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

Bill Number 273-1

Regulatory Impact Assessments

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Prepared by Policy and Strategy, Inland Revenue

June 2020

Impact Summary: Feasibility and other non-deductible expenditure for incomplete assets

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be taken by Cabinet.

Key Limitations or Constraints on Analysis
There is no direct evidence on hand to give an estimate about the extent to which non-deductible expenditure affects efficiency in the tax system. This makes it difficult to quantify the scale of the problem or the potential benefits from introducing the preferred option. Officials were informed during consultation of anecdotal examples where current tax policy settings were acting as a barrier for businesses in respect of developing assets where uncertainty existed in respect of their completion or potential impairment and abandonment. Estimates on the impacts of the proposed option have been based on New Zealand 2018 gross fixed capital formation ($m) provisional statistics. The assessed impacts in the table in section 4.1 contain assumptions regarding taxpayer compliance and the composition of private sector asset creation in the 2018 statistics. Officials have a moderate level of confidence in the assumptions we have used but note the 2018 statistics are subject to volatility as a result of asset revaluations. Although the proposals in this RIA have been developed over several years the recent development of final proposal has been completed in a short timeframe which has limited officials' ability to undertake a complete analysis of the final proposals including its final design. The time available has also prevented officials from fully testing the design of the preferred option with stakeholders.
Responsible Manager (signature and date):
Chris Gillion Policy Lead Policy and Strategy Inland Revenue 13 September 2019

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Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

This RIA considers two questions:

- Do the current tax policy settings hinder businesses from committing resource to developing new assets in situations where the completion of that asset is uncertain, and
- If the answer to the first question is yes, what is the best option for solving the problem.

The first question is considered in this section, section 2, the second question is considered in section 3.

Do current tax policy settings hinder businesses from committing resource to developing new assets in situations where the completion of that asset is uncertain?

Business decision-making on the potential or practicality of developing new assets, business models or processes is vital to innovation and driving productivity improvements.

The Government is concerned that current tax settings are acting as a barrier to business decision-making on these types of investment, specifically investments that decline in value. Under current law, expenditure (that is more than preliminary in nature) incurred to invest in a new asset, process, or business model (feasibility expenditure), and expenditure that is incurred to create a business asset that is subsequently abandoned, is generally not deductible.

As a general principle, the economic value of business expenditure that does not provide an enduring benefit should either be immediately deductible, or, when it provides an enduring benefit, deductible over time if that benefit declines over time and has a finite lifetime. When the tax system does not provide for that treatment, an economic distortion is created.

Overlaying this principle, New Zealand's income tax framework draws a distinction between the treatment of economic income from capital and non-capital sources. The distinction is best described using the following metaphor of a fruit-bearing tree. New Zealand's income tax is designed to tax the fruit from the tree. It does not necessarily tax the tree itself. The corollary of the example is that expenditure is deductible when it has a connection or relationship with producing taxable income (fruit) and is non-deductible when it relates to capital assets (the tree). Consistent with the general principle above, the system also allows depreciation deductions recognising the use of capital assets in producing taxable income.

The income tax system's distinction between income from capital and revenue can result in expenditure not being deductible. For example, feasibility expenditure or other expenditure that results in an economic cost to a taxpayer, but for which neither immediate deductions nor depreciation deductions are available (commonly referred to as "black hole" expenditure). Such examples can skew investment decisions.

Feasibility expenditure is expenditure that is undertaken to determine the practicality of a new proposal. In some cases, the Income Tax Act 2007 will deny taxpayers an immediate deduction for such expenditure when it has a connection with an asset that has the potential to yield future economic benefits beyond the taxpayer's immediate income year. In addition, because of the early-stage nature of feasibility expenditure uncertainty exists over the outcome and this can make it difficult for taxpayers to assess whether an asset indeed exists.

Inland Revenue's original interpretation statement[1] on feasibility expenditure allowed a

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relatively wide scope for preliminary expenditure to be immediately deductible if there was no definitive commitment to proceeding with a project.

Concerns that the Income Tax Act was skewing business decisions came to a head in 2016 as a result of obiter comments by the Supreme Court in *Trustpower Ltd v Commissioner of Inland Revenue*[2] (the *Trustpower* decision). The case itself was about resource costs, which the Commissioner of Inland Revenue maintained were not immediately deductible. The Supreme Court agreed with the Commissioner's view but noted that the statutory test for deducting certain types of expenditure was narrower than Inland Revenue's interpretation and taxpayer expectations at the time.

Officials have been informed that an effect of the *Trustpower* decision is that less expenditure is immediately deductible for tax purposes than previously thought[3] which increases the likelihood that businesses will incur non-deductible expenditure when creating income producing depreciable assets. In 2017 Inland Revenue released an updated interpretation statement that applies the analysis from the *Trustpower* decision.[4]

Inland Revenue has been anecdotally informed by stakeholders that the current state following the *Trustpower* decision is discouraging businesses from undertaking spending on new assets or processes that they otherwise would have undertaken in the absence of tax.

Additionally, if a project or investment is unsuccessful or abandoned, the capitalised expenditure may not generate depreciation deductions over time. As such, businesses may be incentivised to complete projects that, but for the tax effect, would be abandoned. This behaviour affects economic efficiency. Figure 1 illustrates a simple project timeline and the tax treatment of the expenditure incurred in developing that project following the *Trustpower* decision and Inland Revenue's 2017 interpretation statement:

Figure 1: Tax treatment of feasibility expenditure

[1] Interpretation Statement IS 08/02: Deductibility of feasibility expenditure, Tax Information Bulletin Vol 20, No 6 (July 2008) available at https://www.classic.ird.govt.nz/resources/e/e/ee3c54c3-4675-45d3-8fa4-2cea747ff52b/tib-vol20-no6.pdf

[2] *Trustpower Ltd v Commissioner of Inland Revenue* [2016] NZSC 91.

[3] This outcome is appropriate, however, for assets that are not expected to decline in value.

[4] Interpretation Statement IS 17/01: Deductibility of feasibility expenditure, Tax Information Bulletin Vol 29, No 3 (April 2017) available at https://www.classic.ird.govt.nz/resources/3/e/3e0303d0-0b02-4f86-844a-547a6179b661/tib-vol29-no3.pdf

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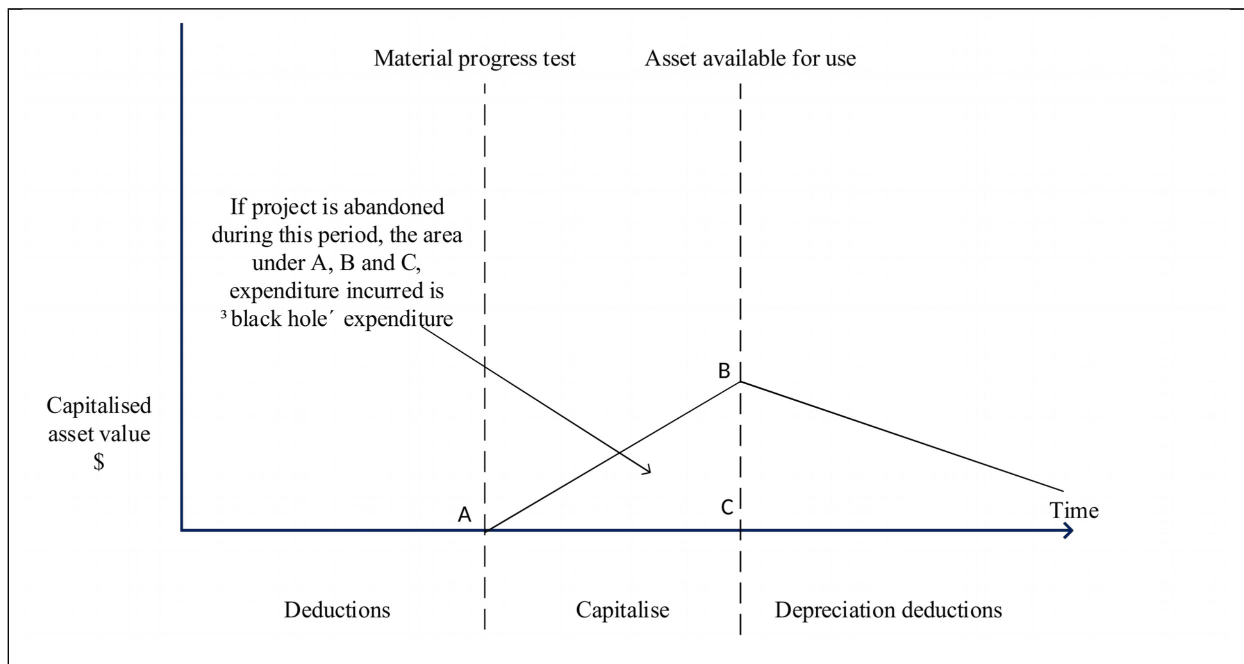

2.2 Who is affected and how?

The proposal in this RIA is directed at businesses, specifically in the following circumstances:

- Businesses delaying or not undertaking feasibility studies that would otherwise occur if there is uncertainty over whether the expenditure would be deductible and the higher after-tax cost of an unsuccessful investment.
- Businesses continuing with feasibility studies that would be uneconomic on a pre-tax basis to ensure they can claim deductions for expenditure already incurred.

The Government is concerned that current tax settings are not providing the correct outcome for businesses in respect of expenditure on new assets and processes (that would, if completed, decline in value). The Government wants to remove these tax barriers to promote economically efficient business decisions.

It is not intended that the reform would have effect on spending related to assets that are not expected to decline in value over time, such as land or shares, or other assets where the Income Tax Act 2007 provides for a specified treatment.

Inland Revenue does not hold information to inform who is directly impacted by the current treatment of expenditure directed at creating new assets. We are, however, aware from tax practitioner comment following the *Trustpower* decision and the views of submitters about the initial problem definition and initial solutions, that there is an impact on small-to-medium sized firms and the large corporate sector. Not for profits, public sector entities and individuals are not considered be within the scope of those affected.

Reform in this area of tax law has had long-standing support from the business community. The magnitude of the impact is also difficult to estimate as Inland Revenue does not directly capture data relating to the costs incurred by business when making investment decisions or when decisions are made that result in physical assets being abandoned. In assessing the revenue impact of the preferred option discussed in this RIA, Inland Revenue has used asset formulation statistics to get an understanding about how asset formulation changes from year to year.

2.3 Are there any constraints on the scope for decision making?

To date, the government has taken an incremental approach to other instances of non-deductible expenditure under New Zealand's tax system in relation to:

- Research and development;
- Company administration costs;
- Resource consents;
- Software projects;
- Patents; and
- Plant variety rights.

The options discussed in this impact statement are not intended to replace or otherwise alter the rules that are specific to the type of expenditure on the activities or transactions listed above. As such, it is not within the scope of this project to review or consolidate these previous responses. It is expected that any policy change would be directed at expenditure that is not the subject of these other rules in the Income Tax Act; as such, it is likely to act as a rule of last resort.

The options in this RIA therefore consider expenditure that is not dealt with elsewhere in the Income Tax Act. The options are also not intended to alter the current non-deductibility for assets that are expected to appreciate in value such, as land or shares, as such assets are not expected to result in an economic loss.

The Tax Working Group's consideration of the treatment of expenditure on feasibility and expenditure on abandoned assets, as set out in its final report in February 2019 have also had a strong influence on the selection of the preferred option.[5]

[5] Future of Tax: Final Report Volume I – Recommendations, Thursday, 21 February 2019 https://taxworkinggroup.govt.nz/resources/future-tax-final-report-vol-i-html#section-3, recommendation 33 refers.

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Section 3: Options identification

3.1 What options have been considered?

The following criteria were used to assess the options considered:

- *Neutrality*: the tax rules should not influence taxpayer decisions about incurring feasibility expenditure
- *Compliance and administration costs*: the impacts on taxpayers complying with the tax rules and Inland Revenue's administration of those rules, should be minimised as far as possible.
- *Integrity*: Tax deductions should not be available for expenditure that when incurred is unlikely to give rise to taxable income now or in the future or for expenditure on assets that are not expected to decline in value over time.

Option One: Status quo

This would leave the deductibility of feasibility expenditure to be considered on a case-by-case basis with guidance from Inland Revenue's 2017 interpretation statement following the *Trustpower* decision.

Option Two: Spread the timing and recognition of feasibility expenditure over 5 years

This option would allow taxpayers to deduct expenditure on developing new assets and incomplete assets over a defined period of 5 years.

Alternative spreading periods have been considered such as 7 years. Officials initially considered 7 years was most appropriate for New Zealand, noting the absence of a comprehensive tax on the income from capital. A 5-year spread was chosen following detailed consideration of the treatment of feasibility and other non-deductible expenditure on incomplete assets by the Tax Working Group headed by Sir Michael Cullen. It is also noted that Australia has a comparable 5 year spreading rule to deal with expenditure incurred for similar purposes when developing new assets.[6] A period shorter than 5 years was considered to introduce a distortion to abandon incomplete assets earlier than would otherwise occur (in the absence of tax).[7]

Officials plan to carry out an additional round of consultation with key stakeholders on the final design of this option including any resulting draft amendments. An outstanding matter for stakeholder comment is the test(s) that would need to be met to establish the point in time in which expenditure can be recognised for tax deductibility.

Option Three: Generally accepted accounting practice (application of Financial Reporting Standards)

This option would allow generally accepted accounting practice (with certain constraints) to determine the recognition and timing of deductions.

[6] Inland Revenue notes that any comparison of this proposal with tax deductibility rules that apply in Australia should be considered in the context of differences between New Zealand's and Australia's treatment of income from capital.

[7] Noting that a tension can exist for taxpayers who are required to comply with financial reporting standards. Assets expensed for tax purposes have a direct reflex in the taxpayer's balance sheet and profit and loss statement.

This would allow for:

- a defined class of expenditure, known as "feasibility expenditure", to be immediately tax deductible until an asset is recognised under generally accepted accounting practice; and
- an immediate deduction if the project or proposal is abandoned and written off under generally accepted accounting practice.

This option would also require support by new rules to deal with abandoned partially completed assets. The additional rule would be needed to remove distortions that would otherwise be created as depreciation deductions are available for completed assets only.

Modifications to options 2 and 3 for compliance and tax base integrity reasons

Options 2 and 3 have modifications that are not separate options in themselves but alter their application and effect to ensure the reform option is appropriately targeted and contains appropriate safeguards.

Reinstatement of expenditure if abandoned or completed asset is subsequently recognised

Under options 2 and 3, safeguards would be added to provide that deductions claimed for abandoned or impaired assets that are subsequently reinstated would be reversed in the year of reinstatement. Reinstatement would involve bringing back earlier tax deductions as an increase in revenue in the year of reinstatement and capitalizing those values in the cost of the asset (which would then be subject to tax depreciation).

Safe harbour for low threshold expenditure

Submitters on option 3 argued that a safe harbour was necessary to reduce compliance costs on small-to-medium sized taxpayers. This was largely due to the fact that such taxpayers were unlikely to be required to comply with New Zealand financial reporting standards. Similar compliance cost savings arguments apply to option 2 as there are costs attached with identifying and spreading expenditure under the option. It therefore makes sense for low levels of spending on investigating and/or developing a new asset, model or process to be immediately deductible. It has yet to be explored with stakeholders if expenditure covered by the safe harbour would have to be reinstated if it related to a completed asset that is expected to decline in value.[8]

A threshold of $10,000 was suggested by stakeholders, and officials considered that it was an appropriate amount that targeted asset creation expenditure by small-to-medium sized businesses. The $10,000 threshold is similar to other compliance cost savings measures in the Income Tax Act that allow taxpayers to deduct low levels of expenditure, such as legal fees.

[8] Ibid footnote 8. Officials note that taxpayers who are not required to comply with financial reporting standards do not always face a tension between accounting for tax and financial reporting when making decisions about whether to abandon an asset prior to completion.

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3.2 Which of these options is the proposed approach?

The Government considers the status quo is inefficient. Current tax policy settings, based on comments from stakeholders and the conclusions reached by the Tax Working Group, act as a barrier to businesses committing to expenditure on developing assets when uncertainty exists as to whether that asset would be completed. In the absence of regulatory change, the current state requires taxpayers and Inland Revenue to take decisions regarding the deductibility of expenses and the recognition of assets through to disputes and the Courts. Regulatory intervention therefore seeks to remove, or substantially reduce, these interpretative transaction costs.

The next question is, which option for reform is preferable. Option 3 was initially developed in response to stakeholder concerns following the *Trustpower* decision and was the subject of the government discussion document *Black hole and feasibility expenditure*. Option 3 proposed that financial reporting should be used by businesses to determine the deductibility of expenditure or if it should be capitalised. Responses to option 3 suggested that it would not be a complete solution and could be expensive for taxpayers, who are not required to use financial reporting standards, to apply. Stakeholders also noted that the tax treatment of abandoned incomplete assets was unsatisfactorily unanswered if financial reporting standards were applied. Further consideration of option 3 by officials identified a concern that immediate tax deductibility could incentivise decisions to abandon incomplete assets earlier than otherwise occur (in the absence of tax).

Option 2 is a response to the concerns stakeholders voiced regarding the application and effect of option 3. Option 2 is preferred as it better meets the assessment criteria in section 3.1. Allowing deductions for expenditure incurred in developing assets, including abandoned incomplete assets, improves neutrality as businesses no longer face tax barriers depending on whether the results of that expenditure are successful or not.

Relative to the other options, option 2 should have a lower compliance and administration impacts. This comment is subject to final decisions about the legislative design of the proposal. Further consultation will be carried out on the practical application of Option 2, if Cabinet decides to proceed.

The details of when reinstatement of previously deducted expenditure is required has yet to be tested with stakeholders. It is, however, necessary to ensure the integrity of the proposal and the wider tax system.

There are no areas of incompatibility with the Government's 'Expectations for the design of regulatory systems'.

A summary of our analysis of the options is set out in the table on page 10. The analysis is by reference to the status quo.

