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WEEKLY COMMENT: FRIDAY 15 FEBRUARY 2013

1. *Reviewing the tax treatment of employee allowances and other expenditure payments - An officials issues paper* ("the Issues Paper") was released in November 2012. Submissions closed on 1 February 2013.

2. This week and next week I look at the proposals in this Issues Paper: this week I look at the general considerations and the proposals regarding accommodation payments. Next week I will look at the proposals relating to meal payments and reimbursement of telephone and internet expenses and clothing expenses.

3. The simplest comment I could make is that every single proposal should result in some employer expenditure payments becoming taxable where they are not taxable at present. The exception is some fairly guarded comments about the interaction between the proposed 12-month exemption for temporary accommodation while travelling and the 3-month accommodation exemption for relocation (see paragraph 32 below).

4. On 7 December 2012, Inland Revenue issued CS 12/01 *Commissioner's Statement: Income tax treatment of accommodation payments, employer-provided accommodation and accommodation allowances* ("the Accommodation Statement"). The main issue discussed is whether the taxable value of accommodation can be measured using a "net benefit" approach. Inland Revenue maintains that the net benefit approach is not the current practice and encourages voluntary disclosures in cases where this approach has been adopted. The contents of the Accommodation Statement are discussed in paragraph 21 below.

The employee exemptions discussed

5. The focus in the Issues Paper is on what is termed "employee expenditure payments" made by employers in respect of meals, accommodation, communication and clothing. A range of employer payments are covered, including the payment of a cash allowance, which could be either:

   (a) Paid in advance of the employee incurring the expenditure and may be based on a reasonable estimate of the expenditure; or

   (b) Paid in arrears to reimburse actual expenditure.

6. It is noted that an employee expenditure payment is not taxable unless there is a private element. Since 1995 it has been the employer's responsibility to make a judgment on what is the correct tax treatment for an employee expenditure payment based on the exemptions available. The exemptions discussed in the Issues Paper are those set out in s. CW 17 of the Income Tax Act 2007, and s. CE 5(3)(a) & (c).

7. Section CW 17 provides an exemption from tax for certain employee expenditure payments in whole or in part. An apportionment may have to be made. The apportionment methodology is not defined.

8. The basis for the s. CW 17 exemption is that employer payments or expenditure should relate to expenditure for which the employee would be allowed a deduction if they incurred the expenditure and the employment limitation did not exist. To be exempt, the expenditure must be incurred in the course of the employee earning the employment income. It is not sufficient that the expenditure puts the employee in a position to earn income–such as, for example, a payment for travel between home and work.

9. Section CW 17 does not prohibit a payment including a depreciation element from being treated as non-taxable. It is noted in the Issues Paper that the depreciation element could include low value asset write-offs.

10. Expenditure on account of employee is defined in the legislation and is employment income unless it is covered by one of the statutory exclusions, which include two general exclusions:

    (a) Expenditure for the benefit of the employee, or a payment made to reimburse an employee for expenditure to the extent that the employee would be entitled to a deduction if they incurred the expenditure and the employment limitation did not exist [s. CE 5(3)(a)].

    (b) Expenditure committed by the employer for which the employee pays and is reimbursed: nothing is really provided to the employee because the employee is acting as agent of the employer [s. CE 5(3)(c)].

General propositions

11. The starting point in the Issues Paper is that payments for private expenses are a salary substitute and should be taxed in the same way as salary and wages. In establishing the taxable amount valuation is a key concern.

12. The expenditure must be viewed from the employee's perspective: *Reid v CIR* (1985) 7 NZTC 5,176. It is noted that there is no statutory definition of a private expense, but in *CIR v Haenga* (1985) 7 NZTC 5,198, Richardson J in the Court of Appeal commented:

    "An outgoing is of a private nature if it is exclusively referable to living as an individual member of society and domestic expenses are those relating to the household or family unit …".

13. Therefore, a private outgoing relates to an individual living as a member of society – for example, food and drink. A domestic expense is one that relates to the household or family unit – for example, a home telephone.

14. A distinction is made between expenditure that puts you in a position to earn income, and expenditure incurred in actually earning that income: in *Case G57* (1985) 7 NZTC 1,251, lodging costs of a mussel farmer were not deductible because they put him in a position to tend his mussel farm rather than incurred in gaining or producing the income from the farm.

