TAXATION POLICY

Business Tax Policy 1991

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30 July 1991

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A Statement on Government Taxation Policy

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Supplement on Business Tax Policy 1991

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SUPPLEMENT ON BUSINESS TAX POLICY 1991

PART I - OVERVIEW

Chapter 1 : Overview

The tax system has an important role to play in the Government's Strategy for Enterprise and Growth. It must be capable of raising the funds needed to finance Government spending in a manner that is fair, while not unnecessarily inhibiting the private sector's ability to provide the impetus for growth in the economy.

There are, however, a number of deficiencies in the current tax system which significantly undermine its ability to perform that role. In particular, the tax system reduces the quality and quantity of investment in New Zealand by:

- increasing the interest rates businesses must pay to raise the finance they need to fund investment
- imposing substantial compliance costs on taxpayers who derive income through offshore entities
- integrating poorly with the tax systems of other countries
- applying an uncertain tax treatment to distributions of dividends and discouraging:
    - businesses from structuring as a group of wholly-owned companies; and
    - small, closely-held, businesses from incorporating; and
- creating an uncertain environment for investment in depreciable assets, and altering the pattern of investment in those assets.

In addition, there are also a number of anomalies in the tax system which:

- give companies an advantage over individuals in relation to the tax treatment of dividend income and the utilisation of losses and imputation credits. These anomalies have been exploited in a manner that has caused a substantial erosion of the corporate tax base; and

- result in an inconsistent tax treatment of certain activities. For example, gaming machines are not currently subject to the same tax treatment as lottery and racing activities.

The taxation measures outlined in the Budget are intended to address those deficiencies, thereby ensuring that the tax system is more consistent with the Government's strategy to increase investment, employment and growth.

These measures fall into two broad categories:

- International tax and investment measures

- Base maintenance measures.

International tax and investment measures

In order to improve the quantity and quality of investment in New Zealand, the Government has decided to:

- relax the non-resident withholding tax currently applying to the interest income of non-resident lenders

- review the current Controlled Foreign Company and Foreign Investment Fund regimes with a view to implementing changes to reduce compliance costs with effect from 1 April 1992

- review the role of bilateral taxation agreements with other countries

- clarify the definition of dividends, enable groups of companies with a 100% common ownership to consolidate for tax purposes, and allow small closely-held companies to apply for "qualifying company" status so they can be treated in a similar manner to partnerships

- broadly endorse the Valabh Committee's preliminary recommendations for reform of the depreciation regime and announce the Government's commitment to:

- enable taxpayers to claim a deduction for depreciation as a statutory right

- provide statutory criteria for determining the class of depreciable property and setting rates of depreciation in line with economic rates of depreciation. On the basis of this commitment, the Commissioner of Inland Revenue has informed the Government of his intention to commence an immediate and comprehensive review of rates of depreciation

- investigate the desirability and feasibility of extending the depreciation regime to intangible assets with a limited economic life.

Relaxation of non-resident withholding tax applying to interest

New Zealand businesses are heavily reliant on foreigners to supply the funds needed to finance domestic investment.

Since the deregulation of financial markets in New Zealand and the removal of exchange controls, domestic interest rates are now primarily determined by international interest rates. Foreigners will only lend money to New Zealand businesses if they are offered a risk-adjusted, after-tax, rate of interest in New Zealand that is at least as good as that available from other countries.

At the moment, New Zealand imposes a non-resident withholding tax ("NRWT") on the interest income of non-resident lenders.

Many non-resident lenders are either unwilling or not able to use withholding tax credits to offset their tax liabilities in their home countries. Such non-residents will typically lend to New Zealand only if the resident borrower is willing to "gross up" the amount of interest paid by the amount of any withholding tax levied on that interest. This tends to deter investment by increasing the rates of interest New Zealand businesses must pay for funds borrowed offshore, as well as the interest rates they must pay to raise finance in New Zealand.

The Government has decided to relax the NRWT regime as it applies to the interest income of non-residents.

As from 1 August 1991, borrowers will be able to apply to the Commissioner of Inland Revenue to become an Approved Issuer. Approved Issuers will be able to pay tax-free interest to non-resident lenders in relation to registered securities. A tax deductible charge will be levied on Approved Issuers equivalent to 2% of the exempt interest actually paid to non-residents.

This will enable resident borrowers who are currently bearing most of the burden of the NRWT to reduce their interest costs.

It will also encourage resident borrowers who are currently reducing their costs of funds by engaging in highly risky NRWT avoidance schemes to apply for Approved Issuer status, rather than continue to run the risk of being penalised for avoidance of NRWT.

Further details of these measures are outlined in Chapter 2 of this supplement.

Reducing the costs of complying with the international tax regime

As outlined in its separate paper on international tax policy ("Taxing Income Across International Borders : A Policy Framework"), the Government is committed to the maintenance of a robust international tax regime that ensures residents are not able to avoid paying their fair share of tax by accumulating income offshore.

The Government is concerned, however, that the current CFC and FIF regimes impose excessive compliance costs on taxpayers. It will move quickly to address this problem.

As a result, in accordance with its election manifesto, the Government is giving priority to a review of the CFC and FIF regimes with a view to making the changes necessary to reduce compliance costs. Any changes made will be effective from 1 April 1992. The Foreign Dividend Withholding Tax regime will also be reviewed, with special attention being paid to the role of that regime now that the Government has decided to remove the domestic intercorporate dividend exemption.

It is envisaged that the implementation of the proposed amending legislation will reduce the unintended consequences and the high compliance costs arising from the current CFC and FIF regimes, without reducing their ability to protect the revenue base.

Further details of this decision are provided in Chapter 3 of this supplement.

Review of bilateral taxation agreements

Although the Government can achieve many of its international taxation objectives by acting alone, there are often cases where co-operating with foreign Government's can produce an even better result for New Zealand.

Over the coming months, the Government will be reviewing its policy on bilateral tax agreements to ensure they are consistent with our policies for increased investment and growth.

This review will take place within the context of the Government's policy framework on international taxation which is outlined in the document "Taxing Income Across International Borders : A Policy Framework". This document, which was released tonight, outlines in more detail what the Government's objectives will be in bilateral tax negotiations, and the reasons for those objectives.

Priority is being given to the trans-Tasman tax system, within the context of the 1992 Review of the Closer Economic Relations Agreement.

In addition, the Government has decided to investigate the possibility of reducing the effective rate of taxation on cross border equity flows through bilateral agreements. This possibility will be pursued as appropriate in the context of discussions with Australia.

Bilateral tax agreements can play a positive role in attracting investment to New Zealand. However, reducing tax barriers to cross-border investment involves a fiscal cost to the governments involved, which necessitates higher taxes elsewhere.

New Zealand will ensure, therefore, that its policy on bilateral tax agreements is also consistent with its wider fiscal policies.

Further details of the Government's approach are provided in Chapter 4 of this supplement.

Reform of the taxation of dividends and companies

The Valabh Committee has recently submitted its final report to Government on the Taxation of Distributions from Companies.

In that report, the Committee noted that the current dividend definition in the Income Tax Act has been criticised on the grounds that it is: too wide; overly complex; and subject to a number of technical drafting defects. As a result, the definition is uncertain and suffers from a number of deficiencies, including exposing taxpayers to potential double taxation in certain circumstances.

The Committee also noted that the tax system currently acts as a disincentive to small closely-held businesses who want to incorporate. The Committee therefore proposed the implementation of a tax regime targeted at closely-held companies to reduce barriers to incorporation.

Accordingly, the Government has decided to implement most of the Valabh Committee's proposals to:

- clarify and improve the definition of dividends. This will reduce business uncertainty concerning the tax treatment of dividends

- introduce a "qualifying company" regime for small closely-held companies with five or fewer individual shareholders. This will align the tax treatment of small closely-held companies more closely with that accorded partnerships.

Consistent with its desire to simplify the tax regime and reduce compliance costs, the Government has also decided to enable corporate groups with a 100% common ownership to consolidate for tax purposes.

Transactions between companies within a consolidated group, including dividend and interest payments and asset transfers, will generally be disregarded for tax purposes. This will considerably simplify the tax system and reduce compliance costs for such groups of companies. This consolidation system will give effect to many of the preliminary recommendations of the Valabh Committee that are outlined in its discussion document on Tax Accounting Issues and the final recommendations of the Waugh Tax Simplification Committee.

Legislation to give effect to most of these changes is to be introduced into the House at the time of the Budget for referral to a Select Committee. That legislation will, in general, apply to dividends derived on or after 1 April 1992. However, a number of minor technical changes to clarify the definition of dividends, which are in favour of taxpayers, will be made retrospectively to existing provisions to improve the clarity of the definition of dividends.

Further details of the Government's decisions to clarify the definition of dividends and introduce a qualifying company regime can be found in the Valabh Committee's final report on the "Taxation of Distributions from Companies", which has been released tonight as a separate document.

Details of the consolidation option are provided in Chapter 5 of this supplement.

Reform of the depreciation regime

The existing depreciation regime is in need of reform. Rates of depreciation have not been comprehensively reviewed since 1957 and the Valabh Committee's review of the depreciation provisions of the Income Tax Act has revealed a number of deficiencies.

In particular, the Committee noted that the existing provisions do not entitle taxpayers to a deduction for depreciation as a right. Rather, the current depreciation regime provides an allowance at the Commissioner's discretion. In addition, the provisions do not indicate the criteria to be used to determine whether or not an asset is to be depreciable, or the rate of depreciation to be applied to that asset.

The Government supports the broad thrust of the Valabh Committee's preliminary recommendations for reform of the depreciation regime and looks forward to the final recommendations of the Committee.

While not wanting to pre-empt those final recommendations, the Government does not want to hold up the comprehensive review of depreciation rates planned by the Commissioner of Inland Revenue.

For this reason, the Government has decided to announce that it will legislate to enable taxpayers to claim deductions for depreciation as a statutory right, and to provide statutory criteria for determining the class of depreciable property and setting rates of depreciation. The criteria will ensure that the depreciation regime is only applied to assets that can reasonably be expected to depreciate over their economic lives, and that tax rates of depreciation are set in the light of actual economic rates of depreciation. This will create a more certain environment for business investment and improve the quality of investment by ensuring tax rates of depreciation more closely reflect the rate at which asset values decline over most of their economic lives.

In view of this commitment, the Commissioner of Inland Revenue has informed the Government of his intention to commence an immediate and comprehensive review of rates of depreciation. At this stage, the Commissioner considers the review will take about one year to complete.

That review will bring current rates more into line with actual rates of economic depreciation, thereby improving the pattern of investment in New Zealand and increasing prospects for sustained increases in investment, employment and growth.

In accordance with the Government's desire to reduce tax disincentives to innovation and growth, the Government has also instructed officials to investigate the desirability and feasibility of the Valabh Committee's preliminary recommendation to extend depreciation allowances to intangible assets with a limited economic life.

Although the Government supports the broad thrust of the Committee's preliminary recommendations, it does not support the recommendation to allow taxpayers to claim deductions for losses realised on the disposal of buildings, since these assets may in fact appreciate in value over considerable periods of their useful economic life. For this reason, the Government would like the Valabh Committee to explore possible avenues for ensuring that losses realised on the disposal of assets like these are not deductible under the provisions of the revised depreciation regime.

These decisions are discussed in greater detail in Chapter 6 of this supplement.

Base-maintenance measures

As noted previously, there are a number of anomalies in the tax system that give companies an advantage over individuals in relation to the tax treatment of dividend income and the utilisation of losses and imputation credits.

These anomalies cannot be justified. Moreover, they have been exploited by some companies to such an extent that there has been a substantial reduction in the corporate tax base.

The Government will not permit these activities to erode the tax base to such an extent that it is necessary to increase the tax burden on those businesses and individuals who are already paying their fair share of tax. New Zealand's prospects for investment and growth are best served by a tax system that does not disadvantage one particular business form in relation to others.

Accordingly, the Government has decided to:

- remove the tax exemption for inter-corporate dividends
- tighten the criteria under which companies can carry forward their losses and imputation credits, and can offset their losses against the income of other companies having different owners
- prevent companies from transferring imputation credits to shareholders or companies in a manner consistent with the intent of the legislation
- recover tax from the directors and shareholders of a company that has entered into an arrangement or transaction to deplete the assets of the company so that it is unable to fully meet its tax liabilities.

All of these measures are designed to ensure that the income individuals earn though companies is treated in a similar manner to income earned directly by the individual.

In addition, the Government has decided to extend a duty to gaming machines to ensure a more consistent tax treatment of those machines relative to lottery and racing activities.

Removal of the inter-corporate dividend exemption

Dividends are income. They are income under all normal concepts. They are treated as income in company accounts. They are also treated as income in the hands of individuals. However, they are currently exempt from income tax when paid between companies.

This inter-corporate dividend exemption is an historic anomaly. While it might have originally prevented the double taxation of dividends, the imputation regime has now rendered it redundant. It is also anomalous from an international perspective, since comparable countries do not normally have a general inter-corporate dividend exemption along the lines retained by New Zealand. Removal of the inter-corporate dividend exemption is therefore justified in its own right.

In addition, rather than improve the operation of the corporate tax system, the inter-corporate dividend exemption is now being widely used to defeat that system. It forms the basis of many tax planning techniques, including arrangements designed to transfer losses between companies through the use of redeemable preference shares. There has been a considerable growth in this type of transaction over the past year or so and such transactions have made a substantial contribution to the 1990/91 company tax shortfall.

The transfer of losses between companies is contrary to the general intent of the current law and places companies at an advantage over individuals who are unable to transfer losses between each other.

Accordingly, the Government has decided to remove the inter-corporate dividend exemption. This will improve the efficiency of the business sector by reducing the extent to which the tax system favours incorporated as opposed to unincorporated enterprises. It will also provide a far more effective solution to tax avoidance than would the application of anti-avoidance rules.

In recognition of the potential impact of this change on the business sector, and the confusion surrounding the legal status of some of the current loss transfer arrangements, however, the Government has decided to defer the removal of the inter-corporate dividend exemption to dividends paid on or after 1 April 1992.

The impact of this change on businesses organised as corporate groups will also be ameliorated by the Government's decision to allow groups of companies with a 100% common ownership to consolidate for tax purposes. Payments of dividends, interest and transfers of assets between companies within the same consolidated group will be disregarded for tax purposes. This will allow such corporate groups to choose the organisational form which best serves their purposes.

The removal of the inter-corporate dividend exemption is likely to create some problems for unit trusts. As a result, the Government has decided to consider the appropriate treatment of unit trusts after the repeal of the inter-corporate dividend exemption in the light of the Valabh Committee's recommendations on related issues.

Generous transitional relief is to be provided to those taxpayers who have already entered into certain redeemable preference share arrangements. The inter-corporate dividend exemption will be retained until 31 March 1994 for dividends paid in relation to redeemable shares bearing a fixed rate of dividend, or a dividend set solely in terms of commercial interest rates, where those shares were issued prior to Budget night.

However, in order to deter further redeemable preference share deals prior to the removal of the inter-corporate dividend exemption, the Government has decided to tax dividends paid on shares acquired after the Budget where those dividends are in lieu of interest. Dividends paid in relation to debentures that are treated as shares for income tax purposes will be deemed to be payments in lieu of interest.

These measures are discussed in more detail in Chapter 7 of this supplement.

Loss carry forward and offset rules

At the moment, companies are required to have a 40% continuity of shareholding to be able to carry losses forward, and a two-thirds common ownership before the losses of one company can be offset against the income of another company.

The detailed rules implementing these restrictions are inconsistent and have been subject to abuse. Losses have been carried forward and offset in circumstances where those that are able to gain the benefit of those losses are not the same taxpayers as those that have borne the direct economic burden of those losses.

As a result, the Government has decided to implement a number of measures to clarify the circumstances in which taxpayers are able to use losses and to ensure that, as far as practicable, only those taxpayers who have actually borne the direct economic burden of a loss are able to gain the benefit of that loss for tax purposes. These measures will ensure that companies are treated in a similar manner to individuals in relation to losses.