Table: summary analysis

Option	Option 1: Status quo	Option 2: Spread the timing and recognition of feasibility expenditure over 5 years	Option 3: Generally accepted accounting practice
Neutrality	0	+ (tax barriers are removed)	+ (tax barriers are removed)
Compliance and administration costs	0	+ (++ if the safe harbour threshold is included	0 – recognising that financial reporting standards imposes its own asset recognition principles. (+ if the safe harbour threshold is included)
Integrity	0	+	+

Key:

++ much better than doing nothing/the status quo

+ better than doing nothing/the status quo

0 about the same as doing nothing/the status quo

- worse than doing nothing/the status quo

- - much worse than doing nothing/the status quo

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties	Tax records will need to be kept and maintained to support any tax deductions under the proposal. This requirement is expected to align with good record keeping practice. The requirement to spread the expenditure may impose an additional marginal cost on taxpayers.	Low
Regulators	None	Not applicable
Wider government	Reduction in tax revenue	$80 million over the forecast period 2019-2024. In 2024-25, when the proposal is fully implemented the annual cost is expected to be $42 million, increasing by 3% per annum thereafter.
Other parties	None	Not applicable
Total Monetised Cost		$80 million over the forecast period 2019-2024. In 2024-25, when the proposal is fully implemented the annual cost is expected to be $42 million, increasing by 3% per annum thereafter.
Non-monetised costs		*Low*
Expected benefits of proposed approach, compared to taking no action		
Regulated parties	Reduced tax payments for businesses that incur expenditure to develop new assets, business processes or abandon incomplete investments that, if completed, would decline in value. Feasibility expenditure will be more likely to be incurred where it is economic to do so on a pre-tax basis.	$80 million over the forecast period 2019-2024. In 2024-25, when the proposal is fully implemented the annual cost is expected to be $42 million, increasing by 3% per annum thereafter. High but unquantified

	Reduction in uncertainty over whether feasibility expenditure will be deductible.	Medium but unquantified
Regulators	None	Not applicable
Wider government	Tax barriers removed on business decision-making on the potential or practicality of developing new assets, business models or processes is vital to innovation and driving productivity improvements.	Low
Other parties	None	Not applicable
Total Monetised Benefit		$80 million over the forecast period 2019-2024. In 2024-25, when the proposal is fully implemented the annual benefit is expected to be $42 million, increasing by 3% per annum thereafter
Non-monetised benefits		*Medium*

4.2 What other impacts is this approach likely to have?

The intent of the preferred option is to remove barriers to firms carrying out expenditure on developing new assets, business processes and other investments where the result of that expenditure is uncertain and could result in abandonment or impairment of the investment. This type of investment is important to innovation and driving productivity improvements. As such, the preferred option is expected to produce wider benefits to the business community.

The final design of the preferred option has not been the subject of full consultation with stakeholders. This consultation is expected to occur in the next few months following the outcome of Cabinet's decision. To ensure the integrity of the proposal, the consequences of any reinstatement of expenditure have not been fully explored and this may involve trade-offs regarding how simple option 2 operates in practice.

Officials have made certain assumptions regarding taxpayer behaviour in response to the proposal, those assumptions have inherent uncertainties, including:

- Whether the proposal may incentivise taxpayers to commit to completing uneconomic assets to reduce tax payments (raising tax-base integrity risks); and
- Whether this proposal, in conjunction with earlier policy responses outlined in section 2.3, causes introduces more complexity in taxpayer decision-making and associated tax compliance costs.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Following the *Trustpower* decision, the private sector, being corporate taxpayers and their advisors, approached the government seeking a revision of the tax policy settings for expenditure on projects that was more in line with business norms and prevailing practices.

Officials undertook preliminary targeted consultation to define the parameters of the problem and consider initial solutions. The outcome from this consultation was the development of a proposal that was released in May 2017 for wider public comment in the government discussion document *Black hole and feasibility expenditure*. 23 submissions were received that largely supported the policy direction but had concerns regarding the complexity of the proposal and its practical application.

In October 2017, a second round of consultation was held on a revised proposal with key stakeholders. Of the ten responses received, feedback was generally supportive of the revised approach but concerns were again expressed over the complexity of the proposal. Submitters were also concerned that the revised proposal created gaps which could still give rise to non-deductibility of feasibility expenditure.

The preferred option in this RIA simplifies the rule and introduces a trade-off that deductions are spread over five years rather than immediately unless the qualifying expenditure is $10,000 or less in a tax year. Stakeholders have informed officials that the most important issue is the expenditure being deductible; not necessarily the timing of that deduction.

Consultation with stakeholders initially focused on a framework (option 3) that would allow businesses upfront tax deductions for expenditure incurred in developing assets, that if completed would decline in value, at the point when a decision was made to completely abandon progress on that incomplete asset. Immediate tax deductions would also be allowed for feasibility expenditure by reference to accounting principles, with an overlay of tax principles for tax base integrity purposes.

Submissions on the practicality of option 3 noted that the proposed deductibility test for feasibility expenditure was too complex. Submissions also noted that partial write down of assets needed to be recognised for tax purposes. Submitters noted that accounting standards imposed tight requirements on when assets should be written off and specific tax rules were recommended to provide for such impairments. Submitters also recommended a safe-harbour threshold that would allow small- to-medium sized businesses immediate tax deductions for low-levels of exploratory expenditure on new assets. Submitters noted that for businesses considering developing new assets, the requirement to use financial reporting standards could be an impediment if the business was not required to use New Zealand International Financial Reporting Standards, which also have a compliance cost attached to their use and application.

Officials revised the parameters of option 3 in response to submissions and undertook a second round of consultation with key stakeholders. The revised proposal relaxed the basis on which tax deductions could be claimed on partially impaired assets and suggested the tests for deductibility would be based on Inland Revenue's revised interpretation statement. Submitters were supportive of the revision but again noted the degree of complexity with the proposal (as it was a blend of accounting and tax concepts). Concerns were also expressed that the integrity measures that supported option 3 would lead to gaps with its application.

Option 3, without appropriate safeguards could, by allowing immediate tax deductions raise

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integrity risks around activities being claimed to be ceased while they were still intended to be progressed in order to access the tax deduction. This option is an improvement over the status quo, but less than option two. There is a risk that if the proposal is not well targeted the change may incentivise taxpayers deferring the recognition of asset (so as to continue incurring feasibility expenses) or encourage the early abandonment of projects and proposals.

In response to the concerns identified by submitters on option 3, officials considered that option 2 could provide a more complete response to submitter concerns. However, there is a trade-off. While option 2 is intended to deal with the gaps and problems identified in option 3, the deduction allowed under the option is spread over a specified period. As the requirement to track and record expenditure can create compliance costs, a safe harbour threshold is still required to ensure option 2 does not unreasonably disincentivise small-to-medium sized businesses. Consultation on the final design of option 2 has not occurred and is subject to Cabinet decision-making. Subject to Cabinet decisions, Inland Revenue will discuss the practical application of option 2 with stakeholders. Another round of consultation will also available as part of Parliament's consideration of any legislative amendment through the Parliamentary select committee process.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The preferred option would require changes to the Income Tax Act 2007 which could be introduced in the next available tax omnibus bill planned for early 2020. Legislation implementing the preferred option is expected to have effect for new expenditure incurred from the start of the 2020-21 income year (for most firms this is 1 April 2020) even if the feasibility project itself had started in previous years. It is not intended that these rules would apply to expenditure incurred before that date as these periods have already occurred so the change in tax treatment would not be able to impact on business investment decisions. These proposals would be favourable to affected taxpayers and would be enacted before taxpayers would typically file tax returns for the relevant periods. When the bill is introduced into Parliament, a Commentary on the bill will be concurrently released explaining the amendments. Further explanation about their effect will be contained in Inland Revenue's *Tax Information Bulletin* series, which would be released shortly after the bill receives Royal assent. Inland Revenue would administer the proposed legislative changes. Enforcement of the changes would be managed by Inland Revenue as business as usual. Inland Revenue has assessed the magnitude of the administrative impacts and considers that the proposed approach can be implemented and made effective for qualifying expenditure incurred anytime from the start of the 2020-21 income year. No changes to Inland Revenue systems are expected as a result of implementing the proposals. Taxpayers would be expected to use existing schedules and internal record-keeping processes to capture information to support tax positions that involve tax deductions relating to developing new assets, or when decisions are made to impair and abandon incomplete assets (that would otherwise decline in value if completed).

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
There are no plans to specifically collect data on the proposal as, of itself, expenditure on developing new assets is a general business activity that would be incorporated and aggregated within existing business tax disclosures and tax returns. The existing record-keeping rules in the Tax Administration Act 1994 would apply to deductions allowed under the proposal. Monitoring of the proposed approach will be done through existing relationships Inland Revenue has with relevant stakeholders and their advisors. Following enactment of the proposal, any issues with the new law identified by tax practitioners and taxpayers would be considered for inclusion for remedial change as part of the stewardship programme on the Government's tax policy work programme. Comments from stakeholders and their advisors will inform officials if the proposal is not working as intended or creating unintended outcomes. Inland Revenue's enforcement of the relevant rules (referred to in section 6.1) would also

inform officials if the risks noted in section 4.2 are material, or raise concerns regarding the integrity of the tax system.

Inland Revenue would monitor the outcomes as per the objectives of the Generic Tax Policy Process (GTPP) to confirm that the proposed approach meets its objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

7.2 When and how will the new arrangements be reviewed?

If the Government adopts option 2, officials propose to engage with key stakeholders 18 months after the proposal's enactment and receive feedback regarding the effectiveness of the proposal (if feedback is not received earlier) for the period 2020-21.

The Government's tax policy work programme makes provision for work required to deal with remedial matters where tax legislation is not achieving its policy intent. Remedial work is informed from a variety of sources external and internal to Inland Revenue.

Any concerns identified by stakeholders about the proposed approach discussed in this RIA would be considered for priority as part of the remedial items component of the tax policy work programme. If the concerns with the proposal are more substantive, consideration would be given to prioritising the matter on the tax policy work programme.

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Impact Summary: GST on telecommunications services

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by or on behalf of Cabinet.

Key Limitations or Constraints on Analysis
An assumption has been made that applying GST or VAT to outbound mobile roaming services is more likely to become the common approach worldwide. This assumption is based on the OECD finalising in 2017 its *International VAT/GST Guidelines* (*the Guidelines*) which set forth internationally agreed standards for the GST/VAT treatment of international transactions and the European Union applying VAT to outbound roaming services received by its residents. Under the *Guidelines,* remote services (which includes telecommunications services) should generally be subject to GST/VAT in the country that the recipient of the services is normally resident.
Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *GST on telecommunications services* regulatory impact assessment prepared by Inland Revenue and considers that the information and analysis summarised in it **meets** the quality assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of this RIA have been incorporated into this version.
Responsible Manager (signature and date):
Graeme Morrison Policy Lead Policy and Strategy Inland Revenue 23 October 2019

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Under New Zealand's current GST rules for telecommunications services both outbound mobile roaming services received by New Zealand residents travelling overseas and inbound mobile roaming services received by non-residents in New Zealand are not subject to GST (or are subject to GST at the rate of 0%).[1]

The current rules are inconsistent with New Zealand's broad-based GST framework, under which one of outbound or inbound mobile roaming services should be subject to GST.

As GST is intended to be a tax on final consumption, applying GST to either outbound or inbound mobile roaming services received by GST registered businesses should not have a net revenue benefit. Businesses receiving roaming services should (if GST-registered and using the services for making taxable supplies) be able to claim back the GST incurred on these services as an input tax deduction. The net revenue benefit from applying GST to either outbound or inbound mobile roaming services should therefore only be the GST incurred by final consumers.

The OECD released *International VAT/GST Guidelines* in 2017. Under these Guidelines remote services (including telecommunications services) should generally be subject to GST or VAT in the jurisdiction where the recipient of the service is normally resident. Remote services are services in which there is no necessary connection between the place of performance of the services and the location of the recipient of the services.

In light of the OECD's Guidelines, the European Union (EU) and the United Kingdom (UK) have begun applying VAT to outbound mobile roaming services received by their residents travelling overseas.

However, in over 80 other jurisdictions (including Canada, Japan and Singapore) GST, VAT or a local sales tax is added to inbound mobile roaming services, generally by applying these taxes to the wholesale roaming services supplied by local telecommunications suppliers to foreign telecommunications suppliers to enable the supply of inbound mobile roaming services. The GST/VAT rules for telecommunications services in most of these jurisdictions pre-date the OECD finalising its *International VAT/GST Guidelines*. It is unclear whether these countries have made a considered decision to maintain their pre-existing rules for telecommunications services or if they have simply not reviewed these rules yet in light of the OECD's *Guidelines*.

Like New Zealand's current rules, Australia does not apply GST to either outbound or inbound mobile roaming services.

The differing treatment of mobile roaming services around the world can result in both double taxation and double non-taxation. For example, the roaming services received by an EU resident travelling in Canada would be subject to GST/VAT in both the EU and Canada. Conversely, the roaming services received by a Canadian resident in the EU would not be

[1] Inbound mobile roaming services may, in certain circumstances, be subject to GST but these circumstances rarely arise.

subject to GST/VAT in either jurisdiction.

On 8 April 2019 Cabinet agreed as part of Budget 2019 to amend the GST rules for telecommunications services to apply GST to outbound mobile roaming services from 1 October 2020 (refer *DEV-19-MIN-0059*). The issues paper *GST and telecommunications services* was then released on 17 May 2019 to consult on the detailed design of the proposed changes.

This RIA updates the analysis of options following consultation on the issues paper. However, the proposed option is still to apply GST to outbound mobile roaming services.

Application date

Cabinet has previously agreed to an application date for the proposed changes to the GST rules for telecommunications services of 1 October 2020. However, this application date may not give telecommunications suppliers enough time to make and test the necessary systems changes to apply GST to outbound mobile roaming services.

2.2 Who is affected and how?

The affected parties are suppliers of telecommunications services and the consumers of these services. New Zealand telecommunications suppliers will be affected as the proposed options would impact on the GST treatment of their supplies of outbound mobile roaming services. Consumers of telecommunications services will be affected as the price they pay for mobile roaming services may increase depending on whether suppliers pass on the full GST cost, or alter their pricing strategies.

2.3 Are there any constraints on the scope for decision making?

Applying GST to the actual inbound mobile roaming services supplied by foreign telecommunications suppliers to non-residents travelling in New Zealand is unlikely to be a viable option and has therefore not been considered. Many telecommunications suppliers sell global or regional roaming packs that allow a consumer to roam in multiple jurisdictions for a single fee. At the time of supply the telecommunication supplier will not know which jurisdiction a consumer will consume the roaming services in. Furthermore, a consumer may consume the roaming services in multiple jurisdictions. If the actual inbound roaming services were subject to GST it would therefore be likely to cause telecommunications suppliers significant difficulties in attempting to apportion roaming charges between the different jurisdictions in which a customer consumed the roaming service.

Section 3: Options identification

3.1 What options have been considered?

The objective is to maintain New Zealand's broad-based GST framework by extending the application of GST to more services. The following criteria have been used to assess the options against this objective:

- Destination principle: The option should be consistent with the principle that GST or VAT should generally apply in the jurisdiction in which consumption occurs.
- Business neutrality: The option should be consistent with the principle that GST should be borne by final consumers and should not be a cost to businesses.
- International consistency: The option should give consideration to approaches taken internationally to minimise instances of double taxation or double non-taxation.
- Compliance costs – The option should minimise compliance costs for telecommunications suppliers as much as possible.

Option 1: Status quo

Under the status quo both outbound and inbound roaming services are not subject to GST at 15%.

The status quo does not achieve the objective as, under New Zealand's broad-based GST framework, GST should apply to one of outbound or inbound mobile roaming services.

Option 2: Apply GST at 15% to outbound mobile roaming services (proposed option)

Under this option, outbound mobile roaming services received by New Zealand residents travelling overseas would become subject to GST at the standard rate of 15%.

The gross GST that would be collected under this option is estimated to be $12.993 million per annum. However, GST registered businesses paying GST on the outbound mobile roaming services they receive would be able to claim back this GST as an input tax deduction. It is therefore estimated that this option would increase net GST revenue by $7.041 million per annum.

Analysis of option

This option would be consistent with the objective of maintaining New Zealand's broad-based GST framework as it would add GST to the entire outbound mobile roaming services received by New Zealand residents travelling overseas.

Applying GST to outbound mobile roaming services is not consistent with the destination principle as to receive mobile roaming services a New Zealand resident must be outside New Zealand. However, there are circumstances in which it is appropriate to depart from the destination principle. The OECD's *Guidelines* recommend using a consumer's usual place of residence for determining which jurisdiction's GST or VAT applies to a supply of remote services (including telecommunications services) regardless of the physical location of the consumer. For example, if a New Zealand resident downloads a movie while on holiday in Australia, New Zealand GST should apply to the download of the movie. This departure from the destination principle is considered appropriate as often the supplier of a remote service

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will not know the actual location of the consumer and therefore the consumer's residency is considered an appropriate proxy for the most likely place of consumption of remote services.

This option would be consistent with the principle of business neutrality as GST-registered business can claim back the GST they incur as an input tax deduction.

This option would be consistent with rules in the European Union and the United Kingdom which apply VAT to outbound mobile roaming services received by their residents.

