

REPORT - JULY 2018

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The information contained in this report is not advice. We recommend that before readers decide to proceed with any of the matters raised below, that they contact their professional advisors.

RING-FENCING RENTAL LOSSES



Labour's pre-election manifesto proposed to increase the fairness of the tax system and improve housing affordability. In the six months since the Labour-led coalition entered Parliament, we have started to see some changes filtering through.

As part of the proposals aimed at house prices, Inland Revenue has recently released an Issues Paper proposing to ring-fence rental losses, with draft legislation likely to follow once Inland Revenue has considered public responses.

So how would the rules work?

People derive income from multiple sources, such as salary / wages, business income, interest, dividends and rental income. It is a fundamental feature of NZ's tax system that a person is taxed on their total income from all sources, whether a profit or loss.

This aggregation allows losses incurred from rental properties to be offset against other income, reducing a taxpayer's total income and corresponding tax liability. The Government's concern is that this mechanism allows property investors to take on high levels of debt to finance their property investments, giving rise to tax losses, effectively subsidising the rental portfolio through a reduced tax liability. The high-gearing offers an advantage compared to owner-occupiers because their interest cost is not tax deductible.

The proposed ring-fencing rules contained within the Issues Paper will eliminate this advantage by preventing rental losses from being offset against other income. Instead, rental losses will be 'ring-fenced' and offset against future rental income, or any tax incurred on the future sale of the property.

Labour originally indicated losses might be ring-fenced by individual property. Thankfully, the pro-

posed 'portfolio approach' is more logical, enabling investors to pool their profits and losses from all residential properties, including overseas properties. If enacted, the rules will apply to all rental properties irrespective of how they are held, i.e. the rules will apply to individuals, companies and trusts. The proposed rules also use the existing definition of 'residential land'. Thus, the rules will not apply to commercial property or property subject to the mixed-use asset rules.

There is complexity in the new rules because they can impact people that don't hold rental properties. For example, if a person has borrowed to purchase shares in a company and that company uses the funds to purchase a rental property, the interest incurred by the shareholder is normally tax deductible. In this situation, if 50% or more of the company's asset value is derived from residential properties the company will be classified as "residential property land-rich". Amounts paid to the shareholder (e.g. dividends) will be classified as "rental property income" and their interest expense will be classified as "rental property loan interest". The rental interest can only be deducted against "rental property income" derived from the company, or the individual's other rental properties, with any excess loss ring-fenced to the person.

The application of the proposed 50% asset test is currently unclear – the issues paper does not indicate whether it will be based on market value or historical cost. This will undoubtedly be addressed during the consultation period.

If enacted, the proposed rules may be phased in from the start of the 2019 – 2020 income year. This will allow investors time to adjust to the new rules and provide the opportunity for taxpayers to rearrange their affairs before the rules are adopted in full.

BRIGHT-LINE BREACH WARNING

The bright-line test came into force from October 2015, introducing rules that a profit derived on the sale of a residential property is subject to tax if sold within two years of purchase, albeit subject to some exceptions such as the family home. These rules have recently been revised to extend the bright-line period from two years to five.

Whilst the bright-line provisions appear relatively straightforward, there are some intricacies to the rules, so it is advisable to seek professional advice before selling a residential property. A recent High Court decision highlighted the potential consequences of failing to seek sufficient advice.



The case involved Mrs Blackburn, who personally owned a property on Waiheke Island for a number of

years, before selling it to her family trust for \$2.85m on 31 March 2016, 6 months after the introduction of the bright-line test. The following year, the Trust sold the property to a third party for just over \$5m. Although Mrs Blackburn had owned the property for several years, the trust is a separate taxpayer for the purpose of the bright-line provision, hence the profit derived on sale of the property was taxable. However, the Trustees did not return the sale in their tax return and IRD later assessed them for income tax, resulting in a tax liability of approximately \$775,000.

AML/CFT

From 1 October 2018, Accountants will have compliance obligations under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009. The Department of Internal Affairs (DIA) will be the supervisor for the Accountants' sector and we will be required to report on an annual basis.

What is 'Money Laundering'? Money Laundering is the method by which people disguise and conceal the proceeds of crime and protect and enjoy their assets. Money laundering takes many forms and includes:

- The process of concealing the existence or illegal source of income derived from criminal activity;
- Converting criminally derived funds, assets or property into apparently clean funds, assets or property by moving it into the legitimate financial system;
- Handling the proceeds of crimes such as theft, fraud and tax evasion (**undeclared cash sales**); or
- The transfer, movement or involvement with criminally derived funds, assets or property.

You may have experienced the additional lines of questioning and unusual requests (copies of Passport and/or Driver's Licence and a copy of a utilities invoice to prove your address) from your bank for opening bank accounts, depositing cash, or making international transfers, and this is partly due to this Act.