The most significant measures are the Government's decisions to:

- require companies to have a continuity of ownership of 66% (rather than 40%), before they can carry forward losses
- require companies to take into account the lowest percentage shareholding of each taxpayer from the time the loss is incurred to when it is offset, before they can carry forward losses
- require corporate groups to have a minimum of 66% common ownership throughout the year in which the losses and profits of different companies in the group can be offset

- enable groups to use the losses of a loss company to reduce or extinguish the income of one or more profit companies in the same (66% commonly-owned) group by a combination of assessable/deductible subvention payments and simple election

- rationalise ownership tests to prevent companies from belonging to more than one group of companies by applying different grouping tests

- clarify the current rules.

Although the most significant problems will be fixed immediately, most of these changes will not take effect until the beginning of the 1992/93 year. The changes will therefore be co-ordinated with the removal of the inter-corporate dividend exemption and related changes.

These measures are discussed in greater detail in Chapter 8 of this supplement.

Transfers of imputation credits

In order to avoid the double taxation of dividend income, imputation credits can be attached to dividends to enable company tax to be credited against a shareholder's tax liability on those dividends.

However, these credits are of little value to shareholders who are not subject to full New Zealand tax. As a result, there is an incentive for companies to "stream" imputation credits away from those shareholders and sell them to taxpayers who can use those credits to reduce their tax liabilities. Like loss trading activities, such imputation credit streaming activities are contrary to the intent of current law.

There are already provisions within the imputation regime to counter such imputation credit streaming arrangements. However, the IRD has detected a number of very large transactions over the last financial year which illustrate that these specific anti-avoidance rules have been insufficient to prevent a substantial erosion of the corporate tax base.

Accordingly, the Government has decided to amend these rules to prevent companies from transferring imputation credits to shareholders or companies that are not entitled to those credits.

Similar changes will be made to the anti-dividend stripping rules to prevent debentures that are treated as shares for the purposes of the Income Tax Act being used in dividend stripping schemes. These anti-dividend stripping rules are to apply to such debentures from the date of the Budget.

The Commissioner of Inland Revenue will be given the power to deny imputation credits to those shareholders who are parties to arrangements to stream imputation credits. This power will be limited so that it applies only to those shareholders who were a party to the credit streaming arrangement.

These amendments to the anti-imputation credit streaming rules are to apply from the date of the Budget to arrangements entered into on or after that date. In the case of arrangements entered into before that date, the amendments will apply from 1 April 1992.

The shareholder continuity rule for the imputation and associated regimes, which requires continuity of ownership of shares in a company for imputation credits to be able to be carried forward, is also to be amended to ensure that it is consistent with the continuity rule recommended for losses to be carried forward. In particular, the required commonality of shareholding will be reduced from 75% to 66% and will apply from when the credits first arise to when they are distributed.

Provision will also be made to entitle companies that pay excess tax to receive a refund of that excess tax even where there has been a change in share ownership subsequent to the tax payment. This amendment will apply from the beginning of the 1988/89 income year when the imputation regime was introduced. This retrospective amendment will ensure that companies will receive refunds for tax they have overpaid in previous years. This amendment will be to the benefit of taxpayers.

These measures are discussed in greater detail in Chapter 9 of this supplement.

Tax recovery

Even where a company is assessed for tax, it is possible to escape the taxation liability by ensuring that the company has no funds to meet that liability.

Currently, there is a provision within the Income Tax Act to enable the Commissioner of Inland Revenue to collect tax from a successor company (section 276). However, both practitioners and officials have identified a number of deficiencies with that provision. In particular, its scope is too broad and its current wording actually enables companies to strip assets out so they are unable to fully meet their tax liabilities.

Consequently, the Government has decided to replace the existing section 276 of the Income Tax Act 1976 with a better targeted provision. This will allow the Commissioner to recover tax from the directors and shareholders of a company that has entered into an arrangement to deplete the assets of a company so that it is unable to meet its tax liabilities.

The new recovery provision will have effect from Budget night.

Legislation to give effect to these changes is to be introduced into the House at the time of the Budget for referral to Select Committee.

These measures are discussed in greater detail in Chapter 10 of this supplement.

Gaming-machine duty

Currently both the Lotteries Commission and the TAB are taxed at 5.5% of gambling turnover (or 5% in some cases for the TAB). Gaming-machine turnover is currently exempt from gaming tax.

The Government has decided to remove this anomaly by applying a duty of 5.5% on gaming-machine turnover from 1 October 1991. The duty will apply on all gaming machines operated from clubs and hotels.

This measure will ensure a more consistent tax treatment of gaming machines in relation to lottery and racing activities.

This measure is discussed in greater detail in Chapter 11 of this supplement.

PART II - INTERNATIONAL TAX AND INVESTMENT MEASURES

Chapter 2 : Relaxation of Non-resident Withholding Tax on Interest

Introduction

The Government has decided to relax non-resident withholding tax ("NRWT") applying to interest.

The need for the reform

Following the deregulation of financial markets in New Zealand, domestic interest rates are now primarily determined by international interest rates. Non-residents will only lend to New Zealand businesses if they expect that their after-tax rate of return (adjusted for risk) will be at least as high as the after-tax rates of return they can derive from lending to businesses in other countries.

New Zealand currently imposes a withholding tax on the interest income paid to non-resident investors.

Many non-resident investors are either unwilling, or not able, to credit that withholding tax against their foreign tax liabilities. These investors will typically only lend to businesses in New Zealand if they are compensated for any withholding taxes applied to their interest income. This is typically achieved by the inclusion of a "gross up" clause which requires the resident borrower to increase the amount of interest paid by the amount of any withholding tax imposed on that interest payment.

This not only tends to increase the interest rates New Zealand businesses must pay for funds borrowed offshore, but it also enables resident lenders to charge higher rates of interest to resident borrowers. That is, the NRWT currently imposed on interest tends to increase domestic interest rates, thereby deterring investment in New Zealand.

The Government has decided to modify the current NRWT applying to interest in order to place increased downward pressure on domestic interest rates and stimulate investment and growth.

It will also encourage residents who are currently evading or avoiding their obligation to deduct NRWT to apply for status as an Approved Issuer and pay the prescribed levy, rather than continue to run the risks associated with evasion or avoidance. This reduction in uncertainty will further reduce the costs currently incurred by New Zealand businesses raising the funds they need to finance investment.

The relaxation of NRWT has implications for the international tax regime (i.e. the Controlled Foreign Company, Foreign Investment Fund and Foreign Dividend Withholding Payment regimes) as outlined in the accompanying document "Taxing Income Across International Borders : A Policy Framework".

Outline of the reforms

The changes to the NRWT regime announced tonight will enable borrowers to issue securities on or after 1 August 1991 which pay interest to non-residents that is not subject to NRWT. A levy will be payable to the Commissioner for the right to make these tax-free interest payments.

Where the issuer and the non-resident holder of the security are associated parties, NRWT will continue to apply to the payment of interest. Similarly, interest paid to residents will continue to be subject to the provisions of the Resident Withholding Tax regime and will be subject to New Zealand income tax.

Application for approved issuer status

In order to be able to pay interest to non-residents free of NRWT, issuers must first apply in writing to the Commissioner for status as an "Approved Issuer".

The Commissioner will normally approve those applications within 20 working days, unless he considers the issuer has been responsible for serious default or neglect in complying with their obligations under the Income Tax Act 1976.

The Commissioner will be able to revoke an approval if the issuer subsequently fails to comply with their obligations under the Act. However, revocation of approval will apply only to new borrowings. Their existing loans will continue to be exempt from NRWT.

Approved issuers levy

Approved Issuers will be required to pay a levy to the Commissioner for the right to pay tax-free interest to non-resident holders of the securities they issue.

This levy will be equivalent in value to 2% of the exempt interest actually paid to non-residents.

The levy will be payable within 14 days of the end of the month in which the exempt interest was paid to the non-resident.

Registration of securities

Approved issuers will also be required to register with the IRD details of the securities in relation to which they intend to pay tax-free interest to non-residents.

Most types of debt instruments will be able to be registered, including variable principal instruments such as the New Zealand bank accounts of non-residents.

Description of legislative amendments

Amendments will be made to both the Income Tax Act 1976 and the Stamp and Cheque Duties Act 1971 to implement this new system.

Amendments to the Income Tax Act 1976

Section 311(1) will be amended to provide for non-resident withholding income to be zero-rated where the persons paying and receiving the payment are not associated persons and the interest is paid by an Approved Issuer in respect of a registered security.

Under section 309(1), an Approved Issuer will be defined to be one who has approval under section 311A to issue registered securities. A registered security will be defined to be a transaction, or one of a class of transactions, involving money lent that has been issued by an Approved Issuer and registered in accordance with the Stamp and Cheque Duties Act 1971.

The procedure for issuers to apply for Approved Issuer status is outlined in section 311A. As noted above, that application will have to be made in writing to the Commissioner. The Commissioner will approve the person within 20 working days, unless the Commissioner considers that the person has been responsible for seriously default or neglect in complying with the person's obligations under the Act.

Once approval has been given, it will be deemed to have been given at the time of application.

Approval will remain in force indefinitely unless the Commissioner revokes the approval. However, issues registered when the issuer was approved will remain registered as exempt issues, even if the issuer's approval is revoked.

Approval can be revoked if the Commissioner considers that the original criterion for approval is breached.

Amendments to the Stamp and Cheque Duties Act 1971

A new Part VIB of this Act will apply the levy Approved Issuers are required to pay.

Under section 86G an Approved Issuer will be able to apply to the Commissioner for registration of a particular transaction or class of transactions.

If the Commissioner is satisfied that the issue is made after 1 August 1991, the Commissioner shall register the transaction and notify the issuer. The date of registration will be deemed to be the date of application.

Under section 311(1) of the Income Tax Act 1976 a security can be zero-rated only if the interest is paid by an Approved Issuer in respect of a registered security. Interest will only be paid in respect of a registered security if:

- the security is a registered security at the time of the payment
- the levy has been paid.

The rate of the levy will be equivalent to 2% of the amount of interest paid to non-residents that was not subject to NRWT.

If the issuer fails to pay the levy, the security will lose its zero-rating and the payment becomes liable for NRWT, plus any penalties for non-payment of NRWT.

Summary

- The rules requiring payment of NRWT are to be relaxed.
- For revenue reasons this will not involve total removal of NRWT on interest.

- Borrowers will be able to apply to the IRD for approval to issue zero-rated securities.
- In order to issue zero-rated securities, issuers must register the issue with the Commissioner.
- Registered issues will be zero-rated for NRWT but the issuer is liable to pay an approved issuer levy.
- Non-payment of the levy will automatically revoke the zero-rated status of the security and revive liability for NRWT.

Chapter 3 : Reducing the costs of complying with the international tax regime

Introduction

Taxpayers have expressed concerns about the cost of complying with the Controlled Foreign Company (CFC) and Foreign Investment Fund (FIF) regimes. The Government is committed to addressing the compliance problems associated with those regimes.

Background on the CFC regime

The CFC regime attributes the current income of an offshore company back to the New Zealand owners if:

- a group of five or fewer New Zealand residents control 50 per cent or more of an offshore company
- the offshore company is resident outside a "grey list" of seven designated countries - Australia, Canada, France, Germany, Japan, the United Kingdom and the United States - all of which have effective tax rates comparable to New Zealand rates and their own provisions to prevent the diversion of income to tax havens.

During a transitional period following its introduction on 1 April 1988, the CFC regime applied only to companies resident in a "black list" of 61 countries with very low effective tax rates and to specified corporate entities granted tax preferences in 10 other countries.

CFC earnings are subject to New Zealand tax with a credit for foreign income taxes paid.

Compliance costs can be high because the CFC calculation requires a second set of income tax accounts. CFCs are already filing income tax returns in the country in which they are resident. CFC income is first calculated in accordance with the tax laws of the country of residence and then must be recalculated in accordance with New Zealand income tax definitions.

Background on the FIF regime

The FIF regime taxes income that New Zealand residents accumulate in offshore investment vehicles over which they do not exercise control. FIF income is calculated annually by measuring the difference between the market value of a FIF interest at the end of the taxation year plus any cash distributions and the market value at the start of the year.

The definition of what constitutes a FIF is based on a set of qualifying tests of whether the offshore entity is structured to avoid or defer tax. However, individual investors often cannot obtain the information needed to determine whether an entity is or is not a FIF.

Taxpayers have been dependent on determinations by the Commissioner of Inland Revenue on whether particular entities are FIFs. The determination process has itself been lengthy because of the difficulty of obtaining information on foreign entities. As a result, some determinations have resulted in taxpayers being informed of tax liabilities on FIF income for a number of years.

Review of the international tax regime

The Government's Election Manifesto on Taxation pledged it to consider restricting the application of the CFC and FIF regimes only to entities resident in designated tax havens and earning passive investment income.

On 19 December 1990, the Minister of Revenue announced an extension to 31 March 1991 of the transitional period during which the CFC regime would apply only to listed low-tax countries (Seventeenth Schedule) and entities.

On 6 March 1991, the Minister of Revenue announced that implementation of the FIF regime would be delayed to 1 April 1991 (or 6 March 1991 for FIF purchases on or after 6 March 1991). The Minister of Revenue also announced a review of the international tax regime.

Results of the review

The Government has released the first results of the review in the paper entitled "Taxing Income Across International Borders: a Policy Framework".

The Government is announcing:

- that robust CFC and FIF regimes will remain in place in some form to limit the ability of residents to significantly defer tax on their income and to protect the tax base

- that more flexible methods of calculating CFC income are being considered. The Government is reviewing the recommendation of the Consultative Committee on Tax Simplification that CFC calculations be simplified. The Commissioner of Inland Revenue could be provided with the authority to accept some countries' tax treatment of assets and transactions rather than require conversion to New Zealand income tax definitions in all cases

- that changes to simplify the FIF regime are necessary and options are being considered. A simpler method of taxation for taxpayers with FIF investments below a minimum threshold is one possibility. A different tax treatment of interests in foreign superannuation and life insurance funds is another possibility

- the the Foreign Dividend Withholding Payment (FDWP) regime will be reviewed. The review will focus on the implication of the repeal of the inter-corporate dividend exemption for the FDWP regime.

It is planned that changes will take effect for the taxation year starting 1 April 1992.

Summary

- The Government is committed to addressing the compliance problems associated with the CFC and FIF regimes.

- Earlier this year, the Minister of Revenue announced a review of the international tax regime.

- The paper "Taxing Income Across International Borders: a Policy Framework" presents the first results of this review.

- The Government is confirming that some form of robust CFC and FIF regimes will remain in place to protect the tax base.

- More flexible methods of calculating CFC income are being considered.

- Changes to simplify the FIF regime are also being considered.
- The FDWP regime will also be reviewed.
- Once the review has been completed, any changes to the CFC and FIF regimes will be announced to take effect from 1 April 1992.

Chapter 4 : Review of bilateral taxation agreements

Introduction

Chapters 2 and 3 outlined the Government's policy on international taxation.

Most of the reforms flowing from that policy will be implemented unilaterally.

There is, however, a limit to the international taxation objectives New Zealand can achieve alone. By working together, two countries can often obtain better investment patterns than each can obtain working in isolation.

This chapter discusses the bilateral actions on tax New Zealand plans to take in the near future. Further details are contained in the document entitled "Taxing Income Across International Borders".

Existing double tax agreements

New Zealand is already a signatory to 24 Double Taxation Agreements ("DTAs").

The Government will consider instituting an ongoing program of review to ensure that these existing DTAs are operating to promote its taxation goals. Where necessary, the Government may seek to re-negotiate DTAs to bring them in to line with current taxation and economic policy.

Priority will be given to the DTAs with New Zealand's major trading partners.

New double tax agreements

New Zealand will continue to use DTAs where they can provide a positive net benefit to New Zealand in terms of their effect on investment, trade and tax administration.

In addressing international tax matters, the Government will first identify any taxation **problems** before going on to identify the possible **solutions**.

If New Zealand is considering a DTA, it will ask:

- what are the tax problems that the DTAs will overcome?
- how will a DTA correct these problems?
- what will be the fiscal cost of the DTA?
- what are the risks to the New Zealand tax base of the DTA?
- what will be the benefits **to New Zealand as a whole** from the DTA?
- what alternative solutions exist to solve the tax problems the DTA will correct, and what are the costs and benefits of those alternatives?

Once it has answered each of these questions, the Government will carefully weigh the costs and benefits of each proposal before coming to a decision.

