because the transaction was simply recorded by journal and not by actual payment. The Court of Appeal rejected that narrow approach and confirmed that:

> "Under current law, forgiveness of a debt owed to the donor by a charity qualified as a 'charitable or other public gift' under s LD1 of the ITA 2007 with the consequence that the donor was entitled to a tax credit under that section."

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In 2014 the Commissioner had amended the law, intending to restrict the scope of charitable donations under the Income Tax Act, but the Court of Appeal ruled that change was ineffective, and gifts or money could take many forms:

> "From an analysis of the various dictionary definitions of 'monetary' and 'money', it appeared that the words 'monetary' and 'money' in s LD 3(1)(a) meant more than just cash. Such a conclusion was consistent with the Commissioner's long-standing practice of accepting that gifts made by way of electronic bank transfers, credit card payments or cheques qualified as monetary gifts under s LD 3(1)(a)."

In both cases there was no question that the donor had freely given funds to a registered charity, yet the Commissioner chose to dispute the resulting tax credit. Obviously the courts have taken a dim view of that approach but it seems the Commissioner refused to receive the message to apply the law more generously.

Immediately following release of the Court of Appeal judgment on 17 December 2019, the Minister of Revenue issued a media statement proposing an urgent remedial amendment to the Taxation (KiwiSaver, Student Loans, and Remedial Matters) Act to clarify that debt forgiveness does not qualify for donation tax credits. That restriction applies retrospectively to 1 April 2008 (but saves tax credits previously claimed by taxpayers on debts forgiven).[29]

Unsatisfactory GST rules for land

The compulsory zero-rating (CZR) rules for land in the Goods and Services Tax Act 1985 came into effect on 1 April 2011.[30] Despite the intended simplicity of their application, after almost 10 years the rules continue to cause problems for both vendors and purchasers. Inland Revenue has taken steps to publicise the intended operation of the regime and highlight its potential pitfalls,[31] but taxpayers continue to be caught out. Unfortunately, disputes between parties affected by the mistaken mischaracterisation of the correct GST treatment of the sale of land have become commonplace.

First, in *Y&P NZ Ltd v Wang*,[32] the Supreme Court confirmed that it was the GST registration status of the parties, and not their description in the sale and purchase agreement, that determines the correct GST treatment. Accordingly, it rejected an appeal by a vendor that the purchaser could not belatedly alter that GST treatment by unilaterally changing its GST status. The Supreme Court concluded:

> "The appeal did not have sufficient prospects of success to warrant the grant of leave in any event. The fact that Inland Revenue deemed the purchasers to be GST-registered at all times relevant to this appeal, and that the GST status of any transaction was governed by the relevant taxation legislation, presented the vendor with formidable obstacles on the merits."

Second, that reasoning was applied in *Marr v Mills*.[33] In that case a disgruntled purchaser sued the vendor for breaching her warranty recorded in the sale and purchase agreement that she was not registered for GST. The High Court ruled that the vendor's breach prevented the purchaser from claiming the expected second-hand goods input tax credit and therefore awarded it damages calculated as the equivalent amount.

But these cases continue to demonstrate how poorly the rules are understood and the resulting problems. The CZR rules were introduced to protect Inland Revenue against problems caused by phoenix companies, but in doing so they have simply created a host of new problems that most taxpayers struggle to solve.[34] Reform in this area is necessary, so it is pleasing that Inland Revenue has addressed this issue as part of its GST policy review.

GST reform proposed before the world stopped

In the innocent days of February 2020 Inland Revenue released a wide-ranging discussion document entitled *GST policy issues*.[35] It identifies a range of policy proposals and technical reforms to the Goods and Services Tax Act 1985 "where the legislation produces an outcome that does not reflect the underlying

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policy intent. These issues need to be addressed to maintain the certainty, efficiency and fairness of the tax system."

The most significant proposed changes to the GST regime — but which due to the intervention of the COVID-19 crisis and the election are yet to be implemented — include the following:

- Align GST invoicing requirements with changes in business practices and technology — ideally to remove some of the requirements or make them more flexible.
- Correct the unfavourable GST treatment afforded to cryptocurrencies compared to money or other investment products.
- Simplify the complex apportionment and adjustment rules for input tax.
- Extend the current zero-rated rule that applies to the international transportation of goods (so that commercial sub-contracting arrangements are included).
- Enact concessionary rules to allow non-resident businesses to recover GST for a one-off expense of sending their staff to a conference or training course in New Zealand.
- Review the GST treatment of different types of management services supplied to managed investment funds, which are presently unnecessarily complex and apply inconsistently. The intention is to develop new rules for fund manager and investment manager services. Several alternative options are considered, and taxpayer input is sought as to whether these supplies should be:
  - — taxable (15% GST)
  - — exempt financial services
  - — partly exempt (and the remainder taxable)
  - — zero rated, or a reduced input tax credit mechanism applied.
- Clarify the GST treatment when a GST-registered third party unknowingly receives an insurance pay-out which they treat as compensation. It considers 3 alternative options:
  - — making the insurer responsible for the GST obligations
  - — requiring disclosure that the payment is covered by insurance
  - — no law change, but providing education and guidance.
- Address concerns with the scope and operation of the CZR rules that appear to produce flawed outcomes for the timing and application of the relevant provision.
- Consider a range of other technical or remedial changes to the GST grouping rules, the timing of input tax credits for goods not yet physically received at the time the GST return is filed, the second-hand goods input credits on supplies between associated persons, and the right to challenge the Commissioner's decision to reopen time-barred GST returns under s 108A of the Tax Administration Act.

Conclusion

The year 2020 has been a most unusual and difficult year. Few people will remember it fondly. But the law changes, court decisions and policy proposals released this year will continue to have an impact on the tax regime long after we have changed the calendar and put 2020 behind us.

Last reviewed on 1 December 2020

Footnotes

1 A full discussion of all COVID-19 related changes can be found in "Guidance on recent COVID-19 tax legislation" on the Tax Policy website.

2 Income Tax Act 2007, s EE 38.

3 New Zealand National Party, "National would get New Zealand working again", [media release], Scoop website, 5 May 2020.

4 Income Tax Act, ss EE 31, YA 1 ("residential building", "non-residential building").

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5 ibid, s IZ 8.

6 See T Coughlan "Parliament passes the wrong law in an afternoon of urgent lawmaking", *Stuff*, 1 May 2020.

7 New Pt VIIAA of the Tax Administration Act 1994.

8 Inland Revenue "COVID-19 Small Business Cashflow (Loan) Scheme (SBCS)".

9 T Sullivan "COVID-19 crisis brings whirlwind of tax changes", CCH, *New Zealand Tax Planning Report*, No 1, May 2020.

10 See R Stock "IRD's Small Business Cashflow Loan Scheme lends more than $1.3 billion", *Stuff*, 10 June 2020.

11 Tax Administration Act, s 6H.

12 Tax Administration Act, s 6I(4).

13 The fifth Labour Government (1999–2008).

14 *Penny and Hooper* v *C of IR*[2011] NZSC 95; (2011) 25 NZTC ¶20-073 (SC).

15 C Harris "Here's how high earners might avoid new top tax rate", *Stuff*, 31 October 2020.

16 See Inland Revenue regulatory impact statement *Introducing a new top personal income tax rate* , 2 December 2020.

17 Taxation (Income Tax Rate and Other Amendments) Act 2020.

18 See new s 59BA of the Tax Administration Act.

19 Taxation (Income Tax Rate and Other Amendments) Bill.

20 Income Tax Act, ss GB 27–GB 29.

21 *Frucor Suntory NZ Ltd* v *C of IR*(2018) 28 NZTC ¶23-078 (HC).

22 The previous taxpayer win in a tax avoidance case was in 2010 in *White* v *C of IR*(2010) 24 NZTC 24,600 (HC).

23 See the fuller discussion of this decision in M Keating "Commissioner wins Frucor Appeal", CCH, *New Zealand Tax Planning Report*, November 2020.

24 *Church of Jesus Christ of Latter-Day Saints Trust Board* v *C of IR*(2020) 29 NZTC ¶24-066 (CA).

25 Under s LD 1 of the Income Tax Act.

26 *C of IR* v *Church of Jesus Christ of Latter-Day Saints Trust Board*(2020) 29 NZTC ¶24-077 (SC).

27 *C of IR* v *Roberts*(2019) 29 NZTC ¶24-026 (CA).

28 Under s LD 3 of the Income Tax Act.

29 See Inland Revenue court summary CSUM 20/01.

30 Goods and Services Tax Act 1985, s 11(1)(mb).

31 IS 17/08, "Goods and services tax – compulsory zero-rating of land rules (general application)", 15 September 2017.

32 *Y&P NZ Ltd* v *Wang*(2020) 29 NZTC ¶24-062 (SC).

33 *Marr* v *Mills*(2020) 29 NZTC ¶24-081 (HC).

34 For a more detailed discussion of the CZR rules, see P Smith "Side effects and solutions for compulsory zero-rating of land transactions for GST", CCH, *New Zealand Tax Planning Report*, December 2017.

35 See Inland Revenue *GST policy issues: An officials' issues paper* , February 2020.

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