15. On the grounds of reducing compliance and administrative costs, it is conceded that the only circumstances in which payments to meet private expenses may need to be treated as non-taxable are when they are:

    (a) Low in value and incidental to the work element;

(b) Low in value and hard to measure; and

(c) There is little risk of re-characterisation of salary and wages as non-taxable payments.

16. The Issues Paper includes, on page 11, a flowchart for determining whether an employee expenditure payment is taxable or not.

Accommodation payments

17. Officials have ruled out altering the tax treatment of accommodation payments to treat them as fringe benefits.

18. The central contention is that accommodation is a fundamental human and personal need and will normally be "private or domestic expenditure" as defined in *CIR v Haenga*. Therefore, the starting point for the tax treatment of employer-provided accommodation should be that the accommodation benefit is taxed at market value – in relation to this, note that:

(a) The proposition advanced in the Issues Paper is that market value is usually regarded as equal to the market rental value (but this is not currently specified in legislation); but

(b) The Accommodation Statement states that:

(i) The market value of employer-provided accommodation is the price that a willing provider would accept from a willing customer; and

(ii) The market value of an accommodation allowance is the actual amount of the allowance.

19. The discussion is focused on whether adjustments are warranted in the following circumstances and, if so, how the private element should be valued:

(a) Accommodation provided during temporary work travel, when the employee is *temporarily* working away from his normal place of work;

(b) Accommodation provided because of the needs of the job, when an employee is required to live in a particular property, for example an on-site caretaker or school hostel warden; and

(c) A limited number of other circumstances – for example, employees with more than one permanent workplace for the same job, and employees working in countries outside New Zealand.

Accommodation during temporary work travel

20. Temporary travel could involve merely an overnight stay, or it could be a more substantial temporary secondment to a workplace in another city. Officials consider that meeting an employee's accommodation costs while the employee is traveling temporarily is unlikely to lead to salary substitution, even if the employee has not retained a property at the normal place of work. Any potential for salary substitution could be addressed by setting an upper limit, as in Australia.

21. Officials consider that making a specific adjustment for costs incurred by an employee when they retain a property elsewhere is not a practical option. In this regard, it is worth noting that the Accommodation Statement specifically refutes a "net benefit approach" under which some taxpayers have argued that because they are maintaining a home elsewhere, there is no net benefit derived. However:

(a) In relation to employer-provided accommodation or accommodation allowances, the Commissioner acknowledges that the net benefit approach was previously espoused in *Inland Revenue Technical Rulings Manual* paragraph 57.11. Therefore, taxpayers who have taken an incorrect tax position in relation to employer-provided accommodation or accommodation allowances may make voluntary disclosures without exposure to use of money interest or penalties, and will only be required to account for PAYE for the 2-year period prior to the date of issue of the Accommodation Statement on 7 December 2012.

(b) In relation to accommodation payments that were expenditure on account – i.e. payments by an employer on behalf of an employee, the net benefit approach as reflected in the *Technical Rulings Manual* did not apply. Taxpayers who have taken an incorrect tax position in relation to accommodation payments made through expenditure on account are also encouraged to make voluntary disclosures, but will be exposed to use of money interest and penalties, and will be required to account for PAYE for a 4-year period prior to 7 December 2012. (Apparently Inland Revenue has seen a number of arrangements where the employment agreement referred to an accommodation allowance, but what had actually happened was that the employer had made accommodation payments on the employee's behalf.)

22. The alternative tax treatments discussed for accommodation during temporary work travel are to:

(a) Fully exempt an accommodation payment made when working temporarily away from the employee's normal workplace; a full exemption would remove valuation issues, but presents a significant fiscal risk if there is no upper time limit;

(b) Exempt an accommodation payment made when working temporarily away from the employee's normal workplace, but subject to an upper time limit; this is the approach adopted in the US and Australia (a 12-month time limit) and the UK (a 24-month time limit); officials consider that it would take employees longer to regularise their accommodation costs then meal costs and that, therefore, it would be appropriate to set an upper limit that is longer than for a meal payment; if the employee is not permanently relocating, a 12 month period is suggested as reasonable; the time limit would have to be linked to an intention that the employee is temporarily away from their normal workplace;

(c) Exempt an accommodation payment made when working temporarily away from the employee's normal workplace, subject to an upper time limit plus a Commissioner's power to extend the limits in certain circumstances, that might encompass extraordinary events outside the control of the employer and the employee, such as when a contract originally scheduled to finish within the upper time limit overruns because of changes made by the customer or an unforeseen event such as a fire or natural disaster.