Bilateral agreements with Australia

New Zealand's most important bilateral economic relationship is with Australia.

With the achievement of free trade in goods and near free trade in services under the Australia-New Zealand Closer Economic Relations Trade Agreement (CER), the remaining major area of unfinished business under CER is investment.

An efficient trans-Tasman investment regime is important in achieving and realising the full benefits of an integrated Australia New Zealand market.

The tax regime has been identified as a critical impediment to rational investment and efficient trans-Tasman equity/debt markets.

The New Zealand Government is committed to seeking mutually beneficial reforms of the trans-Tasman tax system.

The New Zealand Minister for Trade Negotiations has agreed with his Australian counterpart that tax should be high on the agenda of the 1992 Review of CER.

New Zealand officials have been instructed to pursue trans-Tasman tax reform as a priority issue. Face to face discussions with Australia will begin soon.

Mechanisms for reform

Many trans-Tasman tax issues arise from the CER free-trade zone and, therefore, are outside the scope of a traditional DTA.

The New Zealand Government is committed to finding the best solution to trans-Tasman tax problems.

Reforming trans-Tasman tax brings new challenges to the way taxation policy is developed.

The New Zealand Government has no pre-conceived ideas about whether an expanded DTA, a separate tax treaty under the CER umbrella or reciprocal legislation presents the best solution.

New Zealand's approach is to start with the problems, look for possible solutions and think about possible mechanisms last.

In thinking about solutions, New Zealand will keep in mind its tax design criteria of efficiency, fairness and simplicity. The fiscal cost and likely benefits of each option will also be important factors.

Summary

- Many international taxation reforms can be achieved by New Zealand acting alone.
- By acting in concert with other countries on tax issues, New Zealand can improve on the result of its unilateral actions.
- New Zealand is considering a program to continually review its existing Double Tax Agreements to ensure that they are consistent with its taxation and economic policy.
- New Zealand will seek to conclude new DTAs, based on a set of criteria that emphasises finding the best solution to taxation problems.
- Australia is New Zealand's most important economic partner.
- Taxation has been placed high on the agenda for the 1992 CER Review.
- The New Zealand Government is committed to reforming the trans-Tasman taxation system as an important part of making the Australia/New Zealand free-trade zone more efficient.

- New Zealand has an open policy on the mechanisms for achieving reform.

Chapter 5 : Consolidation

Introduction

The Government has decided to allow groups of companies that have a 100% common ownership to elect to consolidate for tax purposes from 1 April 1992. This will enable these corporate groups to be treated as one company for tax purposes. Transfers of dividends, interest and assets within a consolidated group of companies will generally be disregarded for taxation purposes.

This chapter provides details on:

- the rationale underlying the Government's decision to allow groups of companies to elect to consolidate for tax purposes
- the requirements groups of companies will have to satisfy before they will be able to consolidate for tax purposes
- the consequences of being taxed as a consolidated group
- the manner in which the international tax, PAYE, Resident Withholding Tax ("RWT"), Specified Superannuation Contribution Withholding Tax ("SSCWT"), FBT and GST regimes will apply to consolidated groups of companies
- the treatment of companies that enter and exit the consolidated group
- the transitional rules applying to companies that elect to consolidate.

The rationale for consolidation

The Government has decided to introduce the consolidation option for groups of companies with a 100% common ownership in order to:

- treat those corporate groups for tax purposes more in accordance with the economic substance, rather than the legal form, of their business organisation
- simplify the tax rules applying to those corporate groups
- reduce the extent to which the removal of the inter-corporate dividend exemption might otherwise have disadvantaged those corporate groups.

Economic substance over legal form

Many businesses find it beneficial to operate as a group of companies with a 100% common ownership, rather than operate as a single company with a number of branches.

Although there is no real difference between these two different forms of business organisation from an economic perspective, they are currently treated differently by the tax system. In particular, the tax system acts as a disincentive to businesses that choose to structure as a group of companies with a 100% common ownership.

Ideally, the tax system should not interfere with the manner in which businesses structure their operations. If there are economic advantages to be obtained from structuring as a group of companies with 100% common ownership, it is important to minimise the extent to which the tax system either reduces or increases those benefits. The tax system should neither encourage nor discourage businesses to adopt one form of organisation as opposed to another.

The basic idea underlying consolidation is that a group of companies that are in effect one economic entity because of common ownership should be able to be treated as one entity for tax purposes. In other words, the legal construct whereby each company is regarded as a separate entity should be superseded by the economic substance which is that they are in effect branches of a single entity. The consolidation approach is therefore a substance over form approach to taxing such entities.

Tax simplification advantages

A consolidation approach also has considerable merit from a tax simplification viewpoint. It will allow groups of companies to reduce the number of annual returns they are required to file and the imputation credit accounts ("ICA") they are required to maintain in effect to one return and one account. By ignoring intra-group transactions, some problems with existing rules noted by both the Waugh Tax Simplification Committee and the Valabh Consultative Committee would be rectified.

The consolidation option, together with the removal of the inter-corporate dividend exemption, provides for the effective implementation of the Valabh Committee's preliminary proposals to allow:

- corporate head office expenses to be deductible by deeming dividends to be assessable for the purposes of section 104

- intra-group assets to be transferred with no tax effect.

The consolidation option also allows for the effective implementation of Waugh Committee proposals to:

- allow a deduction for expenditure incurred by one company in a group in obtaining income by another group member

- ensure that where joint assessments are available, all income tax provisions should reflect the fact that companies are not paying tax individually. A particular concern here is that, under the imputation system, even where a group of companies is allowed to file a joint return and be jointly assessed, separate imputation credit accounts are required. It has been argued that this largely negates the advantages of joint assessment.

As outlined below, these proposals are achieved under consolidation by:

- allowing expenses to be deductible where there is a nexus with group assessable income

- ignoring intra-group transactions

- providing that the group is required to file a single return, be subject to the one group assessment, and operate one active ICA. Individual companies within the consolidated group will keep nil balance ICAs.

Reducing the extent to which the removal of the inter-corporate dividend exemption might otherwise disadvantage corporate groups

The consolidation approach will also ensure that the removal of the inter-corporate dividend exemption does not unfairly disadvantage businesses that structure as a group of companies with 100% common ownership.

If all intra-group dividends were taxable, without exception, this could create:

- compliance problems with respect to non-cash dividends. Non-cash dividends frequently arise with respect to intra-group transactions where it is often inconvenient or disruptive to have transactions take place at full market arms-length prices

- a disincentive for businesses to organise as groups of companies since transactions between the different companies could then give rise to taxation consequences that would not arise if a branch rather than subsidiary company structure were adopted. For the same reason, taxing intra-group dividends could hinder corporate restructuring of a company group

- inconsistencies with other tax simplification proposals such as the Valabh Consultative Committee's proposal for intra-group asset transfers to be able to take place without a tax consequence. That is because an intra-group asset transfer would be likely to give rise to a taxable deemed dividend to the extent to which the asset is transferred for less than full consideration.

An option, aside from consolidation, to meet the above concerns would be to continue to provide an exemption for inter-corporate dividends provided between members of a specified group. There are, however, a number of reasons for preferring the consolidation option:

- consolidation is itself justified on economic grounds and has the added tax simplification advantages noted above

- it will produce a more consistent approach whereby for all income tax purposes the group of companies is treated as the one economic entity. Thus, rather than effectively ignoring specific transactions such as dividend and asset transfers, it will ignore all such transactions, including interest flows and management fees

- it is considered that a consolidation approach will give rise to fewer tax planning opportunities than would be the case with a specified group inter-corporate dividend exemption. That is because consolidation requires a consistent treatment of companies within the consolidated group as the one economic entity. This will, for example, prevent companies within a consolidated group from passing tax-free dividends to another company in the group in return for deductible interest flows in the other direction.

Current law

A number of provisions or practices under current income tax law recognise a form of consolidation:

- section 191 allows for losses of one group member to be offset against the income of another group member. However, as noted in Chapter 8, this provision in its current form is deficient

- it is the practice of the Inland Revenue Department to allow depreciable assets to be transferred (under certain conditions) within the same 100% commonly-owned group of companies without triggering depreciation recovery under section 117. However, as noted by the Valabh Committee, that practice does not have a specific legislative basis

- the proviso to section 85(4) allows trading stock to be transferred between members of an ordinary group of companies without a detrimental tax consequence. However, as noted by the Valabh Committee, that provision is not limited to 100% commonly-owned company groups and is capable of being abused

- section 191(8) allows for the joint assessment of groups of companies. However, the application of the provision is subject to the discretion of the Commissioner of Inland Revenue; the provision provides little guidance as to how it is to operate; it is seldom used in practice; and, as noted by the Waugh Simplification Committee, other provisions in the Act, such as those covering imputation, do not mesh with it.

It is clear that most of these provisions are flawed and the tax system will be improved by providing a more consistent and coherent consolidation option.

As well as the above provisions covering consolidation in an income tax context, section 55 of the GST Act provides for a consolidation option in a GST context. This allows for group registration for GST purposes. If a group of companies elects to adopt this option, individual companies carry on their GST activities but one company is nominated to file one return as representative of the group. This return excludes intra-group transactions except where there is a change in use such as a supply from a taxable to an exempt activity.

Other jurisdictions

A number of overseas jurisdictions offer consolidation methods for groups of companies. Principal countries with such rules are: USA, France, Netherlands, and Germany. Usually consolidation in these countries allows a group of companies to file one joint return of income and to ignore intra-group transactions (including dividends) in calculating assessable income for the group.

Requirements for consolidation

100% common ownership

A group of companies will be able to elect to consolidate where these companies have the same ultimate individual owners. This is a 100% common ownership test. Thus, where two or more companies wish to constitute a consolidated group, it will be necessary to establish that each company is owned by the same persons (traced through any intermediary companies), and that the ownership is in the same proportions.

For the purposes of this test, ownership will be measured by a shareholder's economic interest in a company. Economic interest will be defined on the same basis as for loss offset rules. In general, this will mean that an economic interest will be equal to a percentage of a shareholder's voting power in a company. However, a lower of voting rights or market value rule will apply where:

- a shareholder has a fixed entitlement to profits and can veto any alteration in that entitlement
- the company has issued, after Budget night, variable rate debentures covered by section 192 of the Act
- the company has issued options, other than certain listed company options or options to acquire shares at their market value
- the shares have been subject to an arrangement with the purpose or intention of defeating the consolidation provisions.

All shares and options will be taken into account in determining an economic interest except for: certain listed company or market value options, fixed rate debentures covered by section 195 of the Act, fixed rate dividend shares (appropriately defined), and variable rate section 192 debentures issued before Budget night.

In determining whether the 100% common ownership requirement is met, the Commissioner will disregard any insignificant share holdings where such a share holding is for the purpose of meeting company law requirements. This provision will mirror, but clarify, the current section 191(6)(c).

A 100% common ownership requirement (rather than a smaller percentage requirement, such as 66%) is consistent with the rationale for consolidation and is necessary to prevent the consolidation option being able to be abused. This is because where there is less than 100% common ownership, any intra-group transaction will result in an in-substance change in the economic position of the underlying shareholders. For example, where a revenue asset is transferred from one company in a group with less than 100% commonality of shareholding to another company in that group, tax must be levied on the transaction. Otherwise the accrued profit of the asset is transferred, at least in part, to a new group of taxpayers.

Moreover, where a group has less than 100% commonality of shareholding, commercial and legal considerations would generally require that transactions take place on a market arms length basis so that the rights of minority shareholders are protected. There should therefore be minimal compliance costs involved in establishing correct tax values for intra-group transactions in such cases.

The need to restrict a consolidation approach to groups with 100% commonality of ownership was recognised by the Valabh Consultative Committee in its report on tax accounting issues. The Committee rejected suggestions that assets should be transferable free of tax consequences within an ordinary group, stating (at page 36): "An underlying change in economic ownership, of potentially significant proportions, frequently results in transactions between ordinary group members."

Of other jurisdictions operating a consolidation approach, France requires 95% common ownership and the Netherlands requires 99%. Germany requires that the companies in the group act as one economic entity. The USA implemented its consolidation approach by requiring 95% common ownership but subsequently relaxed this to 80%. A high degree of common ownership is therefore a feature of overseas tax systems. Generally, the higher the degree of common ownership required, the simpler and more comprehensive is the consolidation approach. For example, the relatively low threshold required by USA results in a system that is less than full consolidation with only some intra-group transactions being ignored for tax purposes.

Sale of interests in a group

The sale of a share or other interest in a member of a group will not result in deconsolidation or disqualify a member of a group from remaining a member of that group, provided the requirement for

100% common ownership in the same proportions of every member of the group is constantly maintained. Thus, for example, a proportion, or all, of the shares in a parent company could be sold and it would still be able to consolidate with its 100% owned subsidiaries. Similarly, if two sister companies were owned by the same individual, and the individual sold both companies to another person, those companies would be able to consolidate both before and after the sale.

In these cases, sale of interests in members of a consolidated group would be treated in the same way as the sale of one ordinary company. As with a single company, it could result in a breach of continuity rules for loss carry forward or imputation purposes, but would not generally otherwise affect the tax position of the companies involved.

All member companies of the group must be New Zealand resident taxpayers

Every member of the group will be required to be resident in New Zealand for income tax purposes. For this purpose, companies will be treated as not resident in New Zealand where they are non-resident under double tax agreement provisions. However, New Zealand branches of overseas life offices that elect to be treated as New Zealand resident entities under section 204M of the Act will be treated as New Zealand resident companies for consolidation purposes to the extent of their New Zealand branch activities. Other branches of non-resident companies will, of course, be non-residents and thus be unable to consolidate.

A consolidation approach assumes that all consolidated entities are taxed under consistent rules for any particular activity. A company not resident in New Zealand is subject to different tax rules from a company that is resident here. For example, non-resident companies are not taxable on world-wide income while also being DTA protected on some forms of New Zealand source income. In addition, a non-resident is unable to maintain an ICA account. It would therefore be inappropriate for non-resident companies to be included within a consolidated group. If a non-resident company were included in a consolidated group, it would be impossible to ensure that tax on income derived by the non-resident did not result in inappropriate ICA credits.

Qualifying and non-qualifying companies

With the implementation of the reforms to the taxation of distributions from companies proposed by the Valabh Consultative Committee, a distinction will be drawn for company tax purposes between qualifying and non-qualifying companies. Qualifying companies will be able to consolidate with other qualifying companies, and non-qualifying companies will be able to consolidate with other non-qualifying companies. However, a consolidated group will not be able to consist of both qualifying and non-qualifying companies. That is in line with the Valabh Committee's recommendation that losses should not be allowed to be transferred from a non-qualifying to a qualifying company.

A company may not consolidate where consolidation is a step in a tax avoidance arrangement

There will be an anti-avoidance rule making one of the criteria for consolidation that consolidation is not a step in a tax avoidance arrangement (including a loss transfer or credit streaming arrangement).

Consolidation criteria must be met throughout an income year

The above consolidation requirements will need to be met by every member of a consolidated group from the beginning to the end of an income year. Failure by any company to meet the requirements at any time would result in that company ceasing to be a member of the group.

Consolidation an elective option

Consolidation will be available at the option of taxpayers. There will be no requirement that a group of companies that meet the criteria be treated as a consolidated group. Nor will there be any requirement that, if a consolidation option is adopted by some members of a company group, all members of the group that meet the consolidation criteria adopt the consolidation option. In other words, taxpayers will have a free choice as to which corporate members they wish to have included in the consolidated group.

Finally, there will be no requirement that one member of the consolidated group be a parent company with all other companies in the group being direct or indirect subsidiaries of that parent. It will thus be possible for two sister companies to consolidate with the parent being outside the consolidated group. This will enable New Zealand resident subsidiaries of a non-resident company to elect to be taxed under the consolidation option.

Compared with the requirements of overseas consolidation regimes, these rules are relatively generous. For example, the USA requires that every company in a group that meets the consolidation criteria must be included in the consolidated group if a consolidation option is adopted. Similarly, the USA, Germany, France and other countries having consolidation regimes, normally require consolidation with a parent and do not allow consolidation of two sister companies without the parent. It is considered unnecessary to impose such strict criteria in the context of the New Zealand proposals and the New Zealand tax system. Any attempt to force consolidation would also encourage companies that did not wish to be included within a consolidated group to structure so that they did not meet the consolidation criteria.