In order to comply with the Act, MRC will be required to undertake an assessment of our money laundering and terrorist funding risk and develop and maintain a program to ensure compliance with the Act. This will include carrying out a customer due diligence (CDD), which will include collecting proof of a client's identity (if an individual), proofs of identity of directors, shareholders, trustees and beneficiaries (if a company or Trust).

In the coming months, we will be asking clients for more information. Initially, it will be for 2 forms of identification and a utility bill with your name and address printed on it.

Please do not be offended with our request. We are simply applying the law and no, we don't make the law.

BRIGHT-LINE TEST - FAQs

We have fielded a number of queries recently regarding the bright-line test which indicates to us there is still confusion among property owners.

Q. What is the 'bright-line test' (Test)?

- A. The Test is, any gains arising from any residential property purchased, whether local or overseas, since the introduction of the legislation on 1 October 2015 is liable to income tax subject to certain exemptions.

Q. What is the period covered under the Test?

- A. When the Test was introduced on 1 October 2015, it covered a period of 2 years; however residential properties purchased from 29 March 2018 are subject to the 5 year Test.

Q. Where is the tax payable on gains made on the sale of an overseas property caught by the test?

- A. NZ tax residents are liable for NZ tax on their worldwide income.

Q. What are the exemptions?

- A. i) Your main home (where there's more than one)
ii) Inherited property
iii) You are acting as executor for an estate

Q. How do you define the main home?

- A. It must be used for at least 50% of the time since you owned it and you must have used more than 50% of the area of the property. Hence, if the property is used partly for your business or partly rented, you could get caught out. Note that you can only have one main home and it could be owned by a Family Trust.

REIMBURSING ALLOWANCES

On 3 April, Inland Revenue issued a draft 'Questions we've been asked' (QWBA) covering the tax treatment of allowances and benefits paid or provided to farm workers. A key principle covering such payments centres on the tax treatment of 'reimbursing allowances' – this is relevant not just to farm workers but all employees.



Reimbursing allowances are paid to employees for expenses incurred, or likely to be incurred, in connection with their employment, e.g., vehicle mileage and tools.

Section CW 17 of the Income Tax Act contains the requirements that must be met for such payments to be received tax-free and one of the key tests is that the expense incurred must be a 'necessary expense' incurred in performing the employment duties.

Furthermore, if employees were allowed to deduct expenses incurred to derive salary or wages, the expense would need to qualify as tax deductible. For example, if an employee was instead self-employed and the expense was tax deductible because it was incurred to derive their self-employed income, the test would be met. A self-employed person can't deduct the cost of a motor vehicle used to derive income because the expense would be capital in nature. Therefore, an employee cannot be paid a tax free reimbursement for the cost of their vehicle. However, vehicle running costs would be tax deductible to a self-employed person, and therefore an employee can be paid a tax-free amount to cover such costs.

The draft QWBA also includes an example of depreciable farm machinery used both in the farm business and privately. In this scenario, an apportionment of the reimbursement would be required, with the business portion of the reimbursement being tax-free, whilst the private portion would be taxable to the employee and subject to PAYE.

In addition to reimbursing specific expenses, allowances can be paid tax free based on a reasonable estimate of the expenditure. The estimation should have some reasonable basis, such as historical data, industry standard, or employee survey information. The employer must also keep sufficient information about the calculation method, and review the amount periodically to ensure the estimate remains reasonable.

Reimbursing allowances can sometimes be paid tax-

free to independent contractors, for example where they receive scheduler payments. This is based on the assumption that the contractor would generally be able to deduct the expenses to which the allowance relates.

However, this raises the issue of whether the contractor is entitled to deduct the expenses as well as receive a tax-free reimbursement, effectively creating a 'double deduction'. The draft QWBA clarifies that this is not the case; if the allowance is treated as exempt income, the contractor is denied a deduction for the attributable expense.

The tax treatment of reimbursing allowances is a 'standard' area of focus by Inland Revenue when reviewing a taxpayer's affairs, hence it is worthwhile checking to make sure they are being treated correctly.

COMMONWEALTH GAMES

New Zealand recently finished its most successful Commonwealth Games since 1990, generating some interesting statistics. It was our most successful games hosted outside of New Zealand, winning 46 medals, 15 of which were gold. This was enough to see us finish 5th on the medal table, punching well above our weight. We sent our largest Commonwealth Games team ever to the Gold Coast, comprising 251 athletes competing across 18 sports. The Commonwealth consists of 53 countries, of which New Zealand is the 23rd largest based on population, thus finishing 5th on the medal table was an awesome effort.

Many people would agree that based on our size, we are one of the most successful sporting countries in the world. Statistics New Zealand announced that we finished 9th for gold medals and 14th for total medals per capita, beating Australia who finished 17th.