Accommodation during temporary work travel: proposed v current

23. The preferred option is to exempt from tax any accommodation payments when an employee has to work temporarily away from their normal workplace overnight, subject to an upper time limit of 12 months, with a Commissioner power to extend that limit in exceptional circumstances. This would apply to either employer-provided accommodation or to an employer accommodation payment.

24. Currently, there may theoretically be a tax liability in relation to accommodation that may be a private expense while travelling, but in practice employers do not treat any amount as

taxable. The proposed 12-month limitation to the exemption will result in some accommodation payments during temporary work travel that are currently treated as tax-free becoming taxable.

Accommodation provided because of the needs of the job

25. In a few cases an employee is required to live in a particular property because of the needs of the job. The contention in the Issues Paper is that this is only likely to apply in the case of employer-provided accommodation. If the employee is able to arrange their own accommodation it means they are likely to have had a choice about where they can live. Therefore there would be no exemption for an employee accommodation allowance in this case.

26. Officials consider that there could be a range of factors that may warrant and adjustment, such as factors linked to the property (location, state of repair etc.) or factors linked to the job (the inconvenience the employee suffers).

27. Officials discussed and rejected:

    (a) A full exemption, because an employee for whom the premises are their permanent residence will still obtain a substantial benefit, even if there is a need to live on the property.

    (b) Linking the taxable amount to a benchmark standard value, because this could promote salary substitution.

    (c) Setting the taxable amount at a proportion of gross income, based on the average ratio of rental values to gross income, say 25%, with a year-end adjustment for any changes in gross income.

Accommodation provided on the job: proposed v current

28. Officials' view is that the factors warranting an adjustment would be built into the level of the accommodation payment: factors linked to the property would affect the market rent, and factors linked to the job would affect the overall remuneration. For this reason, the preferred option for job accommodation is to continue to base the taxable amount on the full market value of the property. Officials want to confirm in legislation that the taxable value is the rental value, subject to any employee contribution.

29. At present, the market value of accommodation provided is taxable. There is no specification that this has to be the rental value, but that is how Inland Revenue administer the current rules.

Accommodation payments in other circumstances

30. Also considered are payments for people who work from home, people with more than one permanent workplace, and overseas temporary transfers:

    (a) Where an employer reimburses an employee's home office costs, officials consider that when a separately identifiable part of the home is used wholly for work purposes, it may be appropriate to base the apportionment on the area used. When there is mixed-use, some other basis for apportionment is suggested, such as treating an accommodation employee expenditure payment as tax-free to the extent that it meets additional heat and lighting costs.

(b) Where an employee is required to work at more than one permanent location, officials' preference is to identify the main place of work – by way of a factual assessment - and treat employee expenditure payments to meet accommodation costs at the second workplace as tax-free.

(c) In the case of overseas temporary transfers, officials consider that it might be appropriate to measure of the private value by reference to a percentage of salary or a standard property in New Zealand because, for example, the overseas property may be significantly more expensive than a comparable property in New Zealand.

31. The current rules are broadly in line with what is proposed, but contain some ambiguities. At present, it is likely that home office cost reimbursements are treated as tax exempt based on an area apportionment, including mixed-use areas. There are no rules to identify the excess accommodation costs in the case of a second workplace, and the determination of the accommodation benefit for overseas transfers is likely to vary quite significantly in practice.

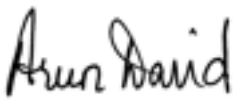
Relationship with the relocation rules

32. The relocation exemption in s. CW 17B allows expenses incurred up to the end of the tax year following that in which the relocation occurs to be reimbursed tax-free. *Determination DET 09/04*, made under s. CW 17B(6) provides for accommodation, or the value of employer-provided accommodation once the employee has arrived in the new location, for up to 3 months after arrival to be paid tax free. The exemption stands independently of any other tax rules.

33. Officials have considered whether the accommodation time limit for the relocation exemption should be linked to the suggested new rules for meals and accommodation allowances. They do not believe this will be necessary if the 12-month time limit for paying a tax-free accommodation allowance while temporarily working away from the employee's normal workplace is clearly expressed as an upper limit.

34. Officials' preference is that both time limits should be linked to the employee's initial arrival at the workplace. When an employee takes advantage of the relocation exemption, this should be an indication that he or she views the new workplace as permanent and the suggested longer time limit for temporary work travel would not apply.

35. Based on the discussion, it is a little unclear as to precisely how temporary secondments in excess of 12 months – for example, 2 years, are to be treated: as relocations, or as travel-related accommodation?



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