One or more companies may form a consolidated group

A consolidated group may consist of one or more companies that meet the consolidation requirements, but must have at least one corporate member. Clearly there is limited advantage in having a group consisting of only one member. However, where a group of companies is reduced to one member it may be considered desirable to keep the group operative so as to allow for new companies to enter the group at minimal compliance cost and/or so as to avoid potential tax consequences arising from de-consolidation.

Consequences of being taxed as a consolidated group

Consolidated group becomes a separate tax entity

The consolidated group will become a taxable entity separate from the individual members of that group. Each individual company within the group will keep its separate IRD number. The new taxpaying entity (the consolidated group) will be established with a separate IRD number. This will be issued by the IRD when notification is given of election to adopt consolidated group treatment for notified group members. Changes and additions to group membership will be required to be notified to the IRD at least one month prior to the income year in which the change or addition takes effect.

This entity approach is preferred to the other options considered which were:

- the parent company approach - the transactions and assets/liabilities of subsidiaries are in effect deemed to be those of the parent company. The income tax return and assessment is that of the parent. This approach seems the most commonly adopted consolidation method employed overseas - for example, France, Germany and USA. This approach, however, requires a parent to be part of the consolidated group and does not allow consolidation of only sister companies

- the nominated company approach - this is similar to the parent approach except that any company in the group can be nominated as the taxpaying group entity. Where the nominated company leaves the group, another company would need to be nominated to replace it. This is along the lines of group registration provided for in section 55 of the GST Act. Ultimately, the same rules and procedures can apply under either the nominated company approach or the entity approach. The entity approach is preferred in that, in an income tax context, it allows a cleaner approach with assessments and ICAs for the group separate from those of any group member.

Assessment and return of income

Only one consolidated income tax return will be required covering all members of the group. That return will list each group member for the year and their IRD numbers. Attached to the return will be tax accounts for each group member. Those accounts will include all intra-group transactions. The actual consolidated return will be the sum of income/losses of each member less intra-group transactions.

Intra-group transactions will not be automatically self-cancelling within the group. That is because a number of transactions can result in income and expenditure between two taxpayers being recognised in different time periods since the time income is derived is not necessarily the same as the time in which expenditure is incurred. For example, lease payments on land are recognised for expenditure on an accrual basis under section 222E whereas for income purposes such payments are recognised when derived, which is often when receivable.

The IRD income tax assessment or determination will be an assessment or determination of the income or loss of the consolidated group. There will be no assessment or determination relating to the individual corporate members of the group.

The requirement to provide separate accounts for each company in the group is considered necessary for the proper policing and administration of the income tax system. For this reason, when providing a joint assessment under the existing section 191(8), IRD generally requires separate company accounts to be provided.

One group balance date

Consistent with treating the group as the one tax entity, the group will have one balance date (31 March unless an alternative is approved by the Commissioner). That means that members cannot have different tax balance dates. This is the same as branches which must have the same tax balance date as their parent. This is also the approach generally adopted by overseas consolidation regimes.

The requirement for one group balance date is proposed here and required overseas because if entities with different balance dates were to be grouped, the group tax calculation would not be a true reflex of income for any one time period. It could be an amalgam of income flows relating to different time periods.

Nominated company

Every consolidated group will be required to have one nominated company to which IRD can address queries. This nominated company will be deemed to be the agent for the group and for each company that is, from time to time, a member of the group. It is therefore to the nominated company that IRD will look in the first instance for payment of tax and for enforcement of any tax obligations, such as the filing of returns. Such a provision is necessary for the proper administration of the income tax system.

Payment of and liability for tax

As noted above, the nominated company will initially be responsible, as agent of the group, for payment of all tax attributed to the consolidated group. However, every member of the group will be jointly and severally liable for meeting any tax liability or tax obligations of the group. This will cover all group tax liabilities incurred up to the end of the income year in which the company ceases to meet consolidation requirements or elects no longer to be a member of the consolidated group. Payment to meet tax liabilities will be able to be made by any member of the group, not just the nominated company.

A company ceasing to be a member of a consolidated group will also have the option of being jointly and severally liable only for tax obligations up to and including the day (the exiting day) on which it ceases to be a consolidated group member. For this option to apply, there must be notification to the IRD within three months of the exiting day, including written agreement of the nominated company of the group to prepare separate returns for the group for the period up to and including the exiting day and for the period covering the remainder of the group's income year.

The imposition of joint and several liability of members for group tax obligations and liabilities is necessary to prevent the consolidation option being used in an abusive manner. It is also consistent with the rationale for consolidation that the group and its individual members form one economic entity, and in recognition of this that all group members should be treated as agents of the group. For example, if each member were in fact a branch of the one group company (in effect the tax treatment provided), then the assets of each branch would be available to meet the tax obligations of the group as a whole. Joint and several liability replicates this.

Joint and several tax liability is also a common feature of overseas consolidation regimes and was recommended by the Valabh Consultative Committee with respect to liabilities arising from tax-free intra-group asset transfers.

Individual group members will, of course, remain individually liable for any tax liabilities (including PAYE and FBT) relating to the period prior to which they elected to become members of the group.

Provisional tax

A consolidated group will pay provisional tax on a group basis. Thresholds on when provisional tax is payable (section 377(2)) and when estimation is required (section 382(2)) will be based on group residual income tax. However, where provisional tax obligations are based on the residual tax for prior income years (for example, when determining whether there is a provisional tax liability under section 382(5), or when basing provisional tax payments on a prior year basis under sections 377(1) or 381(2), or in calculating additional tax payable under section 384(2)), the group will be required to include in prior year calculations the residual income tax of any company that is a member of the group for the current income year but was not a member of the group for the relevant prior income year.

This is necessary to ensure that the consolidation option does not provide a means for reducing or removing provisional tax liabilities. For example, in the first year of a consolidated group it would have no prior year residual income tax. In those circumstances the group should use the sum of the prior year tax of the individual group members.

For the same reasons, where a company leaves a consolidated group, it will have no prior year residual tax. It should nevertheless be liable for provisional tax and be required to pay provisional tax on a reasonable estimation basis.

Imputation and consolidation

The group will have its own separate ICA covering the group's activities. This is consistent with consolidation under the entity approach. Individual ICAs recording individual tax payments for each group member would be inconsistent with the consolidation approach since it would require individual assessments of each group member. This would reduce simplicity advantages and would produce oddities since individual assessments (and credits to individual ICAs) would have to ignore intra-group transactions. Indeed, the need for individual ICAs is a fault in the existing joint assessment provision and led the Waugh Simplification Committee to recommend consistency in legislative provisions impacting on joint assessment procedures.

Credited to the group ICA will be:

- all tax paid by any company on behalf of the group or any member of it

- any credits on dividends derived by any member of the group.

The group itself will not, of course, pay any dividends. Dividends will be paid by individual company members. Since those dividends flow to shareholders out of group income, the relevant imputation debit should be posted to the group ICA. Thus, debited to the group ICA would be credits on any dividends paid by any member of the group.

This raises the issue of how to handle intra-group dividends, particularly where some dividends flow to other group members and some to outside shareholders. Such dividends will not constitute assessable income of the group since intra-group transactions will generally be ignored for tax purposes. However, for the reasons given in the next paragraph, it is not appropriate to ignore intra-group dividends for imputation purposes.

It is proposed that intra-group cash dividends, including taxable bonus issues, (dividends to which imputation credits can be attached) have imputation credits attached. Those imputation credits will come from the group ICA and a debit will be posted to the group ICA. Those imputation credits will also give rise to an equal and offsetting credit to the group ICA. While this offsetting debit and credit to the group ICA may seem complex, it should in fact be simpler than any alternative approach since it would avoid the need to separately identify intra- and extra- group dividends received and paid. This is because all dividends will result in credits or debits to the group ICA. This will also allow anti-imputation streaming rules and the imputation ratio requirement to apply on a group-wide basis to all dividends paid by any member of the group.

While a member of the group, an individual company will continue to retain an individual ICA. However, the only credits to that account will be payments with respect to pre-consolidation assessments or re-assessments. The only debits will be refunds with respect to pre-consolidation years. However, any such imputation credit or debit will then be immediately transferred to the group ICA reducing the individual ICA to a zero balance. The consolidated ICA return will simply note that the ICA of each group member was nil.

The retention of nil balance ICAs for individual companies is desirable for two reasons:

- it recognises that reassessments and refunds relating to pre-consolidation years are the responsibility or property of the individual company and not the group

- it provides an ongoing ICA for use if a company leaves a group and thus assists in the policing and administration of the imputation regime.

Normal continuity and streaming rules would apply to the ICA of the group. Thus, if continuity of ownership of the group were breached, the group ICA would be reduced to zero. Pre-consolidation credits and debits of individual companies are considered below under provisions concerning the exit and entry from a group.

Concern has been expressed that consolidation in this manner could provide an opportunity for imputation streaming. Where a company is sold so as to breach continuity, the imputation credit account is reduced to a zero balance. However, where a group member exits a group and is then sold, imputation credits relating to income derived by that company will remain alive provided group continuity were not breached. This is not considered to constitute a mischief since those credits are still attributable only to the shareholders who effectively bore the tax. Moreover, it is the same result as stripping a company of imputation credits prior to sale.

Losses

Any net loss incurred by the consolidated group will be able to be carried forward or offset against the income of another company under normal rules as if the group were a separate company. Individual group members will not separately be assessed. Therefore any net loss incurred at that level will effectively be able to be offset against the net income of another group member as if the different members were branches of the one company. Pre-consolidation losses are considered below under the provisions affecting exit from and entry into a group.

Where a separate company with losses is sold so as to breach continuity requirements, the losses are wiped. The consolidation regime will allow a company that has incurred losses within the group to leave the group and be sold while the losses will remain utilisable by the group. However, as with imputation, this does not seem to contradict the policy rationale behind rules pertaining to losses since the losses are still attributable to the shareholders who actually incurred them - the original shareholders of the group.

Income measurement of the group

The gross income of the group will be defined as the sum of the gross income of each member of the group less any income attributable to intra-group transactions. This will mean that no tax will be levied on intra-group dividends and intra-group asset transfers will take place without an income tax consequence. The consolidation regime will therefore, in effect, implement the Valabh Consultative Committee's preliminary recommendation that intra-group assets be transferred with no tax effect.

This will be achieved by the following with respect to intra-group transfers:

- for depreciable property and depreciation provisions, deeming the property to be acquired by the transferee for the written-down tax value of the transferor at the time of the transfer. This will be the case unless annual depreciation is based on a straight line method (or any other method based on original cost) in which case any annual depreciation allowance should continue to be based on the original cost to the transferor

- for trading stock, trading stock in the hands of the transferor will be deemed to be trading stock of the transferee. Such trading stock will be deemed to be acquired for:

  - the tax value of that trading stock at the end of the preceding income year where the trading stock was held as trading stock by the transferor at the beginning of the income year

  - its cost to the transferor where the trading stock was acquired by the transferor during the income year

- for financial arrangements, no base price adjustment will take place on an intra-group transfer of arrangements issued or held by the transferor. Instead, the transferee will continue to accrue income or expenditure on the same basis and under the same rules as if the transferor were still the issuer or holder of the arrangement

- no assessable gain or deductible loss will arise on an intra-group transfer of revenue property. Revenue property would be any property (including depreciable property) where, under normal income tax rules, on disposal, any gain gives rise to assessable income or loss is deductible. The transferee will be deemed to acquire the property for the transferor's original or deemed purchase price plus capitalised (non-deductible costs) incurred by the transferor, such as capital improvements.

For the purpose of determining the intention or purpose for which property was acquired by the transferee so as to determine whether a gain on the disposal of the property is assessable or a loss deductible, the property shall be deemed to be held at all times by the transferor and the transferee shall be deemed to be the agent of the transferor. This is to ensure that where a gain is assessable in the hands of the transferor under section 65(2)(e), or any similar provision, it remains assessable to the transferee. On the other hand, should property, a gain on which would not otherwise be taxable, be transferred intra-group for the purpose of sale outside the group, that of itself would not result in the gain being taxable.

Where a parent company sells shares in a subsidiary company which is a member of the same consolidated group, and any gain or loss on that transaction would be assessable or deductible under normal income tax rules, the shares will be treated as a normal property transfer. Thus, if the shares are transferred to another company in the group, no tax consequence will arise. The transferee will hold the shares on the basis outlined above for revenue assets. Where the sale is to a person not a member of the group, the disposal will result in an assessable gain or deductible loss.

However, in calculating that gain or loss a provision is necessary to adjust the acquisition price of the shares to take account of any exempt intra-group transaction. This provision is to be avoidance-orientated along the lines of the existing section 198 but would cover all intra-group transactions, not just dividends.

In addition to applying where a group company is disposed of, the provision will also need to apply where shares in a company that was once part of a group are disposed of for an assessable gain or deductible loss. In the absence of such a provision, a parent could consolidate with a subsidiary; extract assets from the subsidiary tax-free; and dispose of the subsidiary for a tax-deductible loss.

The above asset transfer rules differ in some respects from the Valabh proposals regarding the exemption of intra-group asset transfers. This is for two reasons:

- those proposals were advanced outside the context of removal of the inter-corporate dividend exemption and a full consolidation option. Thus, whereas the Valabh Committee recommended that an exemption for intra-group asset transfers should be optional, consolidation is proposed to be optional but within that regime all transfers will be disregarded for tax purposes

- the Valabh proposals were advanced in conjunction with other measures such as a system for asset classification. These other proposals will not be considered until the Valabh Committee finalises its report. In the meantime, the consolidation option needs to integrate with existing tax rules.

For all other income tax purposes, any intra-group transaction (interest and dividend flows, lease payments, management fees, and so on) would be deemed to be transactions between branches of the same company so that no taxation consequence will arise. This will preserve the inter-corporate dividend exemption (including the exemption from FBT on non-cash dividends) within a consolidated group.

Where, as in the accrual rules, income measurement rules can be determined according to de minimus provisions, the application of the relevant rules will be applied on a group-wide basis.

The gross deductions of the group will be defined as the sum of the gross deductions of each member of the group less any deductions attributable to intra-group transactions. Intra-group transactions and property transfers therefore will not give rise to deductible expenditure or losses. With respect to interest deductions, section 106(1)(h)(ii) will continue to apply to enable a deduction for funds borrowed to capitalise a member of the consolidated group. However, it will not apply to any interest payments by a group member on funds borrowed from another member of the consolidated group.

For deductibility purposes, the expenditure or loss of a group company will be deemed to meet any requirement for a nexus with assessable income (under, say, sections 104 or 136) if there is a nexus with the assessable income of any member of the consolidated group. This will meet recommendations of both the Waugh Simplification and the Valabh Consultative Committees that there should be a procedure for allowing the expenditure of a holding company to be deductible other than by way of somewhat contrived management fees.

Consolidation and international tax rules

Controlled foreign company regime

For the purposes of the CFC rules, a consolidated group of companies would be treated as if it were one company.

This is consistent with the overall consolidation approach. It would mean that the CFC rules operate for a consolidated group of companies in the same way as they already operate for a specified (or 100% owned) group of companies with one main relaxation in the rules. This is that, as for ordinary losses and imputation credits, continuity rules for CFC losses and excess foreign tax credits will not be breached if the corporate member of the group is sold provided group continuity of ownership is maintained.

As a result, for a consolidated group, this would mean that:

- CFC losses and foreign tax credits of a group would be quarantined on a country by country basis but losses and credits from one CFC within a country would be able to offset CFC income or tax from that same county

- excess CFC losses and foreign tax credits would be subject to the same continuity rules as ordinary losses.

Branch equivalent tax accounts

Each group with members holding interests in CFCs will maintain a group branch equivalent tax account (BETA). This account will be credited with any tax paid by the group in relation to income attributed from CFCs. As with imputation credit accounts, individual group members with interests in CFCs will continue to maintain an individual BETA. The only credits to that account would arise from payments resulting from pre-consolidation assessments. The only debits to the account would result from refunds of tax paid in pre-consolidation years. Any debit or credit to individual BETAs will be transferred to the group BETA, thus reducing the individual BETA to a nil balance.

