

## INSIDE THIS EDITION



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## Is your business cyber safe?

Technology and change is prevalent across all areas, right through from the supply chain to the customer. Computers are no longer isolated assets; complex cloud based systems allow all areas of an organisation to be truly digital.



Although this can have many benefits, an increased digital presence, combined with the expansion of mobile technology, is exposing businesses to risks; particularly where there has been the rapid introduction of new technologies to keep pace with competitors. As a result, businesses can often lack awareness of the true extent of their digital footprint and cyber-crime is unfortunately on the increase.

Whilst organisations are often aware of the cyber security and privacy threat, a recent survey (Global State of Information Security 2016) found that NZ businesses' investment in cyber security measures are lagging behind that of comparable economies. Only 17% of NZ digital businesses currently have an internet security policy in place compared to 39% of Australian businesses. Similarly, just 20.5% of NZ businesses surveyed have aligned cyber security spending with business revenue, compared to an overwhelming 63% of global businesses.

There is a further risk that NZ industries may be losing out to global competitors due to a lack of investment in digital security. The EU, South Korea, Hong Kong and Singapore have all introduced comprehensive new data protection regulations. By comparison, NZ has a lack of mandatory reporting obligations for data breaches, which means our businesses may be unprepared to operate in global markets. Although security measures and policies are not currently compulsory here, companies looking to

expand cannot afford to neglect the issue.

As every organisation uses digital technology and the internet to different degrees, context is key and a personalised approach specific to the business needs to be taken.

However it is of paramount importance that thought is given to implementing IT security strategies; as a security failure could result in catastrophic damage to the business on a reputational level and severely damage customer relationships.

In the event of a data breach, the business is no longer seen as a victim, but as someone who has not taken sufficient care over data provided to them.

It is therefore recommended that:

- cyber security measures are built into new digital initiatives as they are being developed,
- businesses increase their investment into more advanced tools for detection of potential cyber attacks, and
- policies are put in place to respond swiftly to any security breach, as reassurance to all stakeholders and to avoid reputational damage.

In-house IT teams may no longer have the expertise to keep up with the ever changing cyber-threat – outsourced expertise may need to be sought to provide a more cost effective and efficient solution.

## How do we now treat feasibility expenditure?



A recent Supreme Court decision, *Trustpower Limited v Commissioner of Inland Revenue (IRD)*, has drastically changed how New Zealand businesses should treat feasibility expenditure for tax purposes.

Feasibility expenditure is a term used to refer to expenses incurred in the course of determining whether to acquire an

asset; to some degree, such expenditure is incurred by all businesses. Until now, feasibility expenditure has generally been treated as tax deductible up until the point that a decision is made to acquire a particular asset. This is known as the 'commitment approach'.

In the *Trustpower* case, the company had incurred expenditure to acquire resource consents prior to deciding whether to commit to potential power generation projects. The expenditure was treated as deductible feasibility expenditure under the commitment approach, however this was disregarded by the Court.

Instead, the expenditure was held to be non-deductible on the basis that the underlying projects were capital in nature. The Court reasoned that the projects could not proceed without the resource consents and thus represented tangible progress toward their completion.

The Supreme Court conceded that a deduction for feasibility expenditure may still be allowed for early stage work, but only limited guidance was provided regarding when expenses should be deductible. It was acknowledged that a deduction would be allowed for:

- "feasibility assessments which are so preliminary in nature that they cannot sensibly

be seen as directed to the acquisition of an asset of an enduring character";

- "...early stage feasibility assessments may be deductible. Such assessments can be seen as a normal incident of business";
- "Expenditure which is not directed towards a specific project or which is so preliminary as not to be directed towards the advancement of such a project ..."

The decision of the Supreme Court was contrary to IRD's own Interpretation Statement on feasibility expenditure, hence IRD is now updating its statement. The draft statement has summarised the IRD's interpretation of the case:

"... in the Commissioner's view, expenditure is likely to be deductible in accordance with the Supreme Court decision if it is a normal incident of the taxpayer's business and it satisfies one of the following:

- the expenditure is not directed towards a specific capital project; or
- the expenditure is so preliminary as not to be directed towards materially advancing a specific capital project – or, put another way, the expenditure is not directed towards making tangible progress on a specific capital project."

Business expansion and growth is good for the economy, the country, employers and employees. As a result of the Supreme Court decision, expenditure on feasibility expenditure is now more likely to be non-deductible in most cases. This creates an economic disincentive for businesses to consider the feasibility of new projects and will represent a significant increase to the cost of expansion and growth for New Zealand businesses.

From a broader policy perspective, it does beg the question as to whether Government should step in and legislate the treatment of feasibility expenditure to maintain the status quo.

## Employee share schemes

Irrespective of the size of a business, one of the challenges for any business owner is to be able to attract and retain talented staff.

One means to do so is an effective remuneration package that motivates staff in a way that aligns their performance with the owners' business objectives. Not every individual is driven by monetary reward. But it is a key ingredient.

In its most basic form, a remuneration package will comprise payment of a salary or wage and potentially cash bonuses. It is often assumed that the next step is for key staff to be incentivised by having them take a stake in the business. But there is a middle ground that should also be considered. It is relatively straight forward to design a remuneration target that takes into account the performance or value of the business. For example, 'phantom equity' involves remunerating an employee based on a set percentage multiplied by an increase in the value of the business. It is akin to providing shares in a business, without actually giving up ownership of the business.

If consideration is being given to providing employees with an ownership share, or such a scheme is already in place, it is important to be mindful of the tax treatment. Employees will naturally look to the employer to ensure they are fully informed regarding the implications. Unfortunately, the tax treatment of employee share schemes (ESSs) are currently under review by IRD.