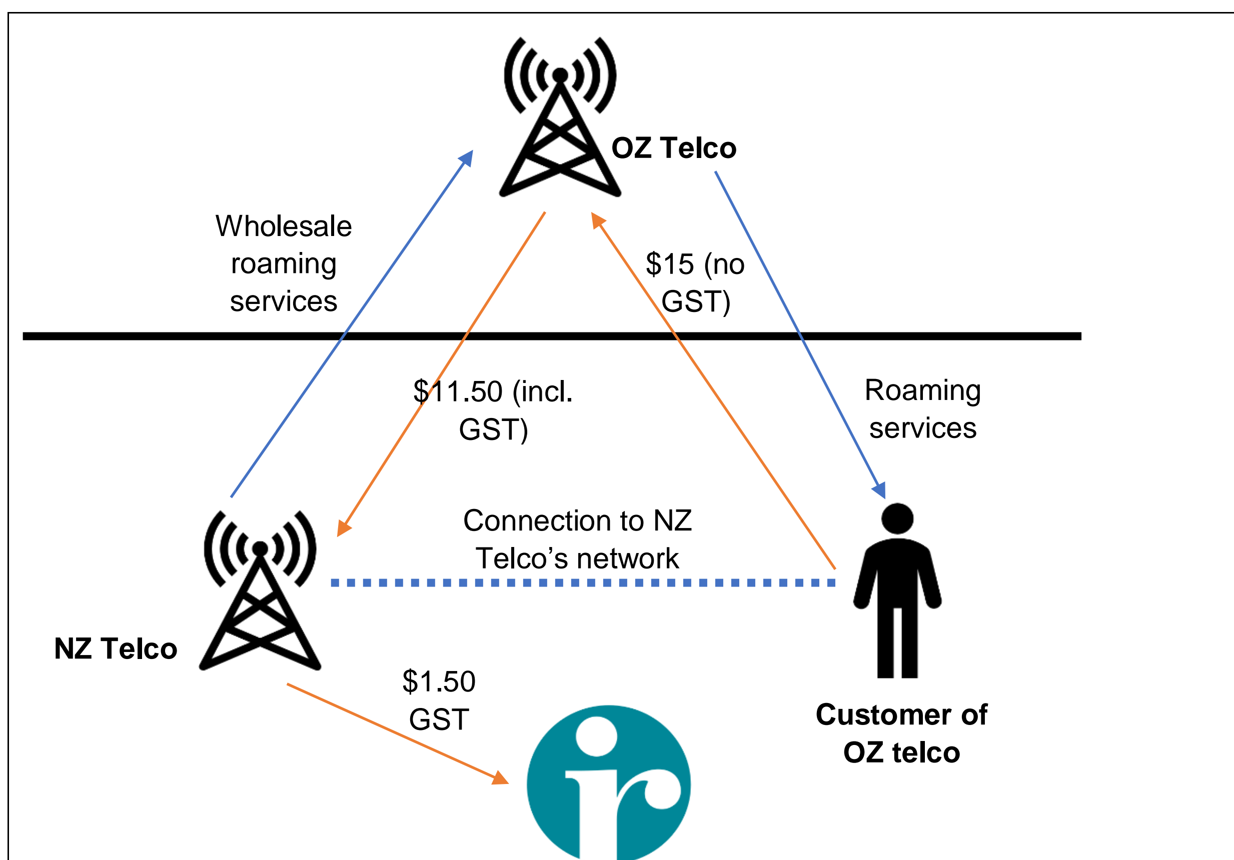
However, this option would be inconsistent with the approach taken in over 80 other jurisdictions which add GST, VAT or a local sales tax to inbound mobile roaming services, generally by applying GST to wholesale mobile roaming services. However, the rules in many of these jurisdictions pre-date the OECD finalising its *International VAT/GST Guidelines.*

The option would also be inconsistent with Australia which, like New Zealand's current rules, does not apply GST to either outbound or inbound roaming services.

The telecommunications industry has estimated that this option would impose on the industry compliance costs associated with updating their billing systems of approximately $1 million. They would also incur costs associated with notifying their customers of the change in the GST treatment of outbound roaming services. The compliance costs for this option would be a one-off cost and on-going compliance costs would be comparable to the status quo.

Option 3: Apply GST to inbound wholesale mobile roaming services

GST could be added to inbound roaming by applying GST to the wholesale mobile roaming services supplied by New Zealand telecommunications suppliers to foreign telecommunications suppliers to enable the foreign telecommunications suppliers' customers to roam in New Zealand. This would result in unrecoverable GST being embedded in the price of roaming services received by non-residents travelling in New Zealand. The diagram on the following page illustrates how applying GST to wholesale roaming charges would work.



As can be seen in the above diagram, applying GST to the wholesale roaming charges would add GST on to the services NZ Telco supplies to OZ Telco to allow OZ Telco's customers to roam in New Zealand. There is no GST on the actual supply of roaming to OZ Telco's customer. However, GST is embedded in the price of the roaming services received by OZ Telco's customer as OZ Telco is unable to claim an input tax deduction for the GST they paid to NZ Telco.

It is estimated that this option would increase GST revenue by $3.8 million per annum. As GST would be imposed on the wholesale roaming services rather than the actual inbound mobile roaming services, non-resident businesses consuming inbound mobile roaming services in New Zealand would not be able to claim back the GST embedded in the price of these services. As such, there is no need to consider the difference between gross and net GST revenue under this option.

Analysis of option

This option partially achieves the objective of maintaining New Zealand's broad-based GST system as it would add GST to the price of inbound roaming services received by non-residents travelling in New Zealand. However, the margins charged by the suppliers of inbound roaming services would remain untaxed.

This option would be consistent with the destination principle.

Applying GST to wholesale roaming services is inconsistent with the principle of business neutrality as it would add unrecoverable GST to the price of inbound roaming services received by non-resident businesses in New Zealand.

This option is inconsistent with the approach taken in the European Union and United

Kingdom. However, it would be consistent with the approach taken in over 80 other jurisdictions which apply GST or VAT to wholesale roaming services. Like option 2, this option is also inconsistent with the approach taken to mobile roaming services in Australia.

The telecommunications industry has not quantified the cost of making systems changes to add GST to wholesale mobile roaming services. However, the industry considers that these costs would not be insignificant. Officials consider that the costs of making systems changes for this option may be similar to the costs of making systems changes for option 2. This option would also impose costs on the New Zealand telecommunications industry related to reviewing and potentially re-negotiating their contracts with foreign telecommunications suppliers. As with option 2, the compliance costs of this option would be one-off costs and on-going compliance costs would be comparable to the status quo.

Application date

An application date of 1 October 2020 was originally proposed for the proposed changes to the GST rules for telecommunications services. However, it is proposed to delay this application date by six months to 1 April 2021.

The bill containing the changes to the GST rules for telecommunications services is scheduled for introduction in March 2020. This would mean that there may be little or no time between the legislation being enacted and the original application date of 1 October 2020. If the bill is not passed before the next general election, enactment might not occur until after 1 October 2020.

A very short time period between the bill being enacted and the application date may not give the telecommunications industry sufficient time to make the necessary systems changes to apply GST to outbound mobile roaming services. The billing systems of telecommunications suppliers are complex as they need to operate in real time to ensure a person is correctly charged as they use the network. As such, while changing outbound mobile roaming services from a zero-rated supply to a standard rated supply is itself a simple change, the telecommunications suppliers would need to do extensive testing to ensure the change does not cause any issues for their billing systems.

Given, the factors discussed above, delaying the application date by six months to 1 April 2021 is considered appropriate.

Delaying the application date by six months would have a fiscal cost of $3.52 million.

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3.2 Which of these options is the proposed approach?

The proposed approach is to apply GST at the standard rate of 15% to outbound mobile roaming services received by New Zealand residents travelling overseas from 1 April 2021 (option 2 with a six-month delay to the application date previously agreed by Cabinet).

While applying GST to outbound mobile roaming services is less consistent with the destination principle than the status quo, it best achieves the objective of maintaining New Zealand's broad-based GST framework and is more consistent with the principle of business neutrality than applying GST to wholesale roaming services. Furthermore, while there is no clear international consensus at this stage, officials consider that, in light of the OECD's *International VAT/GST Guidelines* and the approach taken by the European Union, applying GST to outbound roaming services is more likely to become the common approach worldwide.

The proposed approach is aligned with the Government's expectations for the design of regulatory systems.

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Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties	Comment:	Impact
Additional costs of proposed approach, compared to taking no action		
Regulated parties (suppliers)	One-off compliance costs in complying with the change in GST treatment of telecommunications services.	Approximately $1 million
Regulators (Inland Revenue)	Administration costs of proposed approach are comparable to the status quo.	Low
Wider government	Fiscal cost from delaying application date by six months	$3.52 million
Other parties (consumers)	Potential increase in the costs of outbound roaming services supplied to New Zealand residents whilst outside New Zealand. Whether the costs of roaming increase depends on whether and to what extent suppliers pass the GST cost onto consumers or alter their pricing strategies.	Up to $7.041m per annum if suppliers increase their roaming prices to fully recover the GST. This cost would be spread across New Zealand residents who travel overseas each year
Total Monetised Cost		$7.041m per annum (on-going) $4.52 million one-off cost
Non-monetised costs		*Low*

Expected benefits of proposed approach, compared to taking no action		
Regulated parties (suppliers)	Extra six months to make the required systems changes	Low
Regulators (Inland Revenue)	None	None
Wider government	Increase in GST revenue. Applying GST to outbound mobile roaming services helps to maintain the broad-based framework which underpins New Zealand's GST system.	$7.041 million per annum Low
Other parties (consumers)	Reduced GST payments from six-month delay in application date	$3.52 million
Total Monetised Benefit		$7.041 million per annum $3.52 million one-off benefit
Non-monetised benefits		*Low*

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4.2 What other impacts is this approach likely to have?
We do not anticipate the proposed approach would have any other impacts. We will consult with tax advisors and the telecommunications industry on how best to draft the changes to the GST Act to ensure there are no unintended impacts. The select committee process will also be used to ensure there are no unintended impacts.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

The issues paper *GST on telecommunications services* was released on 17 May 2019 to consult on the technical details of the proposal to apply GST to outbound mobile roaming services. Submissions closed on 28 June and in total 6 submissions were received. Following the close of submissions officials conducted further consultation with representatives of the telecommunications industry.

Support for the proposal

Two submissions from accounting firms expressed support for the proposal as they consider it consistent with the OECD's *International VAT/GST Guidelines*. However, one of these submissions expressed concerned that the benefits of the proposal would be outweighed by the compliance costs.

Opposition to the proposal

Four submissions, including one made on behalf of the telecommunications industry, were strongly opposed to the proposal to add GST to outbound roaming services. In further consultation with the telecommunications industry they have regularly expressed their opposition to the proposal.

The key argument raised in opposition to the proposal was that, as outbound roaming services can only be consumed outside New Zealand, it would be contrary to the destination principle to apply New Zealand GST to outbound roaming services received by New Zealand residents overseas. Under the destination principle, GST should generally apply in the jurisdiction in which consumption occurs.

In arguing that it is inappropriate to apply GST to outbound roaming some submitters also argued that roaming services are on-the-spot services and not remote services as a consumer needs to be in the vicinity of a cell tower to receive the service. In arguing that roaming services are on-the-spot services these submitters were arguing that it would be inappropriate to use a consumer's usual place of residence to determine which jurisdiction's GST or VAT applied to a supply of roaming services. However, roaming services should not be considered on-the-spot services as they are not physically performed at a readily identifiable place,[2] and do not require the physical presence of both the person performing the service and the person consuming the service.

The New Zealand telecommunications industry's strong preference is for the status quo to be

[2] Telecommunications services tend to have multiple places of performance and it is difficult to identify a single place of performance. The GST rules for telecommunications services were introduced to address this issue.

maintained. They note that while it is not a conceptually pure option, the existing rules for telecommunications services have been working well and the consider the status quo to be less of a compromise on a conceptually pure GST system than the proposed option. Furthermore, they do not consider that the increase in GST revenue of $7.041 million per annum would justify the one-off compliance costs of approximately $1 million from making changes to their billing systems.

Application date

The telecommunications industry suggested a delayed application date would be appropriate given the time required to make and test systems changes. They are therefore likely to welcome the delayed application date of 1 April 2021.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

Following Cabinet approval, the necessary amendments to the Goods and Services Tax Act 1985 will be included in an omnibus tax bill currently scheduled for introduction in March 2020. The proposals are intended to apply to supplies of telecommunications services from 1 April 2021.

Inland Revenue will be responsible for the on-going administration of the new arrangements. Inland Revenue officials have assessed the magnitude of these administrative impacts and consider that they would be comparable to the status quo.

Guidance on how the proposed approach would work would be provided in bill commentary published at introduction of the legislation and a Tax Information Bulletin published after enactment.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

Inland Revenue will monitor the outcomes to confirm that they match the policy objectives.

Officials from Inland Revenue expect that, once the proposals are enacted, affected telecommunications suppliers and their tax advisors will raise with them any concerns they have with how the rules are working in practice. Any necessary changes identified as a result would be recommended for addition to the Government's tax policy work programme.

7.2 When and how will the new arrangements be reviewed?

The review will be the monitoring described in section 7.1 above.

Impact Summary: GST refunds using credit notes

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by or on behalf of Cabinet.

Key Limitations or Constraints on Analysis

Number of affected parties and potential future fiscal risks are unknown

The potential future fiscal risk that the time bar may be ineffective for GST refunds made using credit notes is unknown as it depends on the scale of the particular issue that gave rise to the refund (e.g. changing interpretations or errors by the affected businesses that have not yet been identified) and number of past years affected. Therefore, it is not possible to estimate these amounts – although in some potential cases they could be in the tens of millions of GST revenue.

Limited consultation with affected parties

Issue one: *Correct amount of GST adjustment*

A draft interpretation of the current law on the first issue is currently being consulted on and the initial feedback that has been received supports the proposed policy change as it would align the law with common business practices.

Some submissions were received on a similar proposal in 2012 (see section 5.1 below for more detail) which have been used to inform this RIA.

However, there has been no specific consultation on the proposed changes.

Issue two: *Application of the time bar to credit notes*

The second issue has not been consulted on with external parties as informing external parties that the time bar may be ineffective could expose the Government to a significant fiscal risk. A GST registered person may be able to use credit notes to claim large GST refunds if they discovered they had been applying an incorrect GST treatment for a long time (e.g. more than 8 years).

Consultation will occur once the bill is introduced and during the Select Committee stage of the bill.

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *GST refunds using credit notes* RIA and considers that the information and analysis summarised in it **partially meets** the quality criteria of the Regulatory Impact Analysis framework. The Key Limitations or Constraints on Analysis section of the RIA notes that no consultation has been undertaken on the specific proposals and the amount of fiscal risk from not changing issue two is unable to be quantified. The first proposal is taxpayer favourable and maintains current operational practice. The second proposal is a base maintenance change consistent with the policy intent and the fiscal impact, although not quantifiable poses a significant risk if not addressed. The reviewer considers that the information in the RIA is as complete as could be expected and identifies the main risks and uncertainties.
Reviewer Comments and Recommendations:
Comments from the review of earlier versions of this RIA have been incorporated into this version.
Responsible Manager (signature and date):
   Graeme Morrison Policy Lead Policy and Strategy Inland Revenue 23 October 2019

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

GST credit notes are issued by a supplier when the price for a supply is reduced after a tax invoice was issued, for example when faulty goods are returned. When a credit note is issued:

- the supplier must make an adjustment in their GST return in the period they issued the credit note; and
- the recipient (if GST registered), must make an adjustment in their GST return in the period they received the credit note.

Through these adjustments, the supplier will effectively be refunded for the GST accounted for on the portion of the supply that was refunded, and the recipient (if GST registered) will be required to repay the GST claimed on the refunded portion of the supply.

Inland Revenue has recently considered how the GST credit note provisions apply in cases where the GST registered business standard-rated (applied 15% GST) to a supply of goods and services which should in fact have been exempt (e.g. a financial service) or zero-rated (e.g. an export).

This has raised two policy issues:

Issue one: *Correct amount of GST adjustment*

Firstly, from a policy perspective the current law may provide an incorrect amount of GST adjustment in situations where a supply was standard-rated but should have been exempt or zero-rated. This is because, the GST adjustment may be limited to the tax fraction (3/23rds) of the adjusted price.

For example, consider a supply of $100 plus $15 of GST which was incorrectly charged. The supply should have been exempt or zero-rated (no GST). In this situation, the correct policy outcome would be for the supplier to issue a credit note and make an adjustment for the incorrectly returned $15. The recipient (if GST registered) would then make an adjustment for $15 incorrectly claimed.

However, according to a draft interpretation that Inland Revenue is currently consulting on, the GST adjustment is limited to the tax fraction (3/23rds) of the price adjustment. Since the price adjustment is $15, the GST adjustment is limited to $1.96 (3/23 x $15) rather than $15.

This interpretation would not accommodate common commercial practices whereby GST registered persons issue credit notes to provide a $15 GST adjustment (rather than amending the original return). Although GST registered persons can request approval from Inland Revenue to amend their original GST return to get the correct $15 GST adjustment, this approach is inferior to using a credit note as it involves additional compliance costs and administrative costs.

Issue two: *Application of the time bar to credit notes*

The second issue concerns whether the "time bar" is effective at limiting GST refunds that arise due to credit note adjustments. The ability to adjust a GST return to claim a GST refund is "time-barred" which means a GST registered person can only claim a GST refund in respect of GST returns that were filed less than 4 (or in cases of a clear mistake or simple oversight less than 8) years prior to the current date.

In contrast, because the credit note is issued on the current date, the time bar may be ineffective in respect of a credit note adjustment. This poses a potentially large fiscal risk as it means a GST registered person may be able to use credit notes to claim large GST refunds if they discovered they had been applying an incorrect GST treatment for a long time (e.g. more than 8 years). This would be contrary to the policy intent of the time bar on GST refunds.

2.2 Who is affected and how?

The first issue affects some GST registered persons (businesses) which have incorrectly charged 15% GST on a sale of goods and services when that sale should in fact have been exempt or zero-rated (0%).

However, GST advisors have informed us it is a common commercial practice to use credit notes to provide the correct amount of GST adjustment in such cases, in which case the proposed law change would simply align with existing practice (and therefore have no impact on compliance costs).

The second issue could potentially provide additional GST refunds to some businesses on rare occasions where they made a mistake more than 4 or 8 years ago. However, it was not intended that GST registered persons could receive additional GST refunds from using a credit note instead of adjusting the original GST return.