If the group failed to satisfy the continuity of ownership requirements, any balance in its BETA will be wiped. Continuity of ownership requirements will not cease to be satisfied simply because a group member holding an interest in a CFC that gives rise to BETA credits is sold.

The group could elect to use any credit balance in its BETA to reduce any dividend withholding payments payable by the group in respect of foreign source dividends. The group may also elect to transfer any balance in its BETA to its group imputation credit account.

Foreign dividend withholding payments

Where any consolidated group member derives dividends from non-resident companies, the group will be required to deduct dividend withholding payments from those dividends. The group will maintain a group dividend withholding payment account that recorded dividend withholding payments made by the group in respect of dividends derived by any group member. This account will operate in the same way as a group imputation credit account. Debits to the account will be made when dividend withholding payment credits are attached to dividends paid by any group member.

The treatment of intra-group cash dividends will be the same as for imputation. Such dividends will therefore have dividend withholding payment credits attached, resulting in a debit and an offsetting credit to the group's dividend withholding payment account. This avoids the need to identify separately dividends paid to group members and to non-group members.

Foreign investment fund regime

Foreign investment fund (FIF) losses may be deducted from FIF income or from ordinary income to the extent of prior FIF income. Under consolidation, FIF income and losses of the group will be calculated separately from other income and aggregate FIF losses would be set off against aggregate FIF income. Any excess FIF losses could be deducted from other group income to the extent of prior FIF income of the group.

The group could carry forward any excess FIF losses that were not able to be utilised in the current year to future years. The ability to carry forward such losses will depend on the group satisfying the continuity of ownership requirements applying to ordinary losses.

PAYE, RWT, SSCWT, FBT

PAYE, RWT, SSCWT and FBT responsibilities will remain legally with individual companies and not be the responsibility of the consolidated group as a whole. This is to meet administrative concerns.

However, each group member will be jointly and severally liable for meeting those liabilities. IRD would seek payment from the nominated agent in the first instance. Returns and reconciliations with respect to the above will be required for each individual group member. Provision of such returns would be the joint and several liability of each group member, but again IRD would look in the first instance to the nominated agent company.

All intra-group interest and dividend flows will be exempt from resident withholding tax. This exemption will also apply where a company ceases during an income year to be a member of the consolidated group and it is deemed to exit the group from the beginning of the income year. The exemption will then apply up to and including the earlier of the date at which it notifies the IRD it wishes to cease being a member of the group or the date at which it ceases to qualify as a member of the group.

GST

Present GST rules regarding group registration will not be affected by the consolidation proposal. A consolidated group will not be required to adopt group registration for GST purposes.

Other taxes

As recommended by the Valabh Consultative Committee, intra-group asset transfers will not crystallise either a gift duty or stamp duty liability.

Entry to and exit from a group

Timing of entry and exit

A company will be able to enter or establish a consolidated group by meeting the qualifying criteria and by electing to do so. In its election, the company will be required to notify IRD at least one month in advance of the effective date of consolidation. This notification must contain agreement by the company to be jointly and severally liable for all group income tax obligations. This notice must be signed by an authorised officer of the company.

A group may be formed only from the beginning of the group's income year. Where a company elects to become a member of an established consolidated group, it may do so only from the beginning of the group's next income year.

A company will exit a consolidated group where it either:

- elects to do so and notifies the IRD of this
- no longer meets the requirements to be a member of the consolidated group - for example, where it ceases to have 100% common ownership in the same proportions as other companies in the group. A company will be required to notify the IRD when it becomes aware that it no longer qualifies to be a member of the consolidated group.

In either circumstance, the company will be deemed to no longer be a member of the consolidated group from the beginning of the income year in which it elects not to be a member or ceases to meet consolidation requirements. This means that intra-group transactions from the beginning of the income year will have normal tax consequences. However, any stamp duty or gift duty liability which crystallise on departure of a company from the group (as outlined under the next heading) will become payable no earlier than the date of notification of election to cease being a group member or from the date of ceasing to qualify as a group member.

The group will be able to nominate a reasonable proportion of provisional tax payments made that shall be deemed to have been provisional tax payments paid by a company that exits a group in the course of an income year with effect from the beginning of that year.

There will be no requirement that a company remain a member of a consolidated group for any minimum period of time and no penalty if it does not remain a member for a minimum period. Subject to the above timing rules, there will be no restriction on the ability of a company to move into and out of group status. These are relatively liberal rules compared with overseas consolidation regimes where it is normal for restrictions or penalties to be imposed on exit and entry from a consolidated group within a minimum period.

Asset values and taxation implications on entry to and exit from the group

The question of whether a company's taxation liabilities on assets should crystallise on that company's entry to and exit from a consolidated group is one of the more difficult design issues in a consolidation system. The issue arises because the tax system does not generally recognise accrued gains and losses until they are realised. Thus, where a company brings into a consolidated group assets with accrued taxable gains or deductible losses, those gains or losses are properly attributable to the pre-consolidation period and should be treated as such.

Moreover, if no tax consequence arises on entry or exit, and if intra-group transactions are made free of tax consequences, then it would be possible to utilise consolidation rules so as to effect a transaction with independent parties in a way that avoids a tax liability. For example, it would be possible for a consolidated group to avoid tax on the profit from a revenue asset by transferring that asset to a group member and then selling the shares in that company to the ultimate purchaser of the asset who could then transfer the asset freely within another consolidated group. Most sale and purchase transactions could conceivably be structured in this way to avoid any tax liability arising.

This problem was recognised by the Valabh Consultative Committee in its paper on tax accounting issues where it stated (at page 36): "it would be necessary to ensure that any concession with reference to intra-group transactions is not capable of being used by transferors as a means of avoiding a tax liability on what is, in substance, a transfer outside the group."

An additional concern in this area is that there must be sufficient information and an auditing trail to enable the IRD properly to police and administer the income tax system by, for instance, having access to documentation of the actual original purchase price of revenue assets.

Since a consolidated group is to be treated for income tax purposes as a different tax entity from individual company members, it would be consistent to treat entry to a group as constituting a disposal to the group of all the entering company's assets. In terms of normal income tax rules, a disposal would be deemed to be for market value. Similarly, when a company exits a group, the appropriate treatment would be to treat the assets the exiting company takes with it as if they were disposed of by the group to the exiting company for market value.

This therefore suggests that on both entry to and exit from a consolidated group, all assets of the company should be deemed to be disposed of for market value thereby crystallising any accrued tax liabilities. Such an approach would remove avoidance concerns and produce adequate information for IRD's administrative purposes. However, it would also be likely to result in a significant barrier to companies choosing the consolidation option thereby negating many of the benefits for the tax system of having the option available. In addition, since the entering company and the group have the same economic owners, this approach would appear to contradict the rationale underlying consolidation, being that the tax system should look to in-substance changes (that is, look at changes in beneficial ownership rather than formal changes in ownership) when determining when a taxation liability should crystallise.

Other options adopted overseas have their own difficulties. For example, another approach is to defer crystallising tax liabilities on assets brought within a group until those assets are transferred from the original company to another company within the group or to an outside person. On transfer to another company within the group, the accrued gain at time of entry to the group crystallises. This approach, however, means that records must be kept of accrued gains at the time of entry to the group and intra-group asset transfers remain subject to taxation impediments.

The Valabh Consultative Committee's proposal, in the narrower context of enabling intra-group asset transfers to take place without a taxation consequence, was to deem assets transferred within a group to be disposed of for market value only at the time the group relationship between transferor and transferee ceases to exist. While not as robust as an approach that deems disposal on both entry and exit from a group, this approach seems a reasonable compromise between base maintenance, administrative and compliance concerns.

Under this approach there would be no crystallisation of taxation consequences arising from an intra-group transfer, but when the group deconsolidates or a transferor or transferee leaves the group, there would be a deemed disposal and reacquisition of any transferred assets. Where there is a chain of transfers within a group, it is only the initial transferor and the ultimate transferee that would be relevant.

As a result, when an asset is transferred outside the group, all taxation consequences would crystallise. If the asset were previously the subject of an intra-group transfer, since the transferee is deemed to acquire assets at their value to the transferor, the taxation consequences of the intra-group transfer would effectively crystallise when the asset is transferred outside the group. When either the transferor or transferee leave the group, or the group deconsolidates, all assets subject to an intra-group transfer (but not other assets) would be deemed to be disposed of and reacquired for market value crystallising taxation consequences. Those taxation consequences would relate to income tax, stamp duty and gift duty.

This meets avoidance concerns but would require a record to be kept of all assets brought into the group by an entering member that have been subject to a subsequent intra-group transfer. Companies in a group would thus have to identify in their accounts attached to every consolidated return assets brought into the group by that company and such assets that have been transferred from another group member and the identity of the transferor. The group (and, if necessary, IRD) should be able to trace the assets in this way and would be able to establish original cost values since the assets would have been deemed to have been transferred for that value in accordance with the intra-group asset transfer value rules outlined above.

It is recognised that this will impose some compliance costs on taxpayers. However, those costs are justified by the advantages the system provides by not producing significant disincentives to consolidation.

Losses on entry to and exit from the group

Where a company with past losses becomes a member of a consolidated group, if loss continuity rules are complied with, it is, at that point deemed to offset all qualifying losses against group income. This will be allowed even if the result is to produce a net overall loss at the group level. In this way, the group member would not itself have any losses to carry forward. This is to remove the need for individual assessments of group members. Where continuity is breached on becoming a group member, losses are, of course, wiped.

The ability of the group to carry forward losses transferred to the group by an entering group member will be subject to normal continuity rules. The continuity rules would apply both at the group level and at the level of the individual group member. This is necessary because it would be possible for group continuity to be maintained while continuity with respect to the individual member is breached.

For example, Assume ACo is 100% owned by A. In Year 1 ACo incurs losses of $100. In Year 2, 30% of ACo is sold to B. Continuity is not breached. In Year 2 ACo incurs losses of $100. In Year 3 ACo is consolidated with XCo, a company owned 30% by B and 70% by A. In that year the group incurs a loss of $100. In Year 4 A sells 20% of ACo and XCo to C. Group continuity is not breached, but continuity for ACo in Year 1 is breached. The $100 of losses for that year should no longer be able to be carried forward.

For losses brought into a group, it will therefore be necessary for continuity rules to be applied with respect to the individual members to whom those losses are attributable. This will be achieved by requiring those losses to be identified with the company and the income year to which they relate. Where continuity is breached at the company level, the losses will no longer be able to be utilised. The normal ordering rule will be applied: losses will be deemed to be utilised in the order in which they were incurred.

When a company exits a group, it can, of course, take no losses with it that were incurred while a member of the consolidated group. That is because the losses have become those of the group by the offset procedure. This does allow a loss company to be sold, but for its losses to be still alive. However, those losses were ultimately incurred by the individual owners of the group. Thus, there seems to be no reason to prevent such losses from still being utilisable. Under current policy, it is the transfer of losses to new owners that causes concern.

However, where a company exiting a group carried losses into the group on entry, any remaining pre-consolidation losses attributable to that company will be taken with the company on exit. That is to allow continuity requirements to be applied to the individual company.

Where a group deconsolidates, all members in effect exit the group. Exiting members will take with them any unused pre-consolidation losses as outlined above. However, losses incurred on a group basis will then be lost. It will be possible for these losses to be kept alive by not deconsolidating but by keeping one company as the group. This may seem an odd result. It may be thought simpler to allow losses to be attributed to individual group members on deconsolidation. However, that would potentially allow losses to be attributed to companies that were not members of the group in the year the losses were incurred. As a result, policing of the loss continuity rules would become extremely difficult if not impossible.

Imputation credits on entry to and exit from the group

The rules regarding imputation credits and debits on entry to and exit from a group will mirror those pertaining to losses. On entering a consolidated group, credits or debits in the ICA of the company will be transferred to the group ICA. However, credits will need to be identified as being attributable to a particular company and a particular year so as to apply continuity rules. Credits will be deemed to be utilised in the order in which they first arose in the individual company.

Debits brought into a group by a company and relating to EMTI will need to be separately identified and carried forward.

When a company exits a consolidated group, it will not be able to have transferred to its ICA any credits for tax payments made by the group. However, any remaining unutilised credits brought into the group by the company will be transferred to the exiting company's ICA. Continuity requirements will then apply to those credits from the date at which the credits originally arose.

As with losses, when a group deconsolidates, unused pre-consolidation imputation credits would be able to flow through to individual group members. Other group imputation credits, however, will be lost.

International tax rules and entry and exit from the group

Where a company becomes a member of a consolidated group, the following rules will apply:

- any balances in the company's dividend withholding payment account or branch equivalent tax account will be transferred to the corresponding group account. These credits will remain separately identified, however, so that the continuity of ownership requirements may be applied

- any attributed foreign losses carried forward by the company under the CFC regime will become attributed foreign losses of the group. The losses will continue to be separately identified so that the continuity requirements can be applied

- any foreign investment fund losses carried forward by the company will become FIF losses of the group. These losses will continue to be separately identified so that continuity requirements can be applied.

When a company exits a group, it will not be able to take any dividend withholding payment credits, branch equivalent tax account credits, foreign tax credits, attributed foreign losses or foreign investment fund losses with it other than those that it originally brought to the group on becoming a member.

If a group deconsolidates, the same rules would apply.

Transitional rules

The consolidation regime will become effective from 1 April 1992, the date on which the general inter-corporate dividend exemption is removed. It may be difficult for companies to meet such a deadline for an election to adopt a consolidation option. Therefore, all companies will have until 1 October 1992 to elect to adopt the consolidation option and have that election backdated until 1 April 1992. If they do so, an individual company's provisional tax payments will be deemed to be payments for and on behalf of the consolidated group.

To avoid any potential resident withholding tax liabilities on intra-group interest or dividend flows, payments between specified companies will be exempt resident withholding tax until 1 October 1992.

If a consolidated group receives approval for a non-standard balance date, consolidation will apply from the beginning of that group's first income year starting after 1 April 1992. As a transitional measure, inter-corporate dividends otherwise becoming taxable from 1 April 1992 will remain exempt until the group enters the consolidation regime provided:

- consolidation criteria are met from 1 April 1992 to the end of the group's first income year following 1 April 1992
- the group prior to 1 October 1992 elects the consolidation option.

This is to prevent an interim period arising between 1 April 1992 and the beginning of the group's income year when inter-corporate dividends are taxable.

Consequential legislative amendments

As a consequence of adopting the consolidation regime, the proviso to section 85(4) will be repealed (as proposed by the Valabh Committee) as will section 191(8); both with effect from 1 April 1992. Since the consolidation option subsumes the Valabh Committee intra-group asset transfer proposals, those recommendations will not be advanced outside the consolidation context. The proposed revised depreciation provisions will not provide legislative authority for the current IRD practice of allowing depreciable assets to be transferred within a specified group without triggering depreciation recovery under section 117. This will only be available within the statutory rules provided for transfers within a consolidated group.

Summary

The rationale for consolidation

- The Government has decided to allow groups of companies that have a 100% common ownership to elect to consolidate for tax purposes from 1 April 1992. This will:
  - enable these corporate groups to to be treated as one company for tax purposes. Transfers of dividends, interest and assets within a consolidated group of companies will generally be disregarded for taxation purposes

  - considerably simplify the tax treatment of these corporate groups, thereby reducing their compliance costs. Consolidated groups will only have to file one return, will only be subject to one joint assessment, and will only be required to keep one active Imputation Credit Account

  - reduce the extent to which the removal of the inter-corporate dividend exemption might have otherwise adversely affected those corporate groups

  - replace a multitude of consolidation-like provisions currently within the Act with a more consistent and coherent consolidation option

- a number of overseas jurisdictions including USA, France, Netherlands, and Germany already offer businesses a tax consolidation option.

Requirements for consolidation

- consolidation is an elective option. Groups of companies that meet the criteria required for consolidation do not have to consolidate for tax purposes

- one or more companies may elect to consolidate for tax purposes where:

  - the companies have the same ultimate individual owners. Ownership will be measured on the same basis as for loss offset rules

  - every member of the group is a New Zealand resident for tax purposes

  - consolidation is not a step in a tax avoidance arrangement

  - the group does not consist of both qualifying and non-qualifying companies

- these criteria must be met by every member of the consolidated group from the beginning to the end of an income year.

Consequences of being taxed as a consolidated group

- the consolidated group will become a taxable entity separate from the individual members of that group and will be issued with its own IRD number
- only one consolidated income tax return covering all members of the group will be required. Attached to the return will be tax accounts for each member company
- the IRD income tax assessment or determination will be for the consolidated group as a whole. There will be no assessment or determination relating to the individual corporate members of that group
- the group of companies will have the one balance date
- every consolidated group will be required to have one nominated company to which IRD can address its queries. This nominated company will be deemed to be the agent of the group
- the nominated company will initially be responsible, as agent of the group, for payment of all tax attributed to the consolidated group. However, every member of the group will be jointly and severally liable for meeting any tax liability or tax obligations of the group
- a consolidated group will pay provisional tax on a group basis. Thresholds on when provisional tax is payable will be based on group income and group residual income tax
- a consolidated group will have its own Imputation Credit Account covering the group's activities
- any net loss incurred by the consolidated group will be able to be carried forward and offset against the income of another company under normal rules as if it were a separate company
- the gross income of the group will be defined as the sum of the gross income of each member of the group less any income attributable to intra-group transactions. This will mean that no tax will be levied on intra-group dividend payments and intra-group asset transfers will take place without income tax consequences
- intra-group asset transfers will not crystallise either a gift or stamp duty liability.

Consolidation and international tax rules

- for the purposes of the CFC rules, a consolidated group of companies would be treated as if it were one company
- each group with members holding interests in CFCs will be required to maintain a group branch equivalent tax account ("BETA")
- where any consolidated group member derives dividends from non-resident companies, the group will be required to deduct dividend withholding payments from those dividends
- foreign Investment Fund ("FIF") income and losses of the group will be calculated separately from other income and aggregated FIF losses will be offset against aggregate FIF income. Any excess FIF losses could be deducted from other group income to the extent of prior group FIF income. Excess FIF losses can be carried forward.

Consolidation and PAYE, RWT, SSCWT, FBT and GST

- PAYE, SSCWT, RWT and FBT responsibilities will remain legally with individual companies and will not be the responsibility of the consolidated group as a whole. However, each company in the group will be jointly and severally liable for meeting those liabilities
- all intra-group interest and dividend flows will be exempt from RWT
- present rules regarding group registration for GST will not be affected by the consolidation proposal. A consolidated group will not be required to adopt group registration if it so chooses.

Entry to and exit from a consolidated group

- a company will be able to enter or establish a consolidated group by meeting the qualifying criteria and by electing to do so
- a group may only be formed from the beginning of the group's income year
- a company exits a consolidated group where it either elects to do so and notifies the IRD of this, or no longer meets the criteria to be a member of the group. In either instance, the

company will be deemed to not be a member of the group from the beginning of the income year in which it elects to leave the group or ceases to satisfy the criteria

- the assets of a company joining a consolidated group will be deemed to have been disposed of for tax purposes when both the transferor and transferee cease to be members of the consolidated group. That is, there will be no crystallisation of the taxation consequences arising from an intra-group transfer, but when the group deconsolidates, or a transferor or transferee leaves the group, there will be a deemed disposal and reacquisition of any transferred assets

- where a company with past losses becomes a member of a consolidated group, if loss continuity rules are complied with, it is at that point, deemed to offset all qualifying losses against group income

- the ability of the group to carry forward losses transferred to the group by a new member company will be subject to normal continuity rules. The continuity rules will apply both at the group level and at the level of the individual company

- the rules regarding imputation credits and debits on entry to and exit from a group will mirror those pertaining to losses. On entering a consolidated group, credits or debits in the ICA of the company will be transferred to the group ICA. However, credits will need to be identified as being attributable to a particular company and a particular year so as to apply continuity rules. Credits will be deemed to be utilised in the order in which they first arose in the individual company. Debits brought into a group by a company and relating to EMDI will need to be separately identified and carried forward

- when a company exits a consolidated group, it will not be able to have transferred to its ICA any credits for tax payments made by the group. However, any remaining unutilised credits brought into the group by the company will be transferred to the exiting company's ICA. Continuity requirements will then apply to those credits from the date at which the credits originally arose

- as with losses, when a group deconsolidates, unused pre-consolidation imputation credits would be able to flow through to individual group members. Other group imputation credits, however, will be lost.

International tax rules and entry and exit from the group

- where a company becomes a member of a consolidated group:
    - any balances in the company's dividend withholding payment account or branch equivalent tax account will be transferred to the corresponding group account. These credits will remain separately identified, however, so that the continuity of ownership requirements may be applied
    - any attributed foreign losses carried forward by the company under the CFC regime will become attributed foreign losses of the group. The losses will continue to be separately identified so that the continuity requirements can be applied
    - any foreign investment fund losses carried forward by the company will become FIF losses of the group. These losses will continue to be separately identified so that continuity requirements can be applied
- when a company exits a group, it will not be able to take any dividend withholding payment credits, branch equivalent tax account credits, foreign tax credits, attributed foreign losses or foreign investment fund losses with it other than those that it originally brought to the group on becoming a member.

Transitional rules

- the consolidation regime will become effective from 1 April 1992, the date on which the general inter-corporate dividend exemption is removed. All companies will have until 1 October 1992 to elect to adopt the consolidation option and have that election backdated until 1 April 1992. If they do so, individual company provisional tax payments will be deemed to be payments for and on behalf of the consolidated group
- payments between specified companies will be exempt resident withholding tax until 1 October 1992
- consolidated groups with approved non-standard balance dates will consolidate from the beginning of that group's first income year starting after 1 April 1992

- inter-corporate dividends otherwise becoming taxable from 1 April 1992 will remain exempt until the group enters the consolidation regime provided:

  - consolidation criteria are met from 1 April 1992 to the end of the group's first income year following 1 April 1992

  - the group, prior to 1 October 1992, elects the consolidation option.

Consequential amendments

- the proviso to section 85(4) will be repealed (as proposed by the Valabh Committee) as will section 191(8); both with effect from 1 April 1992

- the proposed revised depreciation provisions will not provide legislative authority for the current IRD practice of allowing depreciable assets to be transferred within a specified group without triggering depreciation recovery under section 117. This will be available only within the statutory rules provided for transfers within a consolidated group.

Chapter 6 : Depreciation

Introduction

This chapter provides more detail on:

- the Government's endorsement of the Valabh Committee's preliminary recommendations for the reform of the depreciation regime

- the Government's commitment to implement the Valabh Committee's proposals to enable taxpayers to claim deductions for depreciation as a statutory right, and to specify criteria in the legislation to ensure tax rates of depreciation are set in the light of actual economic rates of depreciation

- the Commissioner of Inland Revenue's intention to commence an immediate and comprehensive review of rates of depreciation in the light of the criteria suggested by the Valabh Committee

- the Government's desire to reduce tax disincentives to innovation and growth, by investigating the desirability and feasibility of the Valabh Committee's preliminary recommendation to extend the depreciation regime to intangible assets with a limited life.

Problems with the current depreciation regime

The current depreciation regime is deficient. Rates of depreciation have not been comprehensively reviewed since 1957. In addition, following detailed review of the depreciation regime, the Valabh Committee has identified a number of important deficiencies with the current depreciation provisions of the Income Tax Act. In particular, the Committee noted these provisions:

- are ambiguous, scattered throughout the Act and their relationship to other sections of the Act is unclear

- give little indication of the criteria used to determine whether or not an asset should be included in the class of depreciable property

- exclude many intangible assets that can be expected to fall in value over their economic lives

- leave the determination of depreciation deductions (which are of considerable importance to business) up to administrative discretion

- do not entitle taxpayers as of right to an annual deduction for depreciation according to explicit statutory criteria

- give little guidance as to the criteria the Commissioner should employ when setting rates of depreciation

- do not outline procedures for taxpayers to apply for rates of depreciation higher than those prescribed by the Commissioner

- do not specify the method to be used by the taxpayer in calculating depreciation (such as straight line or diminishing value)

- do not consistently apply the same "depreciation recovery" provisions to all depreciable assets (e.g. losses realised on the sale of buildings are not deductible)

- impose unnecessary compliance costs on business.

Government broadly endorses reforms proposed by the Valabh Committee

In its report on Tax Accounting Issues, which was released for public comment in February of this year, the Valabh Committee has proposed a range of preliminary recommendations to address these deficiencies. In particular, it proposes to:

- give taxpayers a statutory entitlement to depreciation, rather than rely on the Commissioner's discretion

- allow taxpayers to claim deductions for intangible assets that are expected to depreciate in value (with the exception of goodwill)

- specify the criteria which must be satisfied for an asset to be classified as depreciable property as well as the criteria the Commissioner must apply in determining rates of depreciation

- outline the methods taxpayers may employ to calculate depreciation (i.e. either the straight line or diminishing value method)

- outline the procedures to be followed by taxpayers who wish to apply for higher rates of depreciation

- reduce compliance costs by allowing taxpayers to elect to use straight line depreciation and to pool assets below a specified value.

The Government supports the broad thrust of these preliminary recommendations for reform and looks forward to receiving the final report of the Committee. Once that report has been submitted, the Government will be able to announce detailed decisions on the Committee's final recommendations, and those amendments could be implemented with effect from 1 April 1992.

Depreciation rates to be comprehensively reviewed

While not wanting to pre-empt the Committee's final recommendations, the Government wants to facilitate a comprehensive review of depreciation rates by the Commissioner.

Accordingly, the Government has decided to announce its commitment to implement the Valabh Committee's preliminary recommendations to enable taxpayers to claim deductions for depreciation as a statutory right and to provide statutory criteria to align those rates more with economic rates of depreciation.

In view of this commitment, the Commissioner of Inland Revenue has informed the Government of his intention to commence an immediate and comprehensive review of rates of depreciation. At this stage, the Commissioner considers the review will take about one year to complete.

This review will bring current rates of depreciation more into line with economic rates of depreciation, thereby improving the pattern of investment and increasing prospects for sustained increases in employment and growth. Given that rates of depreciation have not been comprehensively reviewed since 1957, the potential exists for increases in some rates and decreases in others.

Incorporating the criteria for determining the class of assets that are expected to depreciate, and for determining rates of depreciation, into legislation will also establish a more certain tax environment for business investment.

Depreciation of intangible assets to be investigated

As noted above, the Valabh Committee considers the current depreciation regime is deficient to the extent that it does not apply to intangible assets that are expected to depreciate in value over their economic lives.

At the moment, the depreciation regime is restricted to tangible assets such as plant, machinery, equipment and premises. There are other provisions in the Act that enable taxpayers to amortise expenses incurred in relation to the grant or renewal of a lease and expenditure incurred to acquire patent rights. However, the depreciation incurred in relation to most intangible assets is not currently deductible. For example, expenses incurred in relation to licence and franchise arrangements cannot be spread over the term of those arrangements.

This clearly provides a tax disincentive to those activities which incur considerable non-deductible expenditure on intangible assets that have a limited economic life.

In accordance with its desire to reduce tax disincentives to innovation and growth, the Government supports in principle the extension of depreciation to intangible assets with a limited economic life.

However, there are a number of practical considerations which need to be resolved before the Government would be prepared to extend the depreciation regime to such intangible assets.

In particular, it will be necessary to investigate the feasibility of restricting the extension of depreciation to intangible assets with a limited economic life. This may be difficult in view of the ease with which intangible assets with an indefinite life could be divided up into a series of intangible assets with limited economic lives.

In addition, it will also be necessary to develop appropriate rules to ensure that taxpayers are not able to claim deductions for expenses incurred in relation to intangible assets that are not actually used to generate assessable income in New Zealand.

The Government has therefore directed officials to investigate the desirability and feasibility of extending the depreciation regime to intangible assets with a limited economic life.

Losses on the disposal of buildings

The Government does not support the Valabh Committee's preliminary recommendation to allow taxpayers to claim deductions for the losses realised on the disposal of buildings. This is because assets like these may appreciate in value over considerable periods of their useful life.

Accordingly, the Government would like the Valabh Committee to explore in its final report possible avenues for ensuring that losses realised on the disposal of assets like these are not deductible under the provisions of the revised depreciation regime.

Summary

- The current depreciation regime is deficient. Rates of depreciation have not been comprehensively reviewed since 1957 and a review by the Valabh Committee has identified a number of important deficiencies with the current depreciation provisions of the Income Tax Act.
- The Government broadly endorses the preliminary recommendations of the Valabh Committee to correct these deficiencies. However, it does not support the Valabh Committee's preliminary recommendation to allow taxpayers to claim deductions for the losses realised on the disposal of buildings because they may appreciate in value over considerable periods of their useful life. Accordingly, the Government would like the Valabh Committee to explore in its final report possible avenues for ensuring that losses realised on the disposal of assets like these are not deductible under the provisions of the revised depreciation regime.
- The Government will implement the Valabh Committee's proposals to enable taxpayers to claim deductions for depreciation as a statutory right, and to specify in the legislation the criteria to be used by the Commissioner to ensure tax rates of depreciation are set in the light of actual economic rates of depreciation.
- In view of that commitment, the Commissioner of Inland Revenue will commence an immediate and comprehensive review of rates of depreciation in the light of the criteria suggested by the Valabh Committee.

- Consistent with its desire to reduce tax disincentives to innovation and growth, the Government has directed officials to investigate the desirability and feasibility of extending the depreciation regime to intangible assets with a limited life.

PART III - BASE MAINTENANCE MEASURES

Chapter 7 : Removal of the inter-corporate dividend exemption

Introduction

The Government announced in the Budget that the tax exemption for dividends flowing between companies is to be removed. This measure is aimed at:

a ensuring that dividends are taxable in the same manner as other income

b ensuring that treatment of companies deriving dividends is aligned to the treatment of individuals deriving dividends

c removing the opportunity for using the inter-corporate dividend exemption in tax avoidance strategies such as the transfer of losses between companies through redeemable preference share deals.

Problems with existing rules

Exemption an historical and international anomaly

Before the adoption of an imputation system for taxing company income in 1988, the inter-corporate dividend exemption performed the necessary function of preventing multiple taxation of income as it passed between a number of companies. Under the imputation regime, however, multiple taxation of income passing between companies can be avoided by allowing companies receiving dividends to utilise any attached imputation credits. Under this approach, companies that receive fully credited dividends would be taxed essentially in the same manner as at present, since the imputation credits attached to the dividends would offset any tax liability. Companies receiving dividends that did not carry full imputation credits would have to pay tax on the dividends, but only to the extent of the difference between the company tax rate and the attached credits.

Most other countries comparable with New Zealand do not provide a general inter-corporate dividend exemption. For example, Germany removed a similar exemption when it introduced an imputation regime in 1977.

Dividends taxed differently for companies

Dividends are income. Therefore, they should be taxed in the same manner irrespective of the person who derives them. Under current law, however, dividends are taxed more favourably if they are earned by companies rather than by individuals.

Exemption creates avoidance opportunities

The inter-corporate dividend exemption is utilised in a number of tax planning strategies including the transfer of losses through redeemable preference share deals. These typically involve dividends being paid on redeemable preference shares issued by a loss company to a corporate investor. The loss company receives equity finance at a relatively low cost since the return is tax-free to the shareholders. It can therefore invest this money profitably in interest bearing securities. No tax is payable on this interest because it is offset by the company's losses. If the investor in redeemable preference shares borrows money to acquire the shares, the overall result is that the investor incurs a deductible interest expense and earns exempt dividend income, while the loss company earns taxable income but pays no tax because that income is offset by its losses. The tax benefits of the losses are therefore transferred effectively from the loss company to the shareholder.

The removal of the inter-corporate dividend exemption will prevent loss transfers through redeemable preference share transactions. A more limited measure targeted only at redeemable preference shares would be likely to have only a limited impact on loss transfer transactions, particularly after company law changes.

Removal of inter-corporate dividend exemption

The inter-corporate dividend exemption is to be removed with effect from 1 April 1992. After that date, dividends derived from non-resident companies, or from resident companies that are treated as non-resident under a double taxation agreement, would remain exempt. However, any company receiving such dividends would be required to deduct dividend withholding payments under the foreign dividend withholding payment regime. After 1 April 1992, dividends payable on certain redeemable preference-type shares issued before Budget night would also remain exempt until 1 April 1994. This transitional measure is discussed below. Finally, after 1 April 1992 inter-corporate non-cash dividends will be subject to tax under the fringe benefit tax regime.

The continued exemption for dividends paid by companies that are resident in New Zealand, but which are treated as non-resident for the purposes of a double tax agreement, is necessary to prevent such dividends escaping both income tax and the dividend withholding payment regime. After the removal of the inter-corporate dividend exemption these dividends would ordinarily be subject to income tax and would therefore not fall within the dividend withholding payment regime. However, under some double tax treaties New Zealand would be required to exempt the dividends. This would place recipients of such dividends in a privileged position relative to other taxpayers. To avoid this, dividends derived from New Zealand resident companies that are treated as non-resident for the purposes of a treaty will be exempt from income tax and subject to the dividend withholding payment regime.

Income tax payable on dividends derived by a company will be reduced by imputation credits attached to those dividends. The treatment of inter-corporate dividends will therefore be the same as the treatment of dividends earned by individuals. However, a company receiving dividends with imputation credits attached would not only be able to use the credits to reduce its tax liability, but would also be able to credit its imputation credit account by the amount of the credit received. This will ensure that dividends flowing through a chain of companies are never taxed more than once. For example, assume that a company receives a cash dividend of $67 with imputation credits of $20 attached. In these circumstances, the company would include a dividend of $87 in its assessable income. Tax of $29 would be payable on that dividend. The $20 imputation credit would be deducted from that amount, leaving a net tax liability of $9. The company would credit to its imputation credit account the $20 credits attached to the dividend it received and the $9 tax that it actually paid. The company could then attach the $29 credits to any dividends paid to its shareholders.

Dividend withholding payment credits will operate in the same way. If the dividend received by the company in the above example had dividend withholding payment credits of $20 attached to it, the company would pay $9 income tax, credit $20 to its dividend withholding payment account, and credit $9 to its imputation credit account.

A company in tax loss that received a taxable dividend would be treated in a similar way to an individual in tax loss receiving imputation credits. It would include the dividend and any attached imputation credits in its assessable income, thus reducing its losses. There would be an offsetting increase in the company's loss calculated as the grossed up amount of the unutilised imputation credit. The gross up factor would be the resident companies' tax rate, 33%. For example, if a loss company derived a cash dividend of $67 with imputation credits of $33 attached, its losses would be reduced by $100. An offsetting increase in the loss of $100 would then occur calculated as $33/.33 = $100.

Exemption for certain dividends deductible in another country

An exception to the inter-corporate dividend exemption is currently provided for certain dividends paid by a company that is not incorporated in New Zealand where the dividends are deductible in another country. These dividends are currently subject to income tax. Consequently, they are not subject to the foreign dividend withholding payment regime. This gives rise to an avoidance opportunity since some double tax agreements require New Zealand to exempt dividends derived from companies resident in the treaty partner country. Where the double tax agreement exemption applies, the dividends would be exempt from New Zealand tax and would not be subject to the dividend withholding payment regime. The amendments to section 63, the provision that currently exempts inter-corporate dividends, will highlight this avoidance opportunity.

The taxation of foreign source dividends for which deductions have been allowed in another country was introduced to stop an avoidance scheme that was utilised in the period prior to the enactment of the dividend withholding payment regime. With the dividend withholding payment regime in place, there is no reason to continue to treat these dividends as assessable income of companies deriving them. Accordingly, from Budget night the inter-corporate dividend exemption will apply to dividends for which deductions have been allowed in another country. This will have the effect of subjecting these dividends to the dividend withholding payments regime.

Where that is not the case (where the dividends are paid by a New Zealand resident company that is not treated as non-resident under a double tax agreement) the dividends will remain taxable.

Transitional exemption for pre-Budget redeemable preference share transactions

Dividends paid on certain redeemable preference-type shares will continue to be exempt until 1 April 1994. This exemption will be available where the following conditions are satisfied:

a the dividends are payable by a company that is not exempt from New Zealand income tax

b the shares are not subject to a change in their terms including an extension of time under a roll-over provision or option

c the shares were acquired by the taxpayer before Budget night or under a binding contract entered into before Budget night

d the shares are redeemable without High Court approval

e the shares carry a fixed rate of dividend or a rate set in terms of commercial interest rates

f the shares are not specified preference shares under pre-1986 legislation (section 194) that allows dividends to be deductible.

Dividends paid on debentures issued before Budget night, or pursuant to a binding contract entered into before Budget night, and not subject to changes in their terms, will also qualify for the transitional provision. Finally, the exemption would not apply where the dividend results from a forgiveness of debt or to dividends paid by local authority trading enterprises to local authorities. These dividends are already taxable.

This transitional provision is intended to apply to dividends paid on redeemable preference type shares issued before Budget night. Companies that have borrowed money to invest in these shares derive a profit from the after-tax margin between the non-assessable dividend paid on the shares and the deductible interest costs. Taxing the dividends payable in these circumstances could turn a profitable transaction into an unprofitable one. This could cause undue disruption to the financial market since a feature of these transactions (unlike a normal equity investment) is that the level of profit is predetermined. The transitional exemption should avoid this problem.

Taxation of dividends on redeemable preference type shares from date of Budget

Dividends paid on certain redeemable preference type shares entered into after the Budget will be taxable from the date of the Budget. This measure is designed to prevent companies entering into loss transfer transactions after the Budget and prior to the general removal of the inter-corporate dividend exemption.

This measure will apply to post-Budget shares paying dividends more in the nature of interest than an equity return.

Dividends would be taxable under this provision if they are paid on shares or section 192 or section 195 debentures acquired after the Budget, except where they are acquired under a binding pre-Budget contract. Shares issued before the Budget but which are subject to a post-Budget alteration in terms or that are the subject of a post-Budget financial arrangement will also be subject to this provision. In the case of shares in this category, dividends will be taxable only if they are payable at a fixed rate or at a rate determined by reference to commercial interest rates, or if they are otherwise equivalent to interest having regard to redeemability, security and variability.

This provision is modelled on Australian legislation. It would be unacceptable as a long term way of preventing loss transfers because of the uncertainty that it would create in marginal cases and because of its limited scope. However, it should protect the tax base until the general removal of the inter-corporate dividend exemption on 1 April 1992. The Government will closely monitor the operation of this provision, and is prepared to take action to overturn loss transfer transactions entered into after the Budget if this provision is not effective.

Resident withholding tax and inter-corporate dividends

Resident withholding tax will apply to inter-corporate dividends, subject to the normal exceptions. In addition, two further exemptions are to be provided as transitional measures. The first exemption is with respect to dividends paid on redeemable preference type shares and section 192 or section 195 debentures where those dividends are assessable from Budget night under the measures discussed in the preceding part of this chapter. An exemption is considered desirable in these circumstances because identifying the dividends may involve a judgement as to whether the dividend is paid in lieu of interest. This would make the application of withholding taxes difficult. The exemption will apply until 1 April 1992 when inter-corporate dividends generally become taxable.

The second specific exemption is for dividends paid between resident companies with 100% common ownership. The exemption will apply until 1 October 1992. This date is critical because it will be the final date that companies that are 100% commonly owned will be able to elect to be treated as a consolidated group from 1 April 1992. If they do elect consolidation, dividends flowing between group members will be exempt from 1 April 1992. The exemption is therefore designed to avoid the problem of companies having to deduct resident withholding tax from dividends which are later deemed to be exempt. The temporary exemption is unlikely to create a significant problem.

Consequential changes

The provisions in section 394E of the Income Tax Act 1976 requiring life insurance offices that derive exempt dividends, the benefits from which flow to non-resident policy holders, to debit their imputation credit accounts by 18% are to be repealed. The provisions are of an anti-avoidance nature and are aimed at preventing life offices flowing tax-exempt dividends to non-residents. This strategy will not be available after the removal of the inter-corporate dividend exemption. The relevant provisions of section 394E can therefore be amended to remove the anti-avoidance rule.

Consequential changes will also be made to section 394ZG, one of the anti-avoidance rules in the imputation regime. Currently, that section assumes that an imputation credit tax advantage consists of either a shareholder using imputation credits to offset a tax liability (a "shareholder tax advantage"), or a company increasing its imputation credit account balance ("a company tax advantage"). This distinction will not remain relevant after the removal of the inter-corporate dividend exemption because companies will then also be able to receive shareholder tax advantages. Section 394ZG will therefore be amended to ensure that it accommodates the taxation of inter-corporate dividends.

Summary

- the existing inter-corporate dividend exemption is an historical anomaly, results in dividends being taxed more favourably when derived by companies rather than by individuals, and creates tax avoidance opportunities

- most other comparable countries do not have a similar exemption in their tax systems
- to address these problems, the inter-corporate dividend exemption is to be removed from 1 April 1992. After that date, dividends paid by one New Zealand resident company to another will be subject to income tax. Dividends derived by a resident company from a non-resident company, or from a resident company that is treated as non-resident for tax treaty purposes, will be exempt from income tax but subject to the dividend withholding payment regime. Non-cash inter-corporate dividends will become taxable under the fringe benefit tax regime
- companies consolidating for tax purposes will not be taxed on dividends passing within the consolidated group
- where a company receives a dividend, any imputation credits attached will reduce the tax payable by the company on the dividend. The credit and any tax payable will both be creditable to the company's imputation credit account
- dividends that are currently assessable because they are deductible in another country and are paid by a company not incorporated in New Zealand will become exempt from Budget night. This means that they will be subject to the dividend withholding payment regime from Budget night
- dividends paid on certain redeemable preference type shares issued before Budget night will remain exempt until 1 April 1994
- dividends paid on certain redeemable preference type shares issued after the Budget will be assessable from the date of the Budget. This is intended to prevent loss transfer transactions being entered into after the date of the Budget and before the date of removal of the inter-corporate dividend exemption, 1 April 1992
- resident withholding tax will apply to inter-corporate dividends, subject to the normal exemptions. However, existing exempt inter-corporate dividends will not be subject to withholding tax prior to 1 April 1992. This will apply to dividends on post-Budget redeemable preference shares. As a further measure dividends paid between companies with 100% commonality of ownership will be exempt from resident withholding tax until 1 October 1992.

Chapter 8: Loss Carry-forward and Offset Rules

Introduction

The Government announced in the Budget a number of measures to change the tax rules that apply to the carry-forward and offset of company losses. These changes are aimed at:

a providing rules that are more clear and certain as to the circumstances in which a company can either carry forward its tax losses into future income years for offset against its future income ("loss carry-forward") or offset its losses against the assessable income of other companies ("loss offset")

b limiting the carry-forward or offset of losses so that, as far as practicable, only the individuals who directly incur the initial economic burden of those losses are able to take advantage of them for tax purposes. The new rules in relation to company loss-carry-forward and offset seek to treat companies in a similar manner to individuals

c enabling profit companies that are eligible to offset their profits against the losses of one or more loss companies in a group to do so with minimum complexity.

Problems with existing rules

The current rules in section 188 and 191 of the Act that govern the carry-forward and offset of company tax losses are inconsistent with the objectives outlined above in a number of respects.

Existing rules favour companies over individual taxpayers by allowing the transfer of company losses

The current loss carry-forward rules require that at least 40% of shares are held by the same natural shareholders if a loss is to qualify for carry-forward into a future income year. This threshold means that new shareholders can acquire up to 60% of a company without causing the company to lose its entitlement to carry forward its losses. In effect, current rules permit up to 60% of the interest in a company's losses to be transferred. In contrast, an individual cannot transfer any losses.

The required minimum continuity threshold will therefore be increased to 66%. A 66% continuity threshold means that the shareholders who substantially own a company must retain their interest in the company for it to qualify to carry forward its losses. The threshold is consistent with the minimum requirement before companies can offset losses and income under the offset rules and the new continuity of ownership threshold for carrying forward imputation credits.

These changes to the loss carry-forward and offset rules will mean that the benefit of company tax losses will be derived only by those taxpayers who substantially incurred those losses. Along with the removal of the inter-corporate dividend exemption, these measures will make it more difficult for companies to trade losses. They will therefore contribute towards a fairer tax system by treating companies in a similar way to individual taxpayers who are not allowed to transfer losses they incur.

The existing rules are complex and are incompatible with pending company law reforms

Existing rules require shareholders to measure an interest in a company by reference to one of four percentages represented by the shares they hold. These measures are the percentage of:

- voting power
- profits that may be distributed
- any distribution of paid-up capital
- nominal value of allotted shares.

The application of each of these measures is complex or uncertain. For example:

- voting power is not defined in the provisions, nor are differing rights to vote on different decisions by the company catered for
- how to apply a measure based on percentage entitlement to profits that may be distributed is uncertain and can result in arbitrary effects. For example, it is unclear whether the test should be applied on a year by year basis or should be applied to accumulated, current and future profits. Either way, the test is unworkable and can result in arbitrary effects if it is applied on a year by year basis, particularly if a company has issued

preference shares. The percentage of profits to which the holders of preference shares are entitled may vary markedly between years depending on fluctuations in company profits. Such fluctuations may result in changes in the measured interest of preferred compared to ordinary shareholders that do not reflect any change in the beneficial interest in the company's losses

- the concept of paid up capital will become outmoded after the company law reforms currently being considered by Parliament are enacted. Using subscribed capital measured at historical cost as an alternative would also be unsuitable - it would overstate the economic interests of recent subscribers of capital to a company compared to the original subscribers of capital

- nominal capital will also be superseded by company law reforms and does not give a reliable basis for measuring shareholders' interests since it is easily manipulated.

In the light of these problems new rules to measure a shareholder's interest have been established. Under these new rules, an economic interest in a company for the purposes of applying the continuity and loss-offset rules would, in general, be equal to a shareholder's voting power in a company except in certain circumstances (e.g., where certain near-equity 'debt' instruments have been issued). Voting power will be defined and differing rights in respect of decision-making by the company will be catered for. The rules for determining a shareholder's interest are discussed further below.

In addition, existing loss carry-forward rules in section 188 of the Act are unclear about how interests held in listed companies are to be treated. Where an interest in a listed company subject to the continuity test (the "subject company") is held by another listed company (the "interposed listed company") existing rules imply that it is necessary to trace interests through the interposed listed company in order to determine whether any individual shareholder at any time during the relevant continuity period held an interest of more than 10% in the subject company. Tracing through interposed listed companies is likely to involve relatively high compliance costs for the benefits gained unless the listed company has a controlling interest in the subject company. Existing loss continuity rules also do not cater for companies listed on foreign stock exchanges or for subsidiaries of listed companies.

The new rules will make it clear that it will not be necessary to look through interests held by a listed company in a loss company subject to the loss carry-forward rules unless the listed company and its associates hold an interest of 50% or more in the loss company. If a listed company is itself subject to the loss carry-forward rules, it will not be necessary under the new rules to separately identify direct interests held by individuals, trusts or other listed companies that hold interests of less than 10 percent in the listed company.

Existing rules to limit the transfer of losses are easily avoided

Transferring shares between existing shareholders

Under existing rules, different shareholders who together own at least 40 percent of a company can transfer shares between themselves without breaching the continuity rules. For example, a company with 100 shares, 1 owned by A and 99 owned by B, can change its share ownership to A owning 99 and B owning 1 with no breach of the continuity rules.

To address this problem, the lowest percentage interest of each shareholder during the period over which a minimum continuity of ownership is required will be taken into account. If the lowest percentage interests of each shareholder are added up and the total exceeds 66%, the continuity test will be satisfied. For example, assume taxpayers 'A' and 'B' hold respectively 40% and 60% beneficial interests in the company 'Lossco' at the beginning of Lossco's income year. Assume also that during the year 'B' sells a 40% interest in Lossco to a new shareholder 'C' (i.e., 'B' retains a 20% interest in Lossco). The lowest percentage interest held by each shareholder during the year would be 40% in relation to 'A' (whose interest has not changed), 20% for shareholder 'B' (the interest held at the end of the year) and 0% for shareholder 'C' ('C' held no interest in the company until it acquired a 40% interest part-way through Lossco's accounting year). The total of the lowest percentage interests of 'A', 'B' and 'C' is 60%. Since 60% is less than the 66% continuity requirement, the continuity test would be breached and Lossco's losses would not be eligible for carry-forward to the next income year.

Instruments that are ignored in measuring a shareholder's interest

In measuring a shareholder's interest in a company, certain debt instruments that have many of the same characteristics as ordinary shares (such as debentures that yield a return that is determined by reference to company profits) are ignored under current rules. This provides scope to transfer losses between "shareholders" by transferring or issuing such instruments without breaching the loss carry-forward or loss-offset rules.

Use of corporate trusts

The existing restrictions on the ability to transfer carried-forward losses can also be avoided if shares in a company are owned by a corporate trustee of a discretionary trust. New owners can effectively buy the company (and its losses) by acquiring the corporate trustee. The corporate trustee would then exercise its discretion in the interests of its new owners.

To combat this avoidance technique, shares held by a corporate trustee in a company subject to the loss carry-forward rules would be deemed to be sold to a third person and reacquired where there is a change in the shareholding of the corporate trustee. This would apply unless it can be established that the transaction was not for the purpose or with the effect of defeating the intent and application of the loss carry-forward rule. In particular it would need to be established that the change in the ownership of shares in the corporate trustee did not result in a change in the beneficial ownership of the trust's assets. The rule that deemed the assets of corporate trustees to be realised in certain circumstances would not, however, apply to trustee companies under the Trustee Companies Act 1967 and bare trustees.

Acquisition of a loss company with current year losses shortly before a profit company's balance date

Under the current loss offset rules, a profit company can offset its income against the current year or carried-forward losses of a loss company provided that the two companies are at least two thirds owned by the same shareholders in the income year the loss was incurred. Whether sufficient commonality of ownership exists for two or more companies to be members of the same group is measured on 31 March each year. This means that a loss company with current year losses can be acquired shortly before the end of a profit company's income year and those losses offset against the income of the profit company.

Under the new rules, it will be a requirement that the loss and profit companies are members of the same group at all times from the beginning of the loss company's income year in which the loss was incurred to the end of that company's income year in which the loss is offset.

Arranging for a company to be a member of more than one group

As outlined above, a shareholder's interests under the grouping provisions is currently measured by reference to a number of tests, such as percentage of voting rights held, percentage of paid-up capital and percentage of nominal capital etc. The result is that a single company can be a member of more than one group of companies enabling losses to be more easily transferred. It will not be possible for a company to be a member of more than one group under new rules because the same measure of a shareholder's economic interest must be applied in relation to each company that is a potential candidate for membership of a group of companies.

The method for offsetting losses within a company group is complex and cumbersome

Under existing rules, companies with between two thirds and 100% commonality of ownership (i.e. companies in an "ordinary" group under the Act) can offset profits by a profit company making a deductible "subvention" payment to a loss company. The subvention payment is assessable income of the loss company. A simpler method for offsetting profits by election and notification to the IRD is permitted in relation to two or more companies that have 100% common ownership (i.e. companies within a "specified group" under the Act). The subvention payment procedure has been criticised for being unnecessarily cumbersome.

From 1992/93 whenever a company is permitted to offset its profits against the losses of one or more loss companies in the same 66% commonly-owned group it will be able to do so simply by election and notification to the IRD. As a result, there will be no need for the concept of a 100% commonly-owned "specified group" under the new rules. Provisions relating to deductible/assessable subvention payments will be retained, however, so that taxpayers have the option of offsetting profits by a combination of subvention payments and election.

Measuring an interest in a company under the new rules

To the extent practicable, a common measure of a shareholder's economic interest in a company would apply for the purposes of:

- the loss carry-forward rules in section 188 of the Act

- the credit continuity rules under the imputation and associated regimes. These rules govern eligibility to carry-forward imputation, branch equivalent tax and dividend withholding payment credits and are discussed in Chapter 9

- rules that govern eligibility for two or more companies to be treated as one taxpayer under the consolidation option outlined in Chapter 5

- the loss-offset rules in section 191 of the Act (this and the rules in relation to consolidation are hereafter referred to jointly in this Chapter as "commonality" rules).

In the light of the problems associated with existing rules to measure a shareholder's interest in a company, from the 1992/93 income year a shareholder's interest in a company's tax losses or credits will be measured primarily by reference to the percentage of voting power held by that person in relation to decision making by the company. Apart from measuring an interest by reference to market value, voting power is seen as the best proxy for a measure of a shareholder's beneficial interest in the losses or credits of a company and it will often be relatively simple to apply. By exercising voting power, a shareholder can protect its position relative to other shareholders and can ensure appropriate access to the earnings of the company when they are distributed.

As outlined above, a defect of current rules is that they do not define voting power or cater for situations where voting power might vary in relation to different types of decision-making. Under the new rules voting power will be defined as the percentage of power to vote in relation to decision-making concerning the:

- distributions to be made by the company

- constitution of the company

- variation in the capital of the company; or

- appointment or election of directors of the company.

Where voting rights in relation to a shareholder's interest differ as between the different types of decision-making described in the previous paragraph, the interest would be determined as the percentage it represents of the market value of all interests in the company, as well as percentage of voting power. Because the percentage of voting power differs between different types of decisions, each measure of voting power would be applied independently and the continuity threshold would have to be satisfied in relation to each measure. Resort is made to a measure based on market value because the differing voting rights may result in voting power giving an unreliable indication of a shareholder's economic interest in a company's losses or credits.

There will be other circumstances where voting power is unlikely to give an accurate measure of shareholders' interests. In these circumstances a shareholder's interest in a company would be computed by reference to both the market value of that interest and its voting power for the purposes of applying the loss and credit carry-forward provisions and the commonality rules. If the minimum continuity or commonality of ownership threshold under either measure is not satisfied, eligibility for loss carry-forward and/or offset would be forfeited.

Broadly, a shareholder's interest would be measured by reference to its market value and its voting power where:

- a shareholder has an entitlement to a certain proportion of company profits which it can be ascertained is different from its voting power and can veto any alteration in that entitlement

- the company or its shareholders have issued options, <u>other than certain options over listed company shares</u>, options to acquire shares at their market value, or options issued by shareholders without the company's knowledge

- the company has issued shares (other than fixed rate dividend shares) the returns on which are guaranteed by a third party

- the shares have been subject to an arrangement with the purpose or effect of defeating the intent and application of the credit and loss carry-forward rules or the loss offset and consolidation provisions.

Where any of the above tests is triggered, the interests described (such as options) would be taken into account in determining the percentage of the market value of a company held by any share or option holder.

In addition, computing interests by reference to the share of market value would be triggered (and the instruments described would be taken into account in computing market value) where:

- the company has issued after Budget night variable rate debentures covered by section 192 of the Act (for the purposes of applying the loss and credit continuity and commonality rules). These instruments have many of the features of equity without any voting rights

- the company has issued after Budget night section 195 debentures or fixed rate dividend shares that do not carry the same voting rights as ordinary shares (for the purposes of the credit continuity rules only). These instruments can carry imputation credits.

The transitional rules are designed so that almost all companies will be in a position on Budget night where they can measure shareholders' interests for the purposes of the loss and credit carry-forward and commonality rules by reference solely to voting power. That is because section 192 and 195 debentures and fixed rate dividend shares issued before Budget night would not trigger a requirement to apply the market value test until 1 April 1994, if they are still on issue at that time. It will only be as companies issue such instruments after Budget night that there might be a requirement to compute shareholders' interests by reference to the market value of those interests.

Measuring interests solely by reference to voting power represents a significant simplification of the existing confused and overlapping rules that must be applied to determine shareholders' interests. Even where certain debentures and fixed rate dividend shares are issued after Budget night, in practice it would not be necessary for the market value measure of an interest to be used in applying the loss-offset or carry-forward rules where:

- the company is confident that the value of such instruments is a small proportion of the market value of all equity interests in the company

- the required commonality or continuity of ownership has been breached using voting power as a measure, in which case the application of a market value measure is irrelevant

- the company is not required to apply any measure of shareholders' interests because it has no carried forward losses or it fully distributes its imputation credits as they arise.

Other provisions

The loss offset rules and loss carry forward rules apply to a wide variety of entities and circumstances. Ordinary rules will apply to determine interests in unlimited liability, no liability, and co-operative companies, companies limited by guarantee, building societies, and unit trusts. These entities typically have shares or units that carry voting power or in relation to which a market value can be determined. Special partnerships will be subject to similar rules to ordinary companies.

However, to reduce compliance costs, special rules will apply to determine continuity of ownership in relation to certain 'non-standard' entities that are typically widely-held with a fairly stable shareholding. These rules are that:

- widely-held unit trusts, co-operative companies and building societies will be treated in a similar manner to listed companies for the shareholder continuity rules

- directors of special corporate entities as currently defined in section 191 will be deemed to hold all the interests in those entities. Broadly, special corporate entities currently include statutory companies, producer boards and local authorities, although the entities eligible for this status will be extended to include life insurance funds and group investment funds.

The more significant of the other measures to apply from the 1992/93 income year are that:

- companies will be permitted to carry-forward or group part-year losses by preparing a set of accounts that relate to the part year. This retains the current treatment of part-year losses in relation to the loss carry-forward provisions of section 188

- for the purposes of the continuity rules, transfers by way of bequest and matrimonial property agreements will be ignored

- the current restriction in the loss-offset provisions of section 191 will be retained whereby only the losses of companies incorporated in New Zealand that are not dual resident companies are eligible for offset, unless the losses are attributable to fixed establishments in New Zealand.

Implementation and transition

Changes from Budget night

The changes outlined above will apply from the 1992/93 income year (i.e. in respect of income years commencing on or after 1 April 1992). In general, the existing continuity and loss-offset provisions will apply in the current 1991/92 income year. However, the following changes to those provisions will apply from the date of the Budget to protect the corporate tax base from further erosion before the completely revised provisions are implemented from 1992/93:

- the present minimum 40% continuity of ownership would continue to be required before a company could utilise carried forward losses against its 1991/92 income. However, before carried forward losses could be offset in the current income year, the 40% continuity threshold would need to be satisfied taking account of the lowest percentage of rights referred to in section 188(7) held by each shareholder in the period from Budget night to the end of the 1991/92 income year

- a loss company and one or more profit companies must be members of the same group of companies at all times from Budget night to the end of the loss company's accounting year that corresponds to the 1991/92 year, before the loss company can offset its current or carried forward losses against the 1991/92 income of the profit companies.

Relief would be provided where, in relation to any transfer of any interest in a company between Budget night and the end of the 1991/92 income year:

- the interest was transferred under a binding contract entered into before Budget night

- the transfer of the interest would not have triggered a breach in continuity but for the measures passed on Budget night.

In such circumstances, the transfer of the interest would not breach the continuity test.

Where a binding contract is entered into before Budget night to acquire interests in a loss company after Budget day that result in that company becoming part of a specified or ordinary group in respect of the 1991/92 year, then the loss company must be part of the same group at all times from when the relevant threshold was attained (i.e., either two thirds or 100% commonality of ownership) to the end of the loss company's 1991/92 income year.

Transition

Losses incurred in the 1991/92 and prior years would be eligible for carry-forward into the 1992/93 income year and beyond provided that:

- they could be carried forward under the old rules in section 188, as modified from Budget night, if they had continued to apply

- the 66% continuity threshold under the new rules is not broken from the beginning of the 1992/93 income year to the end of the income year of offset.

In most cases, the first of the rules outlined in the previous paragraph would not in practice determine whether continuity is broken after the new rules come into place. However, the test is necessary to cater for technical issues of transition (e.g., where the former listing exemption applied) and to ensure that taxpayers do not exploit the deferral of the new 66% threshold until the beginning of the 1992/93 income year.

From the 1991/92 year onwards, in order for a loss company to be included in a group of companies with one or more profit companies, the profit and loss companies must be at least 66% commonly-owned <u>at all times</u> from the beginning of the income year of the loss company in which the loss was incurred (or from Budget night if 1991/92 was the year of loss) to the end of the loss company's income year that corresponds to the income year of offset. In relation to carried-forward losses incurred in the 1990/91 and prior years, the loss company and the profit company would have to be members of the same group <u>in</u> the income year the loss was incurred and at all times from Budget night to the end of the income year of offset.

Implications for other sections of the Income Tax Act

Reference is made to the grouping provisions of section 191 in many places throughout the Income Tax Act. Care has been taken in redrafting the provisions of section 191 to keep the number of consequential changes required elsewhere in the Act to a minimum. Unless changes to other provisions that refer to section 191 are proposed as part of the overall package of reforms announced in the Budget, the effect of those other provisions will be retained notwithstanding any changes to the drafting of the grouping provisions.

The interaction of the new section 191 provisions and other provisions of the Act can be illustrated using one of the more significant provisions that inter-relates with the grouping provisions of section 191 - namely, section 106(1)(h)(ii) of the Act. Section 106(1)(h)(ii) is relied on heavily in practice as the statutory basis that enables a deduction for interest to be taken on borrowings used to finance share acquisitions in the context of group companies. The current policy of the Inland Revenue Department in interpreting that provision is that, in order for a company to deduct its incurred interest costs on borrowings to acquire shares in another company, it is sufficient that the companies form a group on 31 March each year.

It will be possible for the current policy of the Department in relation to section 106(1)(h)(ii) to be retained after Budget night because:

- in relation to the 1991/92 income year, the requirement that two or more companies must be members of the same group

- at all times from Budget night will apply solely for the purposes of the loss offset rules in subsections (5) and (7) of section 191. For other purposes, whether two or more companies have sufficient commonality of ownership to form a group will continue to be determined on 31 March each year

- in relation to the 1992/93 income year onwards, two or more companies will be considered to be members of a group of companies at any time if they have at least 66% commonality of ownership at that time. Again, the requirement for two or more companies to be members of the same group of companies at all times during one or more income years will be for the purpose of the loss-offset rules. Only minor modifications to section 106(1)(h)(ii) to take effect from the 1992/93 income year will be necessary to accommodate the current practice of the Department in determining whether a group of companies exists on 31 March in any year.

Economic impact

A significant economic impact of the changes outlined above, together with the removal of the inter-corporate dividend exemption, is the additional tax that will be paid by the corporate sector. This will impact most heavily on large companies. However, this sector will benefit from the downward pressure on interest rates resulting from the more credible fiscal position and the proposal to exempt certain interest flows from non-resident withholding tax.

Restricting the transferability of losses may also act as a disincentive to risk-taking in some circumstances. However, the investment decisions of taxpayers will only be affected by rules to restrict the transferability of company losses to the extent that such losses are expected. Recent experience suggests that most of the existing stock of tax losses were either not expected or were created by exploiting weaknesses that previously existed in the tax base. Any extra economic costs that flow from restricting the ability for company losses to be sold are therefore likely to be small and uncertain when balanced against the very high and tangible fiscal cost of loss trading. In the absence of reforms announced in the Budget, the fiscal costs of company loss trading would have imposed higher tax burdens on current taxpayers or, through a larger deficit, on future taxpayers. Those higher tax burdens would have represented significant impediments to enterprise and growth.

In addition, the greater flexibility of companies to transfer their losses compared to individual taxpayers favours incorporation over other forms of business organisation. If any additional costs do result from limiting the ability of companies to transfer losses (and this is not clear), that cost must also be balanced against the costs that result from favouring certain companies over other taxpayers.

In conclusion, the measures outlined above support and are supported by the removal of the inter-corporate dividend exemption. They will reduce the latitude for companies to transfer losses compared to individual taxpayers, thereby contributing to a fairer tax system. The measures are also aimed at ensuring that all companies pay their fair share of tax. By doing so, they will reduce the extent to which tax interferes with market-led investment decisions, and will contribute to the maintenance of a credible fiscal position.

Summary of main changes to the loss carry-forward and offset rules

The main features of the rules that will apply from the 1992/93 year are summarised below.

Measuring a shareholder's economic interest in a company

- a single provision to define a shareholder's economic interest in a company will apply for the purposes of the loss and credit carry-forward provisions and the commonality rules

- an economic interest in a company will, in general, be equal to the percentage of a shareholder's voting power in a company except in certain circumstances. In those circumstances, the continuity or commonality of ownership tests must also be satisfied using the market value of each shareholder's interest as a proportion of the total market value of all interests in the company as a measure of an economic interest

- for the purposes of the loss and credit carry-forward provisions, simplified rules will apply in respect of listed companies, certain publicly-