The IRD's concern is that there are inconsistencies between ESSs and more vanilla approaches to incentivising employees, such as cash bonuses (and phantom equity).

The IRD have a particular dislike of "conditional" ESSs. Under such schemes, an employee's continued ownership of shares may be subject to continued employment or performance targets being satisfied.

One outcome of such a scheme is that any increase in value after the initial receipt of the share is typically a tax free capital gain.

IRD are of the view that until the shares are free from restrictions, their increase in value should be taxable. Their apparent rationale is that the share is only subject to conditions because the individual is an employee, and therefore any benefit due to an increase in value should be employment income. IRD's point of comparison is to an 'ordinary investor' who might purchase shares on the NZX, who is free from restrictions and whose investment is at risk.

The IRD review commenced in May with the release of an officials' issues paper setting out their view and was followed in September with an update on their proposals. When designing a reward system, consideration should be given to IRD's proposals and the uncertainty that currently exists. Depending on the final outcome, there is a risk that either the employer or employee will find it is the IRD that is being rewarded and not them.

## IRD rulings



Over the past few years there has been a pronounced improvement in the manner in which Inland Revenue selects and conducts its investigations.

There has been an increased focus on data analysis, comparisons to statistical norms, and use of external information such as land transfer data. As a result there is an increasing need to consider how IRD might approach a particular transaction or issue.

In cases where the position is unclear or the dollars involved are material, consideration needs to be given to approaching IRD beforehand to seek their approval or view to treat something in a particular way. This can occur by approaching IRD for a

'private binding ruling' or a 'non-binding indicative view'.

Both processes are positive and collaborative, as IRD generally are focused on determining the correct position under the law. In contrast, if IRD approach the matter 'after the fact' through the course of an investigation there may be more focus on proving a tax shortfall exists; and their view of the law can feel as though it is bending to accommodate that outcome. It can become emotional, as each party becomes increasingly entrenched in their view, giving rise to significant cost to defend a position and if the taxpayer is unsuccessful, penalties could apply. Too often the incremental cost will exceed what it would have cost to approach IRD before-hand.

A private binding ruling provides the highest degree of comfort, because if successful, the outcome is binding on IRD. This provides peace of mind that a different individual from IRD won't take a different

view in the future. The binding rulings process is not subject to a legislated timeframe within which one must be provided, however IRD work to a timeframe of 3 months and are very good at meeting that time frame. They are also willing to provide early indications of their expected view if required for the purpose of a particular transaction that may be occurring. IRD do charge a fee to provide a binding ruling, it does so at an hourly rate of approximately \$160 per hour. The total IRD cost for a ruling is generally about \$15k - \$20k. This cost must be considered in light of the tax involved and the comfort otherwise associated with taking a particular position. When this is balanced with the downside risk of IRD disputing the treatment in the future it

quickly becomes reasonable.

A further option is to acquire an indicative view. We understand IRD will consider issues through this process if it will take 20 hours or less. IRD don't charge for providing an indicative view, however the outcome is not binding. Irrespective of the fact that the IRD is not bound by the outcome, from a practical point of view it should provide a high degree of comfort. It would be unusual for an alternative view to later be taken by IRD, and if this did occur, the fact that an indicative view was acquired should provide a strong negotiating position when asserting no penalties should be charged.

## Snippets

### Farmhouse expenses



The IRD have long permitted a straightforward concession allowing a flat 25% deduction for farmhouse expenses, as well as 100% deductions for interest

and rates. The concession is not legislated and dates back to the 1960s, when farm ownership and operating structures were generally less complicated than they are today.

However, IRD recently announced that the concession is to be withdrawn from the start of the 2017-18 year. It will be replaced by a new approach that is intended to more accurately capture the business versus private costs relating to maintaining the farmhouse.

Under the proposed methodology, farming businesses will generally need to apportion farmhouse expenses between business and private use on a just and reasonable basis – time and space will generally be the appropriate method, consistent with other types of businesses.

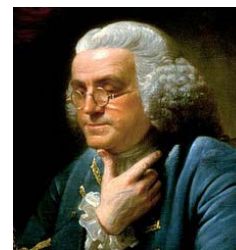
Where expenses are incurred on the farm as a whole, the farmhouse expenses will first need to be determined based on the cost of the farmhouse (including curtilage and improvements) relative to the cost of the farm, before the apportionment between private and business use of the farmhouse is calculated.

The IRD have however recognised that there will be occasions where this will be impractical to calculate. They have addressed this by proposing that where the cost of the farmhouse is less than 20% of the total cost of the farm, farmers can follow an alternative method by deducting 15% of all farmhouse expenses, as well as continuing to claim 100% of the interest costs relating to the farmhouse.

This should make the compliance and record keeping process more straightforward for these entities.

### Nothing is certain, except death and taxes...

Benjamin Franklin's well known phrase does however appear to come as a surprise to some people.



Although tax returns across the world need to be filed annually, taxpayers come up with a variety of creative and ingenious excuses to try and avoid late filing penalties.

In the US, people have gone to the expense of arguing in court that 'Taxation is taking property, thus a violation of the 5th Amendment' and 'Taxation is slavery, thus a violation of the 13th Amendment'. Unsurprisingly both arguments were struck down by the courts.

In the UK, the tax authorities report amongst their best excuses, 'My husband ran over my laptop', 'My tax papers were in the shed, and a rat ate them' and 'I've been busy looking after a flock of escaped parrots and some fox cubs'! Perhaps the parrots can be put to work to generate some income to pay the fines?!

While genuine reasons for late filing may sometimes be accepted, unfortunately passing the blame to hungry pets isn't going to cut the mustard. Hopefully this serves as a good reminder to get your return ready for filing as the next deadline approaches!



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