2.3 Are there any constraints on the scope for decision making?

There are no constraints on the decisions.

Section 3: Options identification

3.1 What options have been considered?

The following criteria was used to assess the options:

- Horizontal equity – the affected parties should be able to achieve the intended policy outcomes and similar outcomes as other groups in similar situations such as those who amend their original GST return.
- Certainty – the affected parties should understand how the tax rules operate.
- Compliance costs and administration costs should be minimised.
- Policy stability / sustainability – the option should be able to be maintained and cope with future developments.

Issue one: *correct amount of GST adjustment issue*

Option 1: No law change (status quo)

GST registered persons will still be required to request approval from Inland Revenue to amend their original GST return to get the correct GST adjustment, or accept a lower GST adjustment through a credit note.

Pros:

- Requirement to amend original return may provide IRD with a greater ability to check / approve the refund.
- IRD can increase certainty by publishing guidance on how the current law operates.

Cons:

- Provides the wrong policy outcome as it results in a much lower amount of GST refund compared to amending the original GST return.
- Uncertain and would impose compliance and administration costs as IRD's draft interpretation does not align with current business practices.
- Inconsistent with self-assessment basis of GST.

Option 2: Make it easier to make the adjustment through amending the GST return

This option would allow the affected GST registered persons to amend their GST returns on a self-assessment basis using Inland Revenue's systems (MyIR). For example, by allowing the amendment to be made in their GST return for the next period, or by relaxing the requirement to apply to Inland Revenue to approve an amendment to an earlier GST return.

Pros:

- May provide IRD with a greater ability to check the refund.

Cons:

- Some additional complexity as to get the correct GST adjustment a different refund mechanism must be used depending on why the GST was incorrect.
- Would impose compliance and admin costs as does not align with current business practices.
- Requires IRD to make systems and process changes and may require a law change.

Option 3: Law change to clarify the correct amount of GST adjustment *(preferred option)*

This option would involve adding a new provision that ensures that when the affected GST registered person issues a credit note for a particular supply, it provides the same amount of GST refund compared to amending the original GST return which included the relevant supply.

Pros:

- Provides the same GST refund amount as amending the original GST return.
- Aligns with current business practices.
- Provides certainty about the refund amounts when GST credit notes are used.
- Reduces compliance and admin costs.

Cons:

- Requires law change.

Issue two: *Application of the time bar to credit notes issue*

Option 1: No law change (status quo)

Because the credit note is issued on the current date, the time bar may be ineffective in respect of a credit note adjustment, even though the relevant supply which is adjusted was included in a GST return more than 4 or 8 years ago.

Pros:

- Allows the business to go back and correct all past mistakes, and claim GST refunds for these, no matter how long ago the mistake occurred.

Cons:

- Potentially large fiscal risk to the Government and could effectively allow GST refunds for time-barred returns contrary to the policy intent of the time bar.
- High compliance and admin costs due to the potentially large refund amounts and the historic nature of the relevant supplies.

Option 2: Align with the time bars which apply for GST refunds made through amending the original GST return *(preferred option)*

This would involve applying a time limit from the date of a supply in which a credit note may be issued. The time limit would match the existing 4 year (or 8 year in the case of a clear mistake or simple oversight) time limits for GST refunds which apply when an amendment is made to the original GST return which included the relevant supply.

Pros:

- Provides the same GST refund amount as amending the original GST return.
- Provides certainty that the time bar applies to credit notes.
- Reduces compliance and admin costs (consistent set of GST refund rules and likely to align with current practices).

Cons:

- Limits the ability to claim GST refunds for past mistakes (but still allows a generous 4 or 8 years for this).

Option 3: Expand an existing provision which provides a 7 year limit for using credit notes when a supply of land has been incorrectly standard-rated

Credit notes cannot be issued in relation to supplies of land which were incorrectly standard-rated more than 7 years ago. This 7 year limit could be expanded to prevent a credit note from being issued in respect of other supplies that occurred more than 7 years ago.

Pros:

- Aligns with an existing 7 year time limit for credit notes and 7 year record-keeping requirements.
- Provides certainty for the time limit that applies to credit notes.

Cons:

- Can allow a different amount of refund to amending the original GST return (as this has a 4 or 8 year time limit) which could change which refund mechanism is used (and increase administration and compliance costs).
- Limits ability to claim GST refunds for past mistakes to 7 years.

3.2 Which of these options is the proposed approach?

Issue one: *Correct amount of GST adjustment*

The preferred option is option 3 – a law change to clarify the correct amount of GST adjustment as it:

- Provides the same GST refund amount as amending the original GST return.
- Reduces compliance and administration costs by aligning the law with some common current practices of the affected businesses.

Issue two: *Application of the time bar to credit notes*

The preferred option is option 2 - align with the time bars which apply for GST refunds made through amending the original GST return because it:

- Provides the same GST refund amount as amending the original GST return.
- Reduces compliance and admin costs (consistent set of GST refund rules and likely to align with current practices).
- Should be a sustainable policy as it means credit notes cannot be used to undermine the policy intent of the existing time bars for GST refunds and also removes the risk of a potentially large, unintended fiscal cost to the Government.

The proposed options are compatible with the Government's '*Expectations for the design of regulatory systems'*.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties	Comment:	Impact
Additional costs of proposed approach, compared to taking no action		
Regulated parties *(Some GST registered businesses which have incorrectly charged 15% GST)*	***Issue two:*** Lose the potential ability to access an unintended windfall of GST refunds in respect of transactions that took place more than 4 or 8 years ago in "time-barred" periods. ***Both issues:*** Minimal ongoing compliance costs as should be no change compared to current practices for most of the affected businesses.	Unknown, potentially high depending on the scale of the issue that creates the GST refund and number of years affected. Low
Regulators *(Inland Revenue)*	***Both issues:*** Minimal ongoing administration costs as should be no change compared to IRD's current operational practices. One-off cost of law change and associated guidance materials / monitoring and responding to any issues queries with the change.	Low Low
Wider government	No expected costs.	
Other parties	No expected costs.	
Total Monetised Cost	***Both issues:*** Not possible to quantify. It depends on future issues that give rise to this type of GST refund which are unknown.	Potentially high but unable to quantify
Non-monetised costs		*Low*
Expected benefits of proposed approach, compared to taking no action		
Regulated parties *(Some GST registered businesses which have incorrectly charged 15% GST)*	***Issue one:*** Certainty and minimising compliance costs by aligning the law with current practices for most of the affected businesses.	Low
Regulators *(Inland Revenue)*	***Issue two:*** Removes the risk of a potentially large, unintended fiscal cost to the Government.	Unknown, potentially high depending on the scale of the issue that creates the GST refund and number of years affected.

	Both issues: Certainty and minimising compliance costs and systems changes by aligning the law with current operational practices.	Low
Wider government	No expected benefits.	
Other parties	No expected benefits.	
Total Monetised Benefit	***Both issues:*** Not possible to quantify. It depends on future issues that give rise to this type of GST refund which are unknown.	Potentially high but unable to quantify
Non-monetised benefits		*Low*

4.2 What other impacts is this approach likely to have?

No other impacts have been identified from the proposed options.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Issue one: *Correct amount of GST adjustment*

A draft interpretation of the current law on the first issue is currently being consulted on (*PUB 00352, Changing GST treatment after reducing the previously agreed consideration*) and the initial feedback that has been received supports the proposed policy change as it would align the law with common business practices.

A similar set of proposed changes to the credit note rules was consulted on as part of 2012 issues paper *GST remedial issues*. However, a decision was made not to proceed with any changes to the credit note rules in 2012. This was because one part of the 2012 proposals suggested that when a credit note was issued in such circumstances it should be necessary to pass on the GST refund to the purchaser. Submissions from private sector GST advisors disagreed with this aspect of the proposal and noted that whether or not a refund should be paid through to the purchaser was a contractual matter and should not be dictated by the GST Act. The new proposal does not include the aspect which these submitters opposed in 2012.

Issue two: *Application of the time bar to credit notes*

The issue of how the time bar applies to credit notes has not been directly consulted on with external parties. Informing external parties that the time bar may be ineffective in such cases could expose the Government to a significant fiscal risk. To manage this risk the proposed option could apply from the date that the bill containing the proposed amendment is introduced.

Despite this, a proposed option which would have addressed the second issue was referenced in the 2012 consultation document *GST remedial issues* (which asked whether that adjustment should be treated as taking place in the same period as the original supply), but no submissions were received on this option. A decision was made not to proceed with any of the proposed changes to the credit note rules in 2012 due to submitter's disagreeing with one aspect of the 2012 credit note proposals that suggested that the refund should be passed onto the purchaser (described above).

Further consultation

Further consultation on both issues / proposals will occur during the Select Committee stage of any bill containing the proposed amendments.

It is expected that some stakeholders will submit against the proposal to apply a time bar to credit notes as the proposed law change could potentially limit businesses ability to claim a GST refund for errors they made in their GST returns more than 4 or 8 years ago.

However, it was not intended that GST registered persons could receive additional GST refunds from using a credit note instead of adjusting the original GST return as this would be contrary to the policy intent of the time bar on GST refunds. Most of the affected businesses have been applying the time bar on GST refunds to credit notes (and this has also been Inland Revenue's operational practice). This means the proposed law change to apply a time bar would align with these current practices.

In contrast, if the existing law is unchanged it could potentially provide an unintended windfall of large GST refunds in respect of transactions that occurred more than 4 or 8 years ago in "time-barred" periods.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The proposals will require amendments to the Goods and Services Act 1985 which could be included in the next available tax omnibus bill expected to be introduced in early 2020. Guidance materials to explain how the amendments would operate will be published when the bill is introduced, in response to submissions raised with the Select Committee and after the bill is enacted. There is a risk that the proposed amendments could have unintended consequences or may not adequately accommodate existing business practices. These risks will be mitigated by aligning the provisions with similar existing rules, consulting GST advisors once the relevant provisions are introduced in a bill and through the monitoring described in section 7.1 below.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

As both proposed law changes are expected to align the law with the current practices of most of the affected businesses and Inland Revenue's operational practice, they should have minor impacts on compliance and administrative costs.

Inland Revenue will monitor if any unintended consequences arise through its usual processes of monitoring GST refunds, and through contacts and feedback from the affected businesses and their GST advisors. Inland Revenue would then consider how best to address specific issues that arise. This could include answering queries, publishing guidance materials, adjusting operational practices, making remedial law changes or reviewing the policy.

7.2 When and how will the new arrangements be reviewed?

The review will be the monitoring described in section 7.1. above, on an ongoing basis.

Impact Summary: Income tax treatment of leases subject to NZ IFRS 16

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be taken by or on behalf of Cabinet.

Key Limitations or Constraints on Analysis

Officials do not hold operating lease payments data for all IFRS[1] taxpayers. Estimating the total amount of annual operating lease payments for all IFRS taxpayers was necessary to determine the fiscal cost of the proposals. We identified the population of IFRS taxpayers and extracted operating lease information on the approximately 43% (by value of income tax payable) of IFRS taxpayers where it was available. This was then used to estimate lease payments for the balance of the population on the assumption their lease payments would be in the same proportion to their income tax payable. This identified total operating lease payments for all IFRS taxpayers of approximately $2.5 billion per annum.

Two other factors that influence the fiscal cost are the average lease term (higher cost for longer terms) and the interest rate (higher cost for higher rates). We could not identify data on average lease terms so estimated these for a variety of situations then checked their reasonableness with external stakeholders. The interest rate on leases will differ from lease to lease and taxpayer to taxpayer; whereas the forecasting model requires a single interest rate. We chose the NZ dollar BBB+ rated corporate 5-year fixed term interest rate on 20 June 2019 which was the date the calculation was performed.

In costing the proposals we have assumed that lease payments will remain static over time. A more realistic assumption is that, due to inflation and economic growth, lease payments will slowly grow over time. If this was factored into the costing there would be a small ongoing cost to the proposals; however, this cost would be very small so has been disregarded on a materiality basis.

We have also assumed that, for the preferred option, all eligible taxpayers will elect to follow their accounting treatment for eligible leases. This is the most conservative assumption, but we expect the proportion will be very high. We have not attempted to estimate the exact percentage expected to elect.

[1] International Financial Reporting Standards – The requirement to prepare accounts under IFRS varies but the most common is having total assets in excess of $60 million or total revenue in excess of $30 million. In 2017 the External Reporting Board (XRB) identified 2,575 entities with IFRS reporting obligations based on 2015 data.

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While changes in these assumptions or the final values will affect the fiscal calculations, officials consider these are sufficiently accurate that they can be relied upon to make decisions on the underlying principles considered.
Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *Income tax treatment of leases subject to NZ IFRS 16* RIA and considers that the information and analysis summarised in it **meets** the quality assurance criteria of the Regulatory Impact Analysis framework.
Reviewer Comments and Recommendations:
Comments from the review of earlier versions of this RIA have been incorporated into this version.
Responsible Manager (signature and date):
Chris Gillion Policy Lead Policy and Strategy Inland Revenue 17 October 2019

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

A lease involves one person (known as the lessor) who owns (or otherwise holds) an asset providing it to another person (known as the lessee) to use in exchange for payment over the term of the lease. For entities with IFRS[2] reporting obligations, the accounting treatment was previously determined under *New Zealand Equivalent to International Accounting Standard 17 Leases* (NZ IAS 17). This standard has been replaced by *New Zealand Equivalent to International Financial Reporting Standard 16 Leases* (NZ IFRS 16 or IFRS 16) for years starting on or after 1 January 2019.[3]

Accounting treatment under NZ IAS 17

Under NZ IAS 17, there was a difference in the accounting treatment between operating and finance leases. NZ IAS 17 defines the distinction as follows:

> *A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership.*

For example, a lease would be classified as a finance lease if the lessee leased the asset for the majority of its estimated useful life then had the right to purchase it from the lessor for a fixed price at the end of the lease. In contrast, a lease would be classified as an operating lease if the lessee only leased the asset for a short portion of the estimated useful life then at the end of the lease it was returned to the lessor to lease or sell to someone else.

Current tax treatment

The Income Tax Act 2007 contains two separate sets of rules for finance and operating leases. These definitions are similar but not identical to the NZ IAS 17 definition. The largest difference is that all leases of real property[4] are operating leases for tax purposes. For finance leases, the lease payments are taxed under the financial arrangements rules and are treated like the repayment of a loan with interest. For operating leases, the lease payments are currently spread equally over the life of the lease. This treatment is similar to the NZ IAS 17 accounting treatment which reduces the need for tax adjustments.

No changes to the tax treatment of tax finance leases are considered in this RIA.

Accounting changes moving from NZ IAS 17 to IFRS 16

For lessees, IFRS 16 removes the distinction between operating and finance leases for accounting purposes. Under IFRS 16, lessees are required to recognise on their balance sheet a new asset, being the right to use the leased asset for the lease term, and a lease liability representing the obligation to pay rentals.

[2] Refer to footnote 1 for an explanation of who is required to follow IFRS 16.

[3] IFRS 16 can also be applied for earlier periods for entities that choose to do so and meet certain other criteria.

[4] Real property is not specifically defined but generally relates to land and buildings.

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This RIA does not attempt to explain how accounting expenditure is calculated under IFRS 16; however, there is usually a slight acceleration of deductions compared to accounting under NZ IAS 17. This can be shown in the following simplified example for a 5-year lease, that was an operating lease under NZ IAS 17, with $100,000 per year of lease payments and a 3.7237%[5] discount rate:

Year	NZ IAS 17 Expenses	IFRS 16 Expenses
1	100,000	106,439
2	100,000	103,337
3	100,000	100,120
4	100,000	96,783
5	100,000	93,322
Total	500,000	500,000

The NZ IAS 17 treatment matches the cashflows of the lease, whereas IFRS 16 more closely matches the economic cost of the lease. The IFRS 16 treatment can be thought of similar to a typical fixed-rate mortgage where total payments are consistent over time, but the interest expenditure is higher in earlier periods when the loan is higher, and the interest expenditure is lower (and therefore capital repayments are higher) near the end of the loan when the amount outstanding is lower. Capital repayments are not deductible; however, for an IFRS 16 operating lease, the capital has been applied to acquire the right to use the asset which is deductible as depreciation over the term of the lease.

IFRS 16 does not significantly change the accounting treatment of leases for the lessor. The lessor will continue to reflect the leased asset on their balance sheet for operating leases. This RIA does not consider changes to the tax treatment of the lessor.

Policy opportunity

The introduction of IFRS 16 provides an opportunity to more closely align the tax treatment of lessees' operating leases with the new accounting treatment. This has two main objectives:

- Efficiency - As finance leases and debt used to purchase assets is already taxed under the financial arrangements rules deductions are accelerated similar to the IFRS 16 example above. Aligning the tax treatment of operating leases with the IFRS 16 treatment will make the tax treatment of all three methods of asset acquisition more similar which will reduce the tax incentive to choose one method over another to obtain a tax advantage.
- Compliance costs - Unlike when entities followed NZ IAS 17, an entity following IFRS 16 will need to make tax adjustments to remove accounting deductions and claim tax deductions. By following IFRS 16 for tax the number of adjustments required could be reduced and therefore compliance costs would be lower as would be the possibility of inadvertent error.

[5] This is the same rate used to forecast the fiscal impact of the proposals as discussed in the Key Limitations or Constraints on Analysis section of this RIA.

Timing cost

As shown in the example above, total deductions under both NZ IAS 17 and IFRS 16 are identical; however, when broken down they are slightly higher in earlier years and slightly lower in later years under IFRS 16. Accelerating the timing of deductions in this way results in a permanent fiscal cost to the Crown. The appendix to this RIA provides an example to explain how this cost arises.

2.2 Who is affected and how?

Businesses seeking to acquire an asset have a choice of financing structures including outright purchase (often funded by borrowing), finance leases and operating leases. IFRS 16[6] provides an opportunity to more closely align the tax treatment of operating leases with how finance leases and debt funded asset purchases are treated. This will reduce the tax incentive for businesses to acquire assets under a particular structure due to their different tax treatment.

More closely aligning tax and accounting treatments also reduces the compliance costs of having to make tax adjustments and reduces the chances that these adjustments will inadvertently be made incorrectly.

All IFRS taxpayers consulted supported alignment of tax with accounting for these reasons, provided it was on an optional basis.

2.3 Are there any constraints on the scope for decision making?

There is a distinction in the tax treatment between operating and finance leases and there was previously a (slightly different) distinction in the accounting treatment between operating and finance leases. The adoption of IFRS 16 has removed this distinction for accounting purposes. Officials consider the tax distinction between operating and finance leases is well understood and working as intended so removing or amending this boundary has not been considered. Instead, the project has been limited to changes aimed at simplifying the tax treatment of leases that would have previously been, and will continue to be, classified as operating leases for tax.

While there are undoubtedly benefits of aligning tax with IFRS 16 for affected taxpayers, early discussions with stakeholders identified that taxpayers wanted alignment to be optional rather than compulsory. As this project is intended to be a taxpayer favourable simplification all of the options in this RIA are for optional alignment rather than applying to all IFRS taxpayers. While this will marginally reduce efficiency, officials do not expect this to be material, especially given the small number of IFRS taxpayers expected not to elect.

[6] Refer to footnote 1 for an explanation of who is required to follow IFRS 16.

While allowing non-IFRS taxpayers to follow an IFRS 16-type treatment for tax would also offer efficiency benefits, officials have not considered extending this treatment to non-IFRS taxpayers. This is because IFRS 16 calculations are relatively complicated and are not required for accounting purposes for non-IFRS taxpayers so requiring or allowing them for tax would require complex calculations solely for tax purposes. This would have a high compliance cost that would outweigh any efficiency benefit available.

Section 3: Options identification

3.1 What options have been considered?

The following criteria were used to assess the options considered:

- *Efficiency*: the option should align with the economic substance and the accounting treatment of tax operating leases as much as possible.
- *Sustainability*: the option should follow existing income tax deductibility principles and should not offer a more favourable treatment compared with that available to non-IFRS taxpayers.
- *Compliance costs*: the compliance cost should be minimised as far as possible.

Option 1: Status quo

This option would retain the existing cashflow treatment of operating leases for lessees who are IFRS taxpayers. Once IFRS taxpayers adopted IFRS 16 they would be required to make tax adjustments to reverse accounting expenses and claim deductions consistent with the current treatment.

This would not provide any of the benefits of alignment. Compliance costs may (depending on specific decisions and taxpayer circumstances) be lower than under some variants of option 3 but would be higher than under option 2 or option 4.

Option 2: Full alignment

This option would allow lessees to claim tax deductions equal to their accounting expenditure under tax operating leases.

This would provide the highest level of efficiency, and compliance cost savings, as it would fully align tax and accounting. However, it would not be sustainable – it would offer a significant more favourable treatment that that available to non-IFRS taxpayers and would have a significant fiscal cost (estimated at approximately $400 million[7]).

[7] As with the cost estimates for Option 3 and Option 4 this cost is the total cost of this option over all time periods. The time period is dependent on the transitional period chosen which has agreed to be 5 years. Changing the transitional period changes the period the cost arises over but doesn't change the total cost. There are no costs beyond this transitional period. Refer to the appendix of this RIA for a more detailed explanation.

Option 3: Full alignment with adjustments

This option would allow lessees to mostly claim tax deductions equal to their accounting expenditure under tax operating leases but would require them to make adjustments to recognise the tax principle that tax deductions should (generally) be available only when expenditure is incurred. This is in contrast to a number of items included in IFRS 16 lease expenditure, such as fair value impairments[8] – which are closer to a provision and provisions are not usually deductible – and make good costs[9] – which are spread over the (remaining) term of the lease rather than when the expenditure is incurred.

This would have similar, or slightly lower, sustainability than option 4. However, it would have a fiscal cost of approximately $89 million assuming all IFRS taxpayers elected to align tax and accounting. It would significantly increase compliance costs as the calculation of adjustments would be complex and would have to be regularly updated. This increase in compliance costs would likely result in many taxpayers choosing not to align tax and accounting as the compliance costs could outweigh the benefits. If the proportion of taxpayers choosing to align tax and accounting was similar to option 4 then this option would have higher efficiency (due to the coverage of more leases); however, due to the increased compliance costs its likely less taxpayers would choose to align resulting in lower efficiency than option 4.

Option 4: Partial alignment with adjustments

This option is the same as option 3 except it would exclude operating leases for real property which would continue to be deductible under the current tax treatment. Real property is a term within the leasing rules and takes its ordinary legal meaning. It can be thought of as land and buildings. A lease of real property cannot be a finance lease for tax purposes even when the terms of the lease would otherwise make it so. Many businesses will have more non-real property leases than real property leases. However, real property leases are typically for longer terms and over higher value assets, so the total value of real property leases is expected to be far higher.

This option does not capture the full efficiency benefits due to its narrower scope of covered leases so is worse than option 2 based on this criterion but still higher than option 1 (which does not align at all) and option 3 (due to the expected low take-up of the optional alignment). This option has significantly lower compliance costs than option 3 as most of the adjustments that would be required under option 3 would not frequently arise in non-real property leases (for example, businesses often must restore a commercial building at or before the end of the lease whereas they don't have to do this with a vehicle lease). It is the most sustainable as it is not significantly more favourable compared with the treatment by non-IFRS taxpayers and also has the lowest cost (approximately $9 million) of any option other than the status quo.

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[8] Fair value impairments are recorded as an accounting expense when the value of the asset to the business is less than that recognised in the accounts. For example, when a business is contracted to keep making lease payments on a building but no longer wants to operate from that site.

[9] Make good costs are the estimated costs of restoring an asset before it can be returned to the lessor. For example, removing fitout from a building.

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3.2 Which of these options is the proposed approach?
Option 4 is the preferred option. It will align tax and accounting for the greatest number of leases given the constraints of not creating a significantly more favourable set of rules for IFRS taxpayers that is not available to other businesses. This option will minimise compliance costs to the extent possible as it is expected that a high proportion of eligible taxpayers will elect to follow it. We have not attempted to estimate what proportion would choose to align tax and accounting but as the rules will reduce compliance costs and marginally bring forward deductions there will be few reasons not to elect to align. The forecasts conservatively assume that 100% of eligible taxpayers will elect to do so. There are no areas of incompatibility with the Government's 'Expectations for the design of regulatory systems'.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Lessees who follow IFRS and elect to follow the accounting treatment for tax	Need to monitor accounting entries that must be adjusted for tax	Low – will require ongoing monitoring but few adjustments are expected for non-real property leases
Wider government	Permanent reduction in tax revenue from deductions being brought forward	$9m over 5-year transitional period. No costs for years after this.
Total Monetised Cost	Reduction in tax revenue	$9m over 5 years.
Non-monetised costs	Ongoing monitoring of tax adjustments	Low

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Expected benefits of proposed approach, compared to taking no action		
Lessees who follow IFRS and elect to follow the accounting treatment for tax	Removal of need to adjust between accounting and tax deductions Timing benefit from deductions being brought forward so tax will be paid slightly later[10] Reduction in tax incentive to enter into different acquisition structures	Medium Medium Medium
Inland Revenue	Reduction in monitoring of tax adjustments for operating leases	Low – some adjustments will still be required but the number of adjustments will be significantly reduced.
Total Monetised Benefit	None	N/A
Non-monetised benefits	Marginal acceleration of lease deductions Reduction in compliance costs for lessees to comply with tax obligations and reduction in administration costs for Inland Revenue reviewing this treatment.	Figure unable to be quantified on an individual lessee basis Medium

4.2 What other impacts is this approach likely to have?
None identified.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Officials undertook targeted consultation with large corporates who enter into operating leases, their advisors, and relevant representative groups.

Stakeholders were supportive of the simplification benefits of more closely aligning tax and accounting for operating leases for IFRS taxpayers provided this was on an optional basis (as the preferred option does and as discussed in section 2.3 above).

Stakeholders generally sought a full alignment with few, and preferably no, adjustments from the accounting position on the basis this would minimise compliance costs. For the reasons

[10] This cost is permanent to the Crown as it considers the economy as a whole where new leases are always entered into (refer to the appendix of this RIA for more explanation). In contrast, taxpayers enter individual leases where the benefit is only the slight acceleration of deductions but the same total deductions over the life of the lease, so this has only a timing benefit.

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set out above we do not recommend a full alignment. However, the exclusion of real property leases is likely to significantly reduce the number of adjustments that will be required. There have been varying degrees of support from individual stakeholders on the decision to exclude real property.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The proposals will require amendments to the Income Tax Act 2007 which could be included in the next available tax omnibus bill expected to be introduced in early 2020. This bill is unlikely to be enacted before late 2020 or early 2021 which is after the application date of IFRS 16 – on or after 1 January 2019.

For the earliest possible balance date that IFRS 16 would apply to, of 31 December, the first tax year following IFRS 16 will end on 31 December 2019. This is the 2019/20 tax year and the relevant return will be due to be filed by 31 March 2021 for taxpayers with an extension of time for filing their returns.

Therefore, in most instances, affected taxpayers will have started their first-year accounting under IFRS 16 before the enactment of the bill containing the proposals but will not file a tax return until shortly after the enactment of that bill.

For a taxpayer who chooses not to elect to align tax and accounting in the 2019/20 year, they should be able to elect to do so in any subsequent year. But all taxpayers, once they elect to align tax and accounting treatment, should be required to do so in all future years where they follow IFRS for accounting purposes.

When a taxpayer chooses to elect to follow the accounting treatment for tax purposes this will usually result in a one-off deduction (arising from deductions that would have been available had the taxpayer been able to follow IFRS 16 in previous periods but were not available under the previous treatment). In order to manage the fiscal cost of this transition to the Crown, we suggest this deduction is spread over the year of adoption and the following four years. Consulted stakeholders have been supportive of this approach.

Inland Revenue will release details of the Cabinet decision once it is made and further detail will be provided in a commentary released when the Bill is introduced and will also be included in the Tax Information Bulletin after the Bill is enacted.

Inland Revenue will be responsible for the ongoing monitoring and enforcement of the rules.

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Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
No specific data collection or monitoring is expected. Inland Revenue maintains a close relationship with many of the small number of affected large taxpayers and has a specific contact for IFRS issues. Any issues with the proposals or their post enactment implementation are expected to be identified through these channels or through contact with Policy staff.

7.2 When and how will the new arrangements be reviewed?
• *How will the arrangements be reviewed? How often will this happen and by whom will it be done? If there are no plans for review, state so and explain why.* • *What sort of results (that may become apparent from the monitoring or feedback) might prompt an earlier review of this legislation?* • *What opportunities will stakeholders have to raise concerns?*
The final step in the Generic Tax Policy Process is the implementation and review stage, which involves post implementation review of legislation, and the identification of remedial issues. A post implementation review could occur around 12 months after implementation. Any recommended changes identified from the review would be considered for potential inclusion on the Government's tax policy work programme.

Appendix: Timing cost example

As referred to in section 2.1, this example explains how a permanent reduction in tax revenue arises from the acceleration of lease deductions even where total deductions for each lease are unchanged.

Assume, each year a three-year lease is entered into with $100 of deductions each year. The total deductions will be $300 each year as follows:

Year	1	2	3	4	5	6	7
Lease 1	100	100	100				
Lease 2		100	100	100			
Lease 3			100	100	100		
Lease 4				100	100	100	
Lease 5					100	100	100
Lease 6						100	100
Lease 7							100
Total			**300**	**300**	**300**	**300**	**300**

Instead, assume the timing of deductions is changed to $105, $100 and $95 for all leases starting from lease 4.

Year	1	2	3	4	5	6	7
Lease 1	100	100	100				
Lease 2		100	100	100			
Lease 3			100	100	100		
Lease 4				105	100	95	
Lease 5					105	100	95
Lease 6						105	100
Lease 7							105
Total			**300**	**305**	**305**	**300**	**300**

This shows that annual deductions start at $300 and return to $300 in year 6 onwards but in years 4 and 5 increase to $305. This $5 increase in deductions, if taxable at 28%, would permanently decrease tax revenue by $1.40 for both year 4 and year 5.

If, in a future year, leases were no longer entered into this cost would reverse as there would be less deductions available. However, on an economy wide basis it is reasonable to assume that leases will continue to be entered into so this cost should be treated as permanent.

Detail decisions such as whether to apply to existing leases or to spread a transitional adjustment over multiple years will affect the year the fiscal cost arises in but will not alter the total cost of the decisions in this RIA.

Due to inflation and economic growth it would be more accurate to assume a small increase in lease payments each year rather than this example's static lease payments. The consequence of such an assumption would be to create a small ongoing cost from an acceleration of lease deductions. However, this effect is not expected to be significant so has been omitted from the analysis.

Impact Summary: Land tax rules review 2019 – habitual buyers & sellers

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Regulatory Impact Assessment (RIA), except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by Cabinet.

Key Limitations or Constraints on Analysis

There are a number of limitations or constraints. These are:

- There is no data to confirm that the issues the policy proposals are intending to address are currently a problem. Instead, officials have identified a gap in the current legislation that may be exploited by taxpayers considering recent and ongoing changes to tighten the rules for taxing land disposals. On that basis, officials consider that it is important to address these issues at this time.
- Options have been limited to considering making the current framework more effective. Officials did not consider options that would tax more categories of land.
- The lack of data on the scope and scale of taxpayer practices and structuring makes it difficult to determine which options best address the problem.
- The lack of data means that no qualitative impact analysis is possible. However, problem definition and solutions were subject to targeted and public consultation.

Quality Assurance Reviewing Agency:

Inland Revenue

Quality Assurance Assessment:

The Quality Assurance reviewer at Inland Revenue has reviewed the *Land tax rules review 2019 – habitual buyers & sellers* RIA and considers that the information and analysis summarised in it **partially meets** the quality criteria of the Regulatory Impact Analysis framework.

As identified in the Key Limitations or Constraints on Analysis section there is no data to support the current scale of the problem or the impact of the proposed changes if they were

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enacted. However, the RIA sets out the rationale for why the status quo is an issue and why a regulatory change is preferred. The reviewer considers that the information in the RIA is as complete as could be expected and identifies the main risks and uncertainties.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of this RIA have been incorporated into this version.
Responsible Manager (signature and date):
 Peter Frawley Policy Lead Policy and Strategy Inland Revenue 19 November 2019

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

This RIA considers proposals to tighten the rules that apply where people regularly buy and sell land that is used mainly as a home or business premises while it is held by them.

Current situation

The land sales rules contained in part CB of the Income Tax Act 2007 tax gains from the sale of land when the land is held by a person effectively as trading stock (in the same way that a furniture vendor is taxed on the gains they make from selling their furniture). It is not intended that the rules tax gains on capital assets (e.g. gains from selling the furniture vendor's shop or a person's home). However, the rules are drafted quite broadly to ensure that people cannot easily structure around them, which means they can catch some land that is inherently a capital asset.

To limit this potential overreach, the rules contain exclusions. Relevantly, the rules exclude from tax gains from the sale of:

- a person's main home, where land sales are subject to tax under the bright-line test[1] (the main home exclusion)
- a person's residence, where land sales are subject to tax because the land was acquired with an intention of disposal, or where the owner or an associated person is in a business involving land (the residential exclusion)
- a business premises, where land sales are subject to tax because the land was acquired with an intention of disposal, or where the owner or an associated person is in a business involving land (the business premises exclusion).

For example, the land sales rules tax all sales of land by a land dealer, but the exclusions ensure the dealer will not be taxed on the sale of their home.

To ensure these exclusions are not abused, they are subject to regular pattern restrictions which stop the exclusions applying where a person has a regular pattern of buying and selling land used as a main home, residence or business premises. The regular pattern restriction in the main home exclusion for the bright-line test is also supplemented by a time-period rule, which states that the main home exclusion will not apply if a person has relied on it twice in the previous two years.

These restrictions ensure that people who regularly buy and sell land effectively as trading stock cannot rely on the exclusions to escape tax.

Why is the current situation a problem?

Given the recent tightening of the land rules[2] there is a concern that taxpayers can avoid the regular pattern restrictions by arranging their affairs so they do not have a pattern of buying and selling main homes, residences or business premises. This is contrary to the policy intention.

[1] The bright-line test taxes gains from the sale of residential land acquired and sold within five years.

[2] Including the introduction of the bright-line test and the new residential rental ring-fencing rules that only allow deductions to be offset against income derived from land (e.g. rental income).

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The risk is that the government is missing out on tax revenue from those that are effectively making trading profits from the buying and selling of land, but are relying upon the main home, residential or business premises exclusions to escape tax. Over time there is a risk that greater numbers of investors may become involved in trading homes and business premises to take advantage of the tax-free gains. We are unable to estimate the size of the current tax gap or how this could change with increased investor activity.

The general anti-avoidance rule (GAAR) will continue to effectively override other provisions of the tax legislation to deny the tax benefits of an arrangement where a more than incidental purpose of the arrangement is to obtain a tax benefit. In some circumstances the GAAR could be invoked where a taxpayer has structured their affairs in such a way that they have avoided establishing a regular pattern of purchase and sale of home or business premises.

However, in many circumstances the GAAR may not be the most effective tool to counter such structuring. It is considered preferable for there to be clarity and transparency in the underlying law to give certainty to both taxpayers and Inland Revenue.

What is the underlying cause of the problem?

Officials have concerns that the current regular pattern restrictions are not working as intended. This undermines the integrity of the tax system by allowing people to take advantage of the exclusions in circumstances where this was not intended.

As the restrictions are currently drafted, taxpayers who are undertaking regular buying and selling activity can structure around the regular pattern restrictions in one of two ways.

Firstly, the regular pattern restrictions apply quite narrowly to the activities of a single person. This allows taxpayers to circumvent the application of the regular pattern restrictions by buying and selling land using different persons or entities each time (for example, the first property is purchased by the person, the second is purchased by their partner, the third by their family trust).

Secondly, the regular pattern restrictions have been interpreted narrowly to apply only when there is a similarity or likeness between the transactions (for example, a pattern of buying land, building a home on the land and then selling). This means that the regular pattern restrictions will not apply where a person does something different to each piece of land. For example, the first property is bought, lived in and sold, the second is renovated while it is lived in and sold, or the third is a bare section where a house is built and occupied then sold.

Why does it need to be addressed now?

The Government has indicated that people who engage in property speculation will come under increasing scrutiny. This is why a review of the land rules was added to the Government's Tax Policy Work Programme earlier in the year. One of the aims of this review is to consider ways to improve the integrity of the tax system.

How much confidence is there in the evidence and assumptions for the problem definition?

While there is currently no data, to the extent that there is currently a gap in the current land rules, it is reasonable to assume that some investors will look to exploit the existence of tax-free gains.

Other context

The issues considered in this RIA have been identified as part of a review of the current land tax rules undertaken by Inland Revenue. As part of this review, other regulatory changes

have been identified, including:

- clarifying the extent to which holding costs (such as interest, rates and insurance) should be deductible when the gain from the sale of private use land (such as a bach) is taxable; and
- moving the requirements of the Land Transfer Tax Statement (a form filed with Land Information New Zealand (LINZ) when people buy, sell or transfer property) from the Land Transfer Act 2017 to new secondary regulations operated by LINZ to provide a more flexible way to make any future changes to the form.

A second tranche of the land review is planned which will include consideration of the following:

- extending the bright-line test to farmland and commercial properties;
- extending Residential Land Withholding Tax to New Zealand residents;
- reviewing the re-zoning rule;
- reviewing the land tax frameworks;
- considering the introduction of a vacant land tax; and
- various compliance and administration matters.

2.2 Who is affected and how?

The group of people potentially affected by tightening the rules are taxpayers who regularly buy land to be used mainly as a home or business premises and then sell that land.

The proposed regulatory changes seek to clarify and support, rather than depart from, existing policy in the area by ensuring that the regular pattern restrictions apply to people who regularly buy and sell land to stop them escaping tax.

2.3 Are there any constraints on the scope for decision making?

The Government announced in April 2019 that it would not be proceeding with a capital gains tax, but that other initiatives to improve the fairness of the tax system would be considered, including tightening the rules around land speculation and working on ways to counter land banking.

Section 3: Options identification

3.1 What options have been considered?

This RIA deals with proposed regulatory changes to tighten the rules that relate to regular buying and selling of homes and business premises to ensure people cannot escape paying tax by relying on the exclusions where that was not intended. The proposals have arisen in the context of the review of the current land tax rules, to meet the Government's objectives of improving the efficient use of land, and ensuring that tax settings are fair, balanced, and encourage and support productive investment.

All options are assessed against the following criteria:

a) **Integrity of the tax system:** the tax rules should operate so as to collect revenue where intended.

b) **Effectiveness:** the tax rules should produce the right amount of tax at the right time; the potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.

c) **Fairness:** the tax rules should not be arbitrary and should be fair to different taxpayers.

d) **Certainty and simplicity:** the tax rules should be as clear and simple as possible so that taxpayers who attempt to comply with the rules are able to do so.

Increasing the integrity of the tax system is a primary objective of these changes. However, it is necessary to balance this objective against ensuring that the rules are effective, fair and balanced, and that they provide certainty and simplicity for taxpayers.

Group of persons or entities

The current regular pattern restrictions apply when a single person (which includes a company, trust or other entity type) has a pattern of buying and selling. This limited application gives rise to a risk that taxpayers can structure around the regular pattern restrictions by using other persons or entities to carry out each transaction, rather than carrying out multiple transactions on their own.

Option 1: Status quo

The first option is to maintain the status quo, so the regular pattern restrictions continue to apply only to the actions of a single person.

This option undermines the integrity and effectiveness of the tax system because it allows taxpayers to structure around the rules to avoid tax. It also unfair as it benefits those taxpayers who are willing and able to structure around the rules.

However, remaining with the status quo could be said to be a simpler option, and would avoid the need for more complex rules.

Option 2: Extend the regular pattern restrictions to groups of people

The second option is to expand the regular pattern restrictions to apply to groups of people, as follows:

- For the residential exclusion, a group of people will be undertaking buying and selling activity together if they all occupy all of the properties as their residence, or if the people who occupy all of the properties as their residences control the trusts or other entities that own the properties.
- For the business premises exclusion, a group of people will be undertaking buying and selling activity together if they are all controlled by the same person or persons (e.g. all the companies have the same shareholders).

This option will protect the integrity and effectiveness of the tax system by ensuring that people cannot structure to avoid their tax obligations. It will also ensure that taxpayers pay their fair share of tax.

However, these changes will introduce further complexity to the rules.

Similar activities

The current regular pattern restrictions have been interpreted as only applying when there is a similarity or likeness in the transactions. There is a concern that this allows taxpayers to structure around the regular pattern restrictions by carrying out different activities on each piece of land so there is not sufficient similarity or likeness in the transactions.

Option 1: Status quo

The first option would be to maintain the status quo.

This option undermines the integrity and effectiveness of the tax system because it allows taxpayers to structure around the rules to avoid tax. It is also unfair as it benefits those taxpayers who are willing and able to structure around the rules.

Option 2: Focus on regularity of transactions

The second option is to amend the rules to capture patterns of buying and selling, with the focus being on the regularity of the transactions, rather than on the similarity or likeness of what is done on the land.

This option will protect the integrity and effectiveness of the tax system by ensuring that people cannot structure to avoid their tax obligations. It will also ensure that taxpayers pay their fair share of tax.

This option will reduce complexity and add clarity to the legislation by simplifying the factors that must be satisfied before the restriction will apply.

Intention test

The residential and business premises exclusions currently apply both:

- when a person acquired land with a purpose or intention of disposal or for business involving land; and
- for disposals of land within 10 years when a person is associated with a person who carries on a business involving land.

Therefore, it is possible that the current regular pattern restrictions could result in a person who is associated with a land dealer being taxed on the sale of their home or business premises because they have been forced to move for family or business reasons several times over a couple of years.

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It has been proposed by submitters that the regular pattern restrictions could be limited to situations where the land has been acquired with a purpose or intention of disposal.

Option 1: Status quo

The first option is to maintain the status quo and continue to apply the regular pattern restrictions to situations where a person is associated with a person in a business involving land.

In the context of the other proposed amendments, this option has the potential to be unfair, because it risks capturing sales of genuine homes and business premises. The potential for unfairness undermines the integrity of the tax system, and heightens the risk of tax avoidance and evasion as taxpayers seek to escape a tax they consider unfair.

However, retaining the status quo could be seen as being simpler as it applies the same rules to all taxpayers who are subject to the exclusions.

Option 2: Introduction of intention test

The second option is to limit the application of the regular pattern restrictions to situations where the owner of the land acquired it with an intention of disposal.

This option improves the integrity of the tax system in that it helps to ensure the rules only operate to collect revenue where intended. It also improves the effectiveness and fairness of the tax system by only taxing true revenue gains.

The introduction of a further limitation will, however, add some complexity to the rules.

Amending the business premises regular pattern restriction

The business premises exclusion applies only where the owner of the land mainly uses the land to carry on a substantial business. Because the business premises exclusion is limited in this way, it has been suggested by submitters that it is already hard to structure around and does not require amendment to cover activities by a group of people.

Option 1: Status quo

The first option is to maintain the status quo.

This option is simple because it will not require complex grouping rules.

However, this option risks allowing taxpayers to structure around the regular pattern restriction, which reduces the integrity and effectiveness of the tax system. It could also be argued that not amending the business premises exclusion if the residential and main home exclusions are amended (as proposed above) would be unfair in that it would allow those owning land for business purposes advantages over those owning land for residential purposes.

Option 2: Amend the business premises regular pattern restriction

The second option is to amend the regular pattern restriction in the business premises exclusion to apply when a person, or a group of people or entities that are all controlled by a person or group of persons, regularly buy and sell land used as business premises.

This option would improve the integrity, effectiveness and fairness of the tax system by ensuring that taxpayers cannot avoid tax by using separate entities to carry on buying and selling activities where those activities would be subject to tax if they were carried on by one

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person alone. By doing so, it will better ensure that the right amount of revenue is collected over time.

This option also improves clarity for taxpayers by clearly indicating activity that should be subject to tax.

This option will, however, not be simpler because it will require relatively complex rules to capture the intended group of people or entities.

Time-period rule

The regular pattern restriction in the main home exclusion for the bright-line test is supplemented by a time-period rule, which states that the main home exclusion will not apply if a person has relied on it twice in the previous two years. This time-period does not appear in the residential and business premises exclusions. To attempt to provide clarity and objectivity, a similar time-period rule could be added to the residential and business premises exclusions.

Option 1: Status quo

The first option is to maintain the status quo and have no time-period restrictions in the residential and business premises exclusions.

This option is simple but leaves uncertainty in the rules because the current rules are subjective making them harder to apply.

However, this option is more likely to maintain the integrity of the tax system by ensuring that transactions would not be subject to tax simply due to volume. In doing so, it would also ensure that the rules are perceived to be fair.

Option 2: Add time period restrictions

The second option is to add time-period restrictions (i.e. the exclusions will not apply if they have been used twice in two years) to the residential and business premises exclusions.

This option could add clarity to the rules because it would introduce an objective test to apply. However, introducing an extra provision decreases the simplicity of the rules.

However, this option could reduce the integrity of the tax system as it risks taxing sales of genuine homes and business premises merely due to the level of transactions undertaken with no consideration given to the person's intention.

3.2 Which of these options is the proposed approach?

Officials consider that the following amendments to the regular pattern restrictions are the best options to resolve the issue:

Group of persons or entities

Recommendation: Option 2 - Extend the regular pattern restrictions to groups of people

The regular pattern restrictions should be extended to apply to a person or a group of persons that undertake buying and selling activity together:

- For the residential exclusion, a group of people will be undertaking buying and selling activity together if they all occupy all of the properties as their residence, or if the people who occupy all of the properties as their residences control the trusts or other entities that own the properties.
- For the business premises exclusion, a group of people will be undertaking buying and selling activity together if they are all controlled by the same person or persons (e.g. all the companies have the same shareholders).

This will protect the integrity and effectiveness of the tax system by ensuring that people cannot structure to avoid their tax obligations. It will also ensure that taxpayers pay their fair share of tax.

Similar activities

Recommendation: Option 2 - Focus on regularity of transactions

The regular pattern restrictions should be extended to apply more broadly to any pattern of buying and selling land used as a residence or business premises. It should not matter whether properties were simply bought and sold, or whether any building or renovation work occurred while the person owned the land. What should be relevant is that there are “regular” transactions (that is, the transactions occur at sufficiently uniform or consistent intervals).

This will ensure that the regular pattern restrictions are no longer restricted to applying only where there is a similarity or likeness between the transactions (for example, a pattern of buying land, building a home on the land and then selling). This will increase the integrity of the tax system.

Intention test

Recommendation: Option 2 - Introduce intention test

The regular pattern restrictions in the residential and business premises exclusions should be targeted so they only apply where the person acquired the land with an intention of disposal.

Expanding the regular pattern restrictions gives rise to an increased risk that they could catch ordinary residential transactions that occur for family reasons, and small businesses who are upgrading as their business grows because the person is, or is associated with, a person in a business involving land. Officials consider that the regular pattern restrictions should be limited to ensure that people who regularly buy and sell land effectively as trading stock cannot use the home or business premise exclusions to escape tax.

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This option improves the integrity of the tax system in that it helps to ensure the rules only operate to collect revenue where intended. It also improves the effectiveness and fairness of the tax system by only taxing true revenue gains.

Amending the business premises regular pattern restriction

Recommendation: Option 2 - Regular pattern restriction in the business premises exclusion should be amended

The regular pattern restriction in the business premises exclusion should be amended to apply to activities by a group of people or entities.

Under the current rules, a single person cannot escape tax by using land acquired as trading stock as a business premises while they hold it. This outcome should not be able to be structured around by using a group of entities controlled by a person. The proposed changes will ensure this is the case.

The main concern raised by submitters appeared to be the concern of overreach. Officials consider that this risk is mitigated by limiting the regular pattern restrictions, so they only apply when land is acquired with an intention of resale.

Time-period rule

Recommendation: Option 1 - Status quo

A time-period rule such as that included in the bright-line main home exclusion is not appropriate for the residential and business premises exclusions.

In the context of the bright-line test, which taxes sales without consideration of intention, presuming the exclusion should not apply simply because there were multiple transactions within a defined period can be justified. However, regularity alone should not be enough to give rise to a taxable transaction under the other provisions. Instead, it is important that the owner also has an intention of disposal.

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Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Taxpayers who regularly buy land, use it as a main home, residence or business premises and then sell it, structuring the transactions around the regular pattern restrictions as the legislation is currently drafted	Will need to return the disposal of land for tax purposes. There will be an increase in income tax paid, however, this is difficult to quantify Possible decrease in number of houses purchased, renovated and then sold within a short space of time	Cannot be quantified Cannot be quantified
Regulators	It is expected that the changes can be managed as part of Inland Revenue's business as usual legislative change. Therefore, no additional funding is required to support this change.	Nil
Total Monetised Cost		Increase in income tax paid but unable to be quantified
Non-monetised costs		Possible decrease in houses being renovated; possible decrease in number of houses being sold (unquantifiable)
Expected benefits of proposed approach, compared to taking no action		
Wider government	The policy changes will be fiscally positive. However, the impact cannot be quantified.	Increase in tax (unable to be quantified)
Total Monetised Benefit		Increase in income tax paid but unable to be quantified
Non-monetised benefits		*N/A*

4.2 What other impacts is this approach likely to have?
There are no other identified impacts of this approach.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Consultation document

Officials issued a consultation document "Habitual buying and selling" in September 2019 setting out the issues and proposing possible solutions and asked for taxpayers' views on the proposals. Prior to releasing the document publicly, officials also tested their thinking with some private sector advisors.

Feedback

In general, submitters appear to understand officials' concerns that taxpayers can structure around the regular pattern restrictions, and most supported changes in the area. However, almost all submitters expressed concerns about the potential for overreach from the proposed amendments and, in particular, that the amendments risk taxing transactions that should not be subject to tax (i.e. sales of genuine homes or business premises).

Submitters also disagreed with proposals to amend the regular pattern restriction in the business premises exclusion. They submitted there was no evidence of any abuse of that exclusion.

Submitters could see that a time-period rule may be useful to supplement the regular pattern restriction in the residential exclusion. However, there was concern that a time-period rule would be arbitrary and could not accommodate factors outside a person's control.

Submitters' views and concerns were taken into account by officials in forming the preferred views discussed above. In particular, officials addressed submitters' concerns around overreach i.e. that the proposals risk taxing the sale of homes or business premises for genuine reasons. In response to those concerns, officials propose to target the regular pattern restrictions to situations where there is an intention of resale.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The proposals will require amendments to the Income Tax Act 2007 which could be included in the omnibus tax Bill scheduled to be introduced in early 2020.

The changes should apply prospectively, i.e. only properties acquired and sold after the application date would be taxable. However, properties acquired before the application date would be able to be considered for the purposes of determining whether a taxpayer has a regular pattern.

Inland Revenue will release details of the Cabinet decision once it is made and further detail will be provided in a commentary released when the Bill is introduced and will also be included in the Tax Information Bulletin after the Bill is enacted.

Inland Revenue will be responsible for the ongoing monitoring and enforcement of the rules.

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Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

Inland Revenue undertakes regular review of land transactions via its Property Compliance Programme (PCP), which is aimed at ensuring that those involved in property dealing or speculation pay their fair share of tax. Inland Revenue undertakes regular reporting to government as part of the PCP.

Inland Revenue is also developing a Data Intelligence Platform (DIP) to enable right-time interaction and appropriate risk-based interventions, by identifying affected customers, understanding customer behaviours and needs, and highlighting areas of compliance focus as well as policy weakness, including how these matters relate to land. The DIP will be able to pull in relevant sources of data and can be used to identify certain types of customer groups, build customer profiles and understand the problem in a wider context. However, as with any other information system it will be dependent upon the personnel, data available and cases run in order to deliver its potential value.

The DIP will continue to be developed to further refine Inland Revenue's ability to target particular transactions including assisting Inland Revenue in monitoring whether the exclusions are operating as intended, and educating taxpayers on the matter as appropriate.

7.2 When and how will the new arrangements be reviewed?

Inland Revenue would closely monitor the effectiveness of the proposed changes as part of the PCP programme.

The final step in the Generic Tax Policy Process is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. A post-implementation review could occur around two years after the tax year that the amendments first apply.

Any recommended changes identified from the review would be considered for potential inclusion on the Government's tax policy work programme.

Impact Summary: Mycoplasma bovis tax issue

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Impact Summary, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing key policy decisions to be taken by or on behalf of Cabinet.

Key Limitations or Constraints on Analysis
Range of options considered A more long-term generic process or provision for handling severe adverse events and future biosecurity incursions affecting livestock has not been considered. Given the timeframe for addressing the current Mycoplasma bovis issue (taxpayers that are clients of tax agents with a valid extension of time are due to file tax returns for the 2018/19 income tax year by 31 March 2020) a specific solution is required as it would not be possible to fully consider a longer-term solution. **Consultation** Consultation has been focussed on discussing the issue and potential solutions with Federated Farmers and Chartered Accountants Australia and New Zealand (CA ANZ). Given the timeframe for addressing this issue other groups have not been consulted at this stage. Officials will consider whether other groups should also be consulted as we work through the detailed design of the proposal before legislation is introduced and at the select committee stage.
Responsible Manager (signature and date):
Geoff Leggett Principal Policy Advisor Policy and Strategy Inland Revenue 26 February 2020

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *Mycoplasma bovis tax issue* RIA and considers that the information and analysis summarised in it **meets** the quality criteria of the Regulatory Impact Analysis framework.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of this RIA have been incorporated into this version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Overview

Some farmers that have had their livestock culled owing to the Government's attempts to eradicate Mycoplasma bovis from New Zealand have faced an unexpected and significant tax liability as a result. This tax liability may impede their ability to replace their culled herd and is contrary to a key principle of the Biosecurity Act 1993 that no person is made better or worse off owing to the Crown's use of its powers under that Act.

Background

Mycoplasma bovis is a bacterium that can cause a range of serious conditions in cattle. The disease may be dormant in an animal – causing no symptoms at all. But in times of stress (for example, calving, drying-off, transporting, or being exposed to extreme weather), the animal may shed bacteria in milk and nasal secretions. As a result, other animals may be infected and become ill or carriers themselves.

The presence of Mycoplasma bovis in New Zealand was first detected in 2017. The Government, in partnership with the dairy and beef sectors, has decided to try to eradicate Mycoplasma bovis from New Zealand. As a result, Biosecurity New Zealand can require all the stock on a farm where Mycoplasma bovis has been found to be culled. In exchange, the Government pays compensation to the affected farmers for the difference between the normal market value of the stock and the amount received when the stock is slaughtered. This compensation is intended to leave farmers in no better or worse position than a person whose property is not directly affected by the exercise of the powers.

To date, around 200 properties have been cleared of stock with a similar number being monitored for the presence of Mycoplasma bovis. These have been predominantly dairy farms although Mycoplasma bovis is increasingly being found on beef farms that acquired young stock from affected dairy farms before the disease was identified. Of the total 90,000 stock culled and compensated for by the end of January 2020, 52,000 were dairy cattle and 38,000 were beef cattle, with the bulk of the beef cattle being from fattening operations rather than breeding operations.[1]

For income tax purposes livestock must be valued annually to establish its opening and closing values as part of determining the cost of sales. A farmer has the choice of several valuation options. Many use the national standard cost (NSC) scheme which values the animals at:

- a standard cost (determined by the Commissioner of Inland Revenue), if the animal is homebred, for the respective age and type of animal that reflects average home breeding costs; or
- at its purchase cost if the animal is purchased.

[1] Fattening operations involve the growing of animals for meat. Such operations have much quicker turnover of stock than breeding operations as the stock will be slaughtered within 1-2 years. Conversely, breeding operations involve the rearing of animals for the ultimate replacement of existing herd animals and the sale of any excess. The quicker turnover of stock for fattening operations means the tax issue discussed in this impact summary is less significant for fattening operations.

A few farmers also use the self-assessed cost scheme which involves farmers using their own farm costs rather than standard costs.

Policy problem in detail

When breeding livestock has been valued under either the NSC scheme or the self-assessed cost scheme, culling the herd can result in a significant and unexpected tax liability that can impede a farmer's ability to restock their farm. This is because the compensation payments plus slaughter receipts are income, and there is no immediate comparable deduction in relation to the replacement stock to offset that income. The replacement stock value for NSC and self-assessed cost purposes is its purchase price and this stock value is only gradually written down (over the next five or so years) as the stock ages and is itself replaced from homebred animals.

Although this is a tax timing issue, there are potential cash flow problems and interest costs for farmers in the meantime that can impede the recovery process.

Simplified example

Cow A with a market value of $1,500 is culled because of Mycoplasma bovis. The farmer receives $1,500 for the cow from a combination of compensation and slaughter receipts.

For tax purposes, as cow A was valued under the NSC scheme at $700, there is taxable income of $800 from its cull.

The $1,500 is used to buy replacement cow B. Under NSC, cow B is valued at its purchase price of $1,500.

Cow B remains in the herd for five years before being slaughtered and is replaced by a cow bred up through the herd (cow C) which has a NSC of $700 (its homebred cost). There is a tax deduction of $800 at that point, being the difference between the cost of cow B and the cost of cow C.

If there had been no Mycoplasma bovis cull, cow A would have remained in the herd and been replaced by the equivalent of cow C with no NSC implications given that both cow A and cow C have a NSC value of $700.

As farmers will have a herd made up of different age cows that will be progressively slaughtered the single $800 deduction in this example will result in a deduction each year when considered on a whole of herd basis.

For fattening stock valued under the NSC scheme or self-assessed cost scheme, the tax issue is less acute as the livestock turn-over much more regularly so that normal tax rules should apply. In that case, or when other valuation methods (such as the herd scheme) are used to value the herd, the income equalisation deposit scheme should provide sufficient flexibility to manage any tax issues.

The income equalisation scheme enables the recognition of income to be deferred by up to five years if the income is deposited into the scheme. The income equalisation scheme will not provide sufficient flexibility to deal with the tax issues created by the culling of breeding animals that are valued under NSC or self-assessed cost because the deposit would need to be withdrawn to pay for replacement stock, at which point the income is recognised.

2.2 Who is affected and how?

The affected parties are farmers that use the NSC scheme or the self-assessed cost scheme to value their breeding stock on hand for tax purposes and have had their herds culled and replaced because of Mycoplasma bovis. Overall, possibly up to 50 farmers to date could have unexpected tax liabilities because they value their dairy and/or beef breeding animals under the NSC or self-assessed cost schemes. The impact is most severe for those with a high proportion of mixed-age cows as, under normal circumstances, they would be relying on holding those animals for several years and on using them to breed replacement stock. Sharemilkers would be particularly affected as their main asset is livestock.

Since very few farmers use the self-assessed cost scheme, because of its complexity, it may be that none of the farmers affected by Mycoplasma bovis are using it. However, if they have there would be a sizeable tax liability as a result of the cull.

Federated Farmers wrote to the Minister of Revenue in December 2019 asking for this issue to be addressed. Chartered Accountants Australia and New Zealand (CA ANZ) also supports the proposals.

2.3 What are the objectives sought in relation to the identified problem?

A core principle of the Biosecurity Act 1993 is that no person should be any better or worse off because of the Crown's use of its powers under that Act. The objective of the proposal is to ensure that farmers are not made worse off because of a tax liability arising from the culling of Mycoplasma bovis infected livestock.

Section 3: Options identification

3.1 What options have been considered?

The following criteria have been used to assess the options:

- Equity – the option should result in farmers using the NSC or self-assessed cost scheme not being made worse off as a result of their herds being culled or better off than farmers who have used other valuation methods.
- Timeliness – the option should be able to be enacted as soon as possible to provide certainty to farmers with culled and replaced herds
- Compliance and administration costs – the option should be as simple as possible.

Option 1: No law change (Status quo)

The status quo would not be an equitable option as farmers using the NSC scheme would face a significant and unexpected tax liability owing to their herds being culled because of the presence of Mycoplasma bovis. This is contrary to the principle of the Biosecurity Act 1993 that no person should be made better or worse off owing to the Crown's use of its powers under that act.

Option 2: Spreading the additional income (preferred option)

Under this option, the additional taxable income arising from culling and replacing a herd would be able to be spread evenly over subsequent income years. This would allow the income to be offset each year by the increased deductions arising from the reducing cost of the stock on hand.

The ideal length of this spread for farmers would be between 5 and 7 years depending on the profile of their herds. Therefore, for simplicity the length of the spread would be 6 years, starting from the income year after the income originally arose.

Certain requirements would need to be met for the income to be spread:

- The business would need to be subject to Biosecurity Security New Zealand requiring a cull of Mycoplasma bovis affected stock.

- Stock would need to be substantially replaced with equivalent stock within a reasonable timeframe, say twelve months. Farmers that choose not to replace their stock after a cull are in a similar position to a farmer that sells their stock to exit the industry.

- The business would need to be a dairy or a beef breeding operation, with the breeding stock valued under the NSC or self-assessed cost schemes.

- Only the income derived from the culling of the breeding stock valued under the NSC or the self-assessed cost schemes could be spread. Income derived from culling fattening stock would not be able to be spread as the tax issue is less acute owing to the more frequent turnover of stock.

- The replacement stock must continue to be valued using, as relevant, NSC or self-assessed cost. This is to ensure that farmers cannot enter the herd scheme on more advantageous terms than those not affected by Mycoplasma bovis.

Analysis of option

This option increases equity as it would ensure affected farmers do not suffer from an unexpected tax burden and associated cash flow issues. This is consistent with the core principle of the Biosecurity Act 1993 that no person should be made better or worse off owing to the Crown's use of its powers under that act.

This option would also be a more timely solution to the problem as it could be announced by the Minister of Revenue prior to the 31 March 2020 due date for 2018/19 income tax returns for clients of tax agents with a valid extension of time. This will help to provide certainty to farmers and their tax advisers.

This option is not expected to have a significant impact on compliance costs for affected farmers. Farmers intending to spread the additional income will be required to advise Inland Revenue when filing their returns so that their files can be manually adjusted.

Given the relatively low number of affected farmers, the costs associated with administering this option for Inland Revenue should be minimal and could be absorbed within existing baselines.

Option 3: Offset the taxable income against the cost of replacement stock

This option would involve offsetting the taxable income against the cost of the replacement livestock, which would essentially write down the purchase price to what the NSC would have been had the incident not occurred.

While this option would conceptually achieve the desired outcome, it would be complex to achieve in practice as it would require an exact matching of the culled stock with the replacement stock, and rules about adjustments where that did not arise. Therefore, this option was not preferred as the option of spreading the income evenly over a number of income years is simpler.

Option 4: Amending the income equalisation scheme

This option would involve enabling deposits made in relation to Mycoplasma bovis to be withdrawn from the income equalisation scheme without being treated as income. This option would compromise the integrity of the scheme and is, therefore, not preferred.

3.2 Which of these options is the proposed approach?

The proposed approach is spreading the additional income arising from culling and replacing a herd affected by Mycoplasma bovis. Spreading the income over the six subsequent income years offsets the income against the expected increased deductions, in effect leaving the farmer in a similar position to if no unexpected income had arisen.

This is the proposed approach as it is the only option that can be implemented in a timely manner and is consistent with the principle of the Biosecurity Act 1993 that no one is made better or worse off owing to the Crown's use of its powers under that Act.

The proposed approach is compatible with the Government's "Expectations for the design of regulatory systems".

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties (Farmers)	Additional compliance costs from informing Inland Revenue that they are spreading the additional income	Low
Regulators (Inland Revenue)	Minimal administration costs that will be absorbed within existing baselines.	Low
Wider government	Upfront fiscal cost of $1.5 million offset by fiscal gains over the following years from already filed returns being adjusted. There will also be a small but unquantified fiscal cost arising from affected taxpayers that have not yet filed returns for the tax year in which the cull occurred, spreading the additional income. This fiscal cost is already included in forecast baselines.	Already filed returns: PV_{2021} = $0.236 million Returns not yet filed: Low but unquantified
Total Monetised Cost		PV_{2021} = $0.236 million
Non-monetised costs		*Low*

Expected benefits of proposed approach, compared to taking no action		
Regulated parties (Farmers)	Cash flow benefit from spreading taxable income over 6 years	Already filed returns: PV_{2021} = $0.236 million Returns not yet filed: Low but unquantified
Total Monetised Benefit		PV_{2021} = $0.236 million
Non-monetised benefits		*Low*

NB. Monetary impacts are calculated by assuming the proposal will result in a fiscal loss of $1.5 million in 2020/21 offset by a gain of $300,000 in each of the following 5 years (as returns are being adjusted the fiscal loss and first year of income being spread will occur in the same fiscal year). A 6% discount rate has been used.

4.2 What other impacts is this approach likely to have?

No other impacts have been identified from the proposed option. Federated Farmers and Chartered Accountants Australia and New Zealand (CA ANZ) will continue to be consulted on the detailed design of the proposal to ensure there are no unintended impacts.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

This issue was raised by Federated Farmers in a letter sent to the Minister of Revenue in December 2019. Since then officials have worked with Federated Farmers and CA ANZ on developing a solution to the issue.

Federated Farmers and CA ANZ both consider that an immediate solution is required and support the proposed income spreading option.

Officials, CA ANZ and Federated Farmers have established a working team to work through the detailed detail of the proposed spreading option.

Given the urgent timeline for addressing this issue the focus has been on consulting with Federated Farmers and CA ANZ. However, officials will consider whether other groups should also be consulted as we work through the detailed design before legislation is introduced and at the select committee stage.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The proposal will require amendments to the Income Tax Act 2007. These amendments would be included in a Supplementary Order Paper (SOP) to an omnibus taxation Bill scheduled to be introduced in April 2020. The SOP would be released at the Finance and Expenditure Committee stage in time for submissions to be made on the proposed amendments. Guidance material will be published on the amendments following the Bill's enactment.

Following Cabinet approving the proposed option the Minister of Revenue will issue a press release advising of Cabinet's decision and the process for affected 2018/19 returns due by 31 March 2020. This will help to provide certainty for farmers and their tax advisers.

Already filed returns

Although the bulk of the impact to date will be in relation to 2018/19 income tax, as the culls began in late 2017, this option would be backdated to include the effects of the cull in the 2017/18 income year. Affected farmers who have already filed returns for 2017/18 or 2018/19 would have the option of applying the spread retrospectively and having their returns reassessed. However, some may instead choose to leave their returns as is as there may be some impact on farmers social assistance entitlements and liabilities if the additional income is now spread. For this to be effective, the Commissioner of Inland Revenue will have to be allowed to make associated adjustments to the farmers' tax positions.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

Inland Revenue will monitor the outcomes to confirm that they match the policy objectives. This will be facilitated by farmers who choose to spread their additional income being required to advise Inland Revenue of their intention to do so.

The proposed option has been developed alongside Federated Farmers and CA ANZ. Officials expect that, once the proposals are enacted, these two groups will raise any concerns affected farmers are having with the rules in practice. Any necessary changes identified as a result would be recommended for addition to the Government's tax policy work programme.

7.2 When and how will the new arrangements be reviewed?

The review will be the monitoring described in section 7.1 above.

Supplementary Analysis Report: Purchase Price Allocation

Section 1: General information

Purpose
Inland Revenue is solely responsible for the analysis and advice set out in this Supplementary Analysis Report (SAR), except as otherwise explicitly indicated. The purpose of this report is to explain the policy rationale and development behind the "purchase price allocation" proposal contained in the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill, as a Regulatory Impact Assessment (RIA) was not required for the proposal. It is a modified version of the approach set out in an officials' issues paper – *Purchase price allocation* – which was released for public consultation in December 2019 with Cabinet's approval. The issues paper functioned as an interim RIA when it was considered by Cabinet and a final RIA was not required as policy decisions were made by the Minister of Finance and Minister of Revenue under delegated authority from Cabinet. Therefore, this SAR has been produced to improve transparency and understanding of the policy as the amendments go through the legislative process.

Key Limitations or Constraints on Analysis
A limitation on the analysis is the absence of precedent for the proposed approach in foreign jurisdictions. However, there is one instance of the approach in current New Zealand statute, and it appears to have worked without problem for many decades. Officials are confident that the approach will achieve the desired outcome, acknowledging that aside from the aforementioned instance, it is untried and therefore less certain.
Responsible Manager (signature and date):
Casey Plunket Special Policy Advisor Policy and Strategy Inland Revenue 27 May 2020

To be completed by quality assurers:

Quality Assurance Reviewing Agency:
Inland Revenue
Quality Assurance Assessment:
The Quality Assurance reviewer at Inland Revenue has reviewed the *Purchase Price Allocation* Supplementary Analysis Report prepared by Inland Revenue, and considers that the information and analysis summarised in the Supplementary Analysis Report meets the quality assurance criteria.
Reviewer Comments and Recommendations:
The reviewer's comments on earlier versions of this draft have been incorporated into the final version. Although this SAR will not be presented to Cabinet it has still been reviewed consistent with the quality assurance framework.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

When business assets are bought or sold, they may be subject to different tax treatments. Some assets, such as land or goodwill[1], are generally held on capital account and are not taxable or deductible. Other assets, such as trading stock[2] and financial arrangements[3], are held on revenue account and are both taxable and immediately deductible. Still other assets – capital assets that are expected to decline in value over time ('depreciable property') – are only deductible over a number of years, in line with their estimated useful lives (if the asset is sold for more than its depreciated value, the excess deductions are clawed back as taxable income).

Parties to a sale of two or more assets with different tax treatments (a 'mixed supply') are required to allocate the total sale/purchase price between the various assets for tax purposes. The allocation determines the vendor's tax liability from the sale, and the purchaser's cost base for claiming deductions in the future. To correctly account for the business going forward, the owner must maintain a schedule for any depreciable assets – which have different depreciation rates – and a register of all the other assets, some of which may be bought or sold separately.

The policy problem is that currently, vendors and purchasers are able to adopt different price allocations that minimise their own tax liabilities, resulting in an overall loss to the revenue base. Moreover, in a small number of cases, parties have been found to adopt different allocations in their tax returns despite having agreed an allocation during the sale process.

The problem stems from the existing legal framework governing purchase price allocation. Under the Income Tax Act 2007, parties are generally required to ascribe market values to the assets transferred. But market value is a range rather than a single value and the parties are not required to use the same market values, other than for trading stock (the specific instance alluded to earlier where a rule akin to the proposed approach – discussed in the next section – is already used). There is also some doubt about how the law applies to a purchaser of depreciable property. Consequently, the vendor can allocate lower amounts to depreciable property and financial arrangements, which are taxable, and higher amounts to non-taxable capital assets, to reduce its tax liability, while the purchaser can allocate higher amounts to depreciable property and financial arrangements in order to maximise its deductions over time.

Since the law does not require consistency, it is difficult for the Commissioner to challenge different allocations that are both based on market values, despite the result being a loss to the tax base. Investigations undertaken by Inland Revenue into a number of large commercial property transactions have revealed discrepancies between vendor and purchaser allocations resulting in overall revenue losses in the millions of dollars. Given the cost and uncertainty of disputes, these losses are often unable to be eliminated. If the status quo continues, such outcomes are likely to recur.

[1] Any excess of the total sale price above the aggregate value of all the assets being sold, attributable to the established reputation of the business.

[2] Items bought and sold regularly in the course of a business, such as books in a bookstore.

[3] Arrangements under which a person receives money in exchange for providing money at a future time, such as loans.

Officials do not consider these discrepancies to be justifiable. In a normal commercial transaction, the vendor and purchaser will take different views of the value of an asset. The vendor will not sell the asset unless it thinks the asset is worth less than the purchaser is willing to pay for it, and the purchaser will not buy the asset unless it thinks the opposite. But the asset is sold and bought for a single price, and that price is the amount taken into account in the tax returns for both parties. There is no obvious reason to depart from this "single price" principle where multiple assets are sold together.

2.2 Who is affected and how?

The purchase price allocation amendments affect vendors and purchasers in mixed supplies – particularly those that do not agree an allocation under current law. Compliant parties to a sale are generally not opposed to alignment between sale and purchase prices but often do not support structured rules that increase compliance costs.

2.3 What are the objectives sought in relation to the identified problem?

The policy objective is to prevent revenue loss arising in mixed supplies – i.e. promote "revenue integrity" – while keeping any additional compliance and administration costs and disruption to natural commercial dynamics as small as possible. Since the only way to prevent revenue loss is for the vendor and purchaser to use the same purchase price allocation, the objective of revenue integrity can also be represented as "consistency".

Section 3: Options identification

3.1 What options have been considered?

- Option 1 – Status quo
- Option 2 – Party allocation (vendor first)
- Option 3 – Commissioner allocation
- Option 4 – Operational approach

Options 2 and 3 are the main legislative approaches considered by officials, and relate to how an allocation is made if the vendor and purchaser do not reach an agreement between themselves. Officials have always considered that if the parties agree an allocation, they should not be able to adopt separate, more favourable allocations in their tax returns. Officials have also been of the view that the allocation should always be based on relative market values (market values proportionate to the total purchase price) – in line with the current law – and that the Commissioner should be able to challenge an allocation that she considers is not so based.

Other elements that did not differ between options 2 and 3 during policy development were:

- *Granularity of allocation:* parties should not be required to agree an allocation to every individual asset, but rather asset categories with unique tax treatments – e.g. depreciable property, buildings, land, revenue account property etc. While this may leave some scope for arbitrage between different write-down rates for depreciable property, for example, the compliance cost of working out and agreeing a value for every single asset might be unrealistic for many taxpayers.

- *Notification of allocation:* parties should be required to notify the Commissioner if they have not agreed an allocation.

- *De minimis:* transactions falling below certain value thresholds should not be subject to the consistency requirement for purchase price allocation, as the scope for tax manipulation is not great enough to present a material risk to the revenue base. The thresholds should be a total purchase price of $1 million, or an allocation to taxable property by the purchaser of $100,000.

Option 4 is the operational approach generally favoured by stakeholders.

The criteria against which the options were assessed are:

- *Compliance costs:* compliance costs for taxpayers should be minimised.

- *Administration costs:* administration costs for Inland Revenue should be minimised.

- *Neutrality*: the tax rules should not distort economic outcomes by incentivising business behaviours that do not make commercial sense, and are only adopted for tax reasons. They should not advantage one party over another.

Option 1 – Status quo

Vendors and purchasers can continue either to agree an allocation or to make their own separate allocations. The Commissioner can challenge allocations that she considers are not at market, but cannot require parties to adopt the same allocation. Revenue would continue to be lost where vendors and purchasers adopt separate allocations that minimise their own tax liabilities.

Pros

Parties would not have to change their behaviour, therefore compliance costs would be low.

Cons

There would likely be an ongoing substantial loss of revenue, meaning the objective of revenue integrity/consistency would not be achieved. Inland Revenue would continue to incur the administration costs associated with identifying inconsistent allocations through audit, and attempting to resolve inconsistencies without a legal basis to require resolution. Moreover, the status quo is not economically neutral, because parties adopting different allocations are relying on an effective subsidy from the revenue base to support their commercial transaction, when the transaction should stand on its own.

Option 2 – Party allocation (vendor first)

If the vendor and purchaser do not agree an allocation, they must step through a short sequence of rules that allow one of the parties to determine the allocation.

For two months after transfer of the property, the vendor is required to determine the allocation, and must notify the purchaser and the Commissioner of it. However, the vendor cannot allocate amounts to taxable property that result in an additional loss on the sale of that property (other than for part year depreciation).[4]

If the vendor fails to notify an allocation within the two-month window, the purchaser must determine the allocation, and notify the vendor and Commissioner of it. Whether the vendor or the purchaser determines the allocation, both parties must follow it in their tax returns. The allocation must be at market, and the Commissioner can challenge the allocation if she considers that it is not.

If neither party notifies an allocation, the vendor is treated as disposing of the assets for market value, and the purchaser is treated as acquiring the assets for nil consideration. The effect of this is that the purchaser is unable to claim any deductions in relation to the property until it has made an allocation. This incentivises the purchaser to make and notify an allocation, which is key to achieving consistency.

[4] The vendor will not be able to satisfy this rule if the total purchase price is lower than the vendor's aggregate carrying cost of the taxable property. In this case, therefore, the minimum allocation to taxable property will be its carrying value reduced (pro rata) in proportion to the difference between the aggregate carrying cost of the taxable property and the purchase price.

Pros

This option achieves the objective of revenue integrity/consistency by driving parties towards using a single allocation. It has low administration costs, as it is the parties who must allocate, not the Commissioner. Importantly, the parties will have much better knowledge of the transaction and the assets in it than the Commissioner, and are therefore better placed to make the allocation.

Cons

This option appears less neutral between the vendor and purchaser, as it allows the vendor to determine the allocation in the first instance. This may be perceived as unfair by some purchasers, or may be an additional source of tension in the negotiations, which could mean increased compliance costs. However, as the purchaser will be aware of the rule when negotiating the sale, an unfavourable or undisclosed vendor allocation could be answered by a reduced purchase price. Moreover, the vendor is constrained by not being able to allocate amounts to taxable property that would result in an additional loss.

Option 3 – Commissioner allocation

If the vendor and purchaser do not agree an allocation, they must request an allocation from the Commissioner. The Commissioner may choose the vendor's allocation, the purchaser's allocation, or any other allocation within a market value range. Both parties must then follow that allocation in their tax returns.

The Commissioner's allocation cannot be challenged. The Commissioner may or may not decide to seek an external valuation to determine the allocation.

Pros

This option ensures revenue integrity/consistency by driving parties towards using a single allocation. It has low compliance costs, because if the parties cannot agree, it is the Commissioner who determines the allocation. The uncertainty of what the Commissioner will decide to allocate also provides a strong incentive for both parties to reach an agreement between themselves. Since neither party is given the opportunity to allocate before the other, this option is relatively neutral in its impact on the commercial dynamic.

Cons

The administration costs of this option could be high. The Commissioner has to dedicate resources to making an allocation every time parties fail to agree one. To avoid costly disputes, the Commissioner's allocation has to be unchallengeable, but this is likely to be seen as unfair by aggrieved parties – particularly if the Commissioner's position is not supported by an independent valuation. This might lead to attempts to challenge an allocation regardless of any legal provisions, for example through judicial review.

Option 4 – Operational approach

The vendor and purchaser can continue either to agree an allocation or to make their own separate allocations. In the latter case, the parties are required to notify the Commissioner that they have not agreed, and to provide both the Commissioner and the other party with

copies of their respective allocations. Penalties will apply to parties who are found not to have complied with this requirement.

If the Commissioner takes issue with one or both of the parties' allocations, she can enter into a dispute with both parties simultaneously, leveraging the associated costs as an incentive for the parties to agree an allocation.

The Commissioner will issue clear guidance to the effect that vendors and purchasers should agree a purchase price allocation or risk a dispute with the Commissioner. She will also clarify the existing legislative provisions governing allocations. There will be no other changes to the legislation.

Pros

This approach may be seen as more subtle and targeted at the concern area – a relatively small number of large transactions where there is deliberate and substantial tax planning. It may seem fairer to vendors and purchasers than enforced legislative rules, and more neutral on transactions.

Cons

The Commissioner cannot require the desired outcome of consistency, because there is no legal basis for her to do so. Parties may be deterred by the costs of dispute, but they may not, and then an operational approach is ineffective at resolving the revenue risk. The Commissioner has failed to achieve consistency in a number of real disputes, and it is unlikely that this would change simply through administrative guidance.

3.2 Which of these options is the proposed approach?

The proposed approach is option 2. Officials consider that it is the best option on balance, for the reasons outlined below.

Legal foundation

Option 2 provides a strong legal requirement for consistency, which does not currently exist. This enables the Commissioner to mandate consistency, not merely expect it. While the operational approach (option 4) may be seen as less intrusive, it is also likely not to lead to the desired outcome in some cases.

Expertise

Where the parties do not agree an allocation, it is better to keep the responsibility to allocate with the parties rather than transfer it to the Commissioner, because the parties are directly engaged in the transaction and have a much better understanding of the assets being sold, and their value. The Commissioner is detached from the transaction, has no particular valuation expertise, and is largely indifferent to what allocation is chosen provided it is a single allocation and is tethered to market values. An allocation determined by the Commissioner will be seen as at least as arbitrary – if not more arbitrary – than an allocation chosen by the vendor or the purchaser, and to avoid the possibility of costly disputes that would ultimately have to be funded by the Government, the Commissioner's

determination has to be unchallengeable. Stakeholder feedback has indicated that this would not be popular.

Neutrality

The main criticism of the proposed approach is that it favours the vendor, since, if the parties do not agree an allocation before filing their returns, the vendor is given the power to determine it first. Thus, the vendor is not incentivised to agree an allocation, and the rules disrupt the neutrality of the commercial dynamic. However, officials consider that this concern is overstated for the reasons outlined below.

In the first place, if the allocation is important to the purchaser, the purchaser can insist on agreeing the allocation with the vendor as a condition of the deal. If the vendor is not prepared to agree the allocation, the purchaser may either refuse to go ahead with the transaction, or lower its price. These strategies operate as a counterbalance to the vendor's perceived advantage.

Even if the vendor gets the opportunity to determine the allocation, it is constrained by not being able to allocate amounts to taxable property that result in an additional loss. This means that the purchaser's cost basis for claiming deductions in the future cannot be lower than the vendor's basis would have been had the transaction not occurred. It also means that if the vendor considers the value of taxable property to be lower than its current carrying value, it is incentivised to agree an allocation with the purchaser to avoid paying more tax on the transaction than it thinks is appropriate. Thus, the ability for the vendor to determine the allocation is only advantageous if it thinks the taxable property is worth *more* than its carrying value. Probabilistically, it seems reasonable to assume this might only be the case half of the time.

Finally, the Commissioner can challenge an allocation that she considers is not based on market values. If the amounts allocated by the vendor to taxable property are unjustifiably low (even taking into account the aforementioned constraint), and the transaction is sufficiently large, the Commissioner may intervene and substitute an allocation that is more favourable to the purchaser.

Awareness of the rules

Another related concern with the proposed approach is that parties may not turn their minds to the tax implications of the transaction until after the sale and purchase is completed, and then the vendor has the power to allocate. This may occur in multiple bid scenarios, or where parties are distressed.

If parties neglect to consider tax until filing their returns, then the result will be either that the purchaser must settle for the vendor's market values *or* the vendor for the purchaser's, if more than two months have elapsed since the property was transferred. However, officials consider that this is unlikely to occur if the parties are well advised and the rules are signalled so that taxpayers and advisors are aware of them. Officials anticipate that taxpayers will adapt sale and purchase practices to ensure there is sufficient time for an allocation to be agreed before the transaction is completed. Moreover, for the reasons given in the previous section, officials do not think purchasers will be significantly disadvantaged by a vendor-determined allocation.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties Vendors and purchasers in mixed supply transactions	Some vendors will pay more tax and some purchasers will claim lower deductions as a result of the new rules. The revenue estimate is based on data from commercial property transactions, extrapolated out to the total base of tangible property. Possible compliance costs for vendors and purchasers associated with having to negotiate an agreed allocation, or to expedite an agreement that might otherwise have occurred after the sale.	Approximately $154 million of additional tax paid/collected over the forecast period (2021-24). Low to medium
Regulators Inland Revenue		
Wider government		
Other parties		
Total Monetised Cost		**Estimated $154 million over forecast period**
Non-monetised costs		**Low to medium**
Expected benefits of proposed approach, compared to taking no action		
Regulated parties Vendors and purchasers in mixed supply transactions		
Regulators Inland Revenue	Inconsistent allocations will not occur, or will be clearly in breach of the law, so able to be effectively challenged.	Medium
Wider government	An increase in revenue is expected.	Approximately $154 million of revenue gain over the forecast period (2021-24).
Other parties		
Total Monetised Benefit		**Estimated $154 million over forecast period**
Non-monetised benefits		**Medium**

4.2 What other impacts is this approach likely to have?

Some sale and purchase transactions may take longer as a result of a single allocation having to be used. This may place more pressure on some purchasers in multi-bid deals where there is competition with foreign purchasers that are not subject to the consistency rule. Officials note, however, that purchasers from different jurisdictions may be on an unequal footing already for a variety of reasons that are unrelated to purchase price allocation.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Officials engaged in targeted consultation with the Corporate Taxpayers Group (CTG), Chartered Accountants Australia and New Zealand (CA ANZ), KPMG, PwC, Deloitte and Russell McVeagh, and an official's issues paper – *Purchase price allocation* – was released for public consultation in December 2019. Submissions on the issues paper were received from the above stakeholders as well as Business NZ, Bell Gully, the New Zealand Law Society, nsaTax, Chapman Tripp, and EY.

Almost all stakeholders support the proposition that parties to a mixed supply should adopt the same purchase price allocation. A number of advisors have noted that they always advise their clients to agree an allocation, as it is considered best practice from a tax perspective. However, clients do not always follow this advice.

A few stakeholders disagree with the central premise that parties should always be required to agree on the value ascribed to an asset, as parties could legitimately take different views of its value (officials acknowledge this reality but do not think it is a valid reason to treat the asset as being sold for two different values for tax purposes).

Nearly all stakeholders disagreed with the proposals set out in the issues paper for legislative reform. Many felt that legislative measures were unnecessary or overly burdensome, and that the policy objectives could instead be achieved operationally through better enforcement of the existing law and the publication of additional guidance for businesses on price allocations.

The strongest concern expressed by most stakeholders was that the approach set out in the issues paper gave too much power to the vendor, by allowing the vendor to determine the allocation if the parties could not reach agreement. Stakeholders were not convinced that the purchaser would always have the negotiating power to insist that the vendor agree an allocation with it, or that the parties would always turn their minds to tax during the negotiation, and once the transaction was completed, the purchaser would have no recourse.

In response to these concerns, officials made a significant modification to the proposal: the vendor cannot allocate amounts to taxable property (depreciable property, revenue

account property, financial arrangements) that result in an additional loss on that property. Therefore, the vendor cannot, for example, allocate to an item of depreciable property an amount that is less than its adjusted tax value. This constraint protects the purchaser from an unreasonably low vendor allocation that may not be challenged by the Commissioner. It also means that the purchaser cannot end up with a lower cost basis for deductions than the vendor would have had if the transaction had not occurred. This enhances the neutrality of the rules.

The modification went some way to allaying stakeholder concerns, but stakeholders are still in disagreement with the proposals. The majority are of the view that legislation is unnecessary, and thus would not agree with the amendments in any form. Officials explored the possibility of an operational solution early on, but determined that it would not be effective, as ultimately the Commissioner would have no legal basis on which to require the desired outcome of revenue integrity/consistency. Parties might choose to agree an allocation, but that is the case under the status quo, and the lack of an *obligation* for them to do so is the problem perpetuating the loss of revenue.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The new rules will be legislated via the Taxation (Annual Rates 2020-21, Feasibility Expenditure, and Remedial Matters) Bill, and will apply to agreements for the disposal and acquisition of property entered into on or after 1 April 2021. In conjunction with the enactment of the legislation, Inland Revenue will publish guidance on the new rules so that taxpayers and advisors are aware of them and have time to prepare. Officials note that the basic requirement for parties to make a purchase price allocation is not new, so a long lead-in period is not necessary.

For vendors and purchasers in mixed supplies that agree an allocation, nothing will be different, other than that they will now be obliged under income tax law to follow the agreed allocation in their tax returns (which happens in almost all cases in any event). For parties that do not agree an allocation before filing their returns, but determine that the transaction falls below at least one of the two de minimis thresholds – a $1 million transaction value or a $100,000 allocation to taxable property by the purchaser – nothing will be different. Officials envisage that these thresholds will exclude many rental property sales (as residential buildings cannot be depreciated by the purchaser and are therefore not counted towards the taxable property threshold), as well as some small business sales.

Where parties do not agree an allocation and both de minimis thresholds are exceeded, whichever party unilaterally allocates under the new rules will have to notify both the other party and the Commissioner of its allocation. This will tell the other party what values it must use to complete its tax return, and will give the Commissioner visibility of the allocation, so that she is in a position to ensure the other party follows it, and to challenge it if necessary. The notification procedures are set out in section 14 of the Tax Administration Act 1994.

Compliance with the new rules will be monitored through routine audit and through evaluation of any allocations notified to the Commissioner by the parties.

Overall, implementation risks are low, provided the rules are well-signalled, as they are intended to be.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

Officials will engage with the tax advisory community and Inland Revenue investigators again when the rules are in force to seek feedback on how the rules are working for vendors and purchasers.

Officials considered requiring all vendors and purchasers in mixed supplies to notify the Commissioner of their allocation, regardless of whether they agreed the allocation or not, however this would increase compliance costs for taxpayers and officials expect the monitoring methods outlined above to be sufficient.

7.2 When and how will the new arrangements be reviewed?

Policy officials maintain strong communication channels with stakeholders in the tax advisory community, and these stakeholders will be able to correspond with officials about the operation of the new rules at any time. If problems emerge, they will be dealt with either operationally, or by way of legislative amendment if needed.