With 79.2% of Kiwis participating in some form of sport each week coupled with our countries competitive sporting culture, it is not surprising we perform well in global competitions. Following our athletes' success on the Gold Coast, there is now talk of New Zealand hosting a future Commonwealth Games.

We congratulate our client, Sam Webster, a third generation client, who continued his winning ways at the Gold Coast Games, capturing both the individual and team track cycling sprint gold medals. He has been a world champion multiple times and with the passion, dedication and drive he has for his sport, there are still more gold medals and world championships to be had.

HEALTH IN THE WORKPLACE

How often have you found yourself vowing to improve your health or fitness? If you are anything like the majority, chances are at some point you have embarked on some fad diet or joined the latest fitness craze in an attempt to get healthier, only to find yourself succumb to the temptation of those pesky workplace morning teas or 3pm sugar cravings. However, with workplace well-being programs continuously growing in popularity, could the workplace soon provide more health-help than harm?

A recent survey by AON suggested that promoting good health and wellness should be a goal of all employers in 2018, with 96 percent of respondents recognising a connection between health and work performance. Perhaps one of the most popular trends already seeing widespread adoption is the introduction of standing desks. For office based employees, the majority of the day is spent sitting at a desk, resulting in lengthy periods of sedentary activity. Such high levels of sedentary behaviour allegedly have a major effect on a person's health, with links to both physical and mental conditions, including obesity and depression. Thus, standing desks should help ease this effect by reducing the amount of time a person is sitting down.

In addition to increasing employees' activity levels, nutrition is also a key component. It is well established that what we eat has a greater impact on our health than the amount of exercise we do. It has been estimated that we eat approximately a third of our day's food at work, meaning the workplace is an ideal place to assist employees in making healthy choices. Initiatives such as offering complimentary fruit, ensuring any food provided is as healthy as possible, and limiting the supply of alcohol, are small steps to encouraging employees to make healthier choices.

For those interested in more quirky initiatives, perhaps implementing an "on-the-hour flash walk" is something to consider. A "flash walk" has been said to generate collective positive energy, as well as provide a break from sustained periods of sitting or standing. Additional physical and psychological benefits are thought to contribute to decreased healthcare costs for companies in the long run.

Sleeping on the job has been a big no-no in the past, however studies have proven that even a 20-minute power nap can reduce stress and increase productivity. Tech giants like Google and Uber are paving the way for workplace naps, introducing in-company sleep pods and resting rooms. For companies that are not quite sold on the idea of employees napping at work, investing in sleep awareness and education programs could be a beneficial alternative to combatting the decrease in productivity caused by sleep deprivation.

It is apparent that investing in the physical and mental health and wellbeing of employees stands to facilitate a healthy and productive workplace. With growing support and commitment towards promoting good health and wellness, expect to see some more innovative health initiatives develop in 2018.



CRYPTOCURRENCY AND TAX



Over the last decade, the use of digital or virtual currencies, known as "cryptocurrencies", has grown dramatically in popularity. A single piece of Bitcoin is currently valued at over \$9,000 NZD. Some New Zealand retailers have already begun accepting Bitcoin as a form of payment, which has led to the Inland Revenue releasing a 'Questions & answers' considering the tax treatment of cryptocurrency.

For tax purposes, cryptocurrency is treated as property, which means that foreign currency gain or loss provisions do not apply. However, if a New Zealand business accepts cryptocurrency as a form of payment, the amount is treated as taxable business income based on the value of the cryptocurrency at the time it is received.

Any gain on sale of cryptocurrency is assessed by considering the original purpose for acquiring the currency. If the currency was acquired with the purpose of disposal, any proceeds made from selling the currency are taxable. IRD consider the nature of cryptocurrency means it is unlikely that a person would acquire it without the intention to sell or exchange it, meaning the majority of gains made on disposals would give rise to a tax liability.

If you invest or trade in cryptocurrencies, be sure to keep an eye out for further developments from Inland Revenue, as they intend to refine its tax treatment as more information becomes available.

JUNE FEE NOTES

We have had some issues in implementing our new billing software which has resulted in a delay this month. You will also note there are changes to the appearance of the invoices and the descriptions provided. Unfortunately, there is a limit to the amount of details we can provide and should you have any queries, we will be happy to provide a further breakdown. We hope to have this fine-tuned over the next few months.

IMPORTANT TAX DATES

20 July - PAYE, RWT, NRWT, FBT Returns are due

28 July - GST due for period-end June

28 July - Provisional Tax due for June Balance Dates (P3)

5 August - PAYE due for large employers

20 August - PAYE, RWT, NRWT Returns are due

28 August - GST due for period-end July

28 August - Provisional tax due for March Balance Dates (P1)

5 September - PAYE due for large employers

20 September - PAYE, RWT, NRWT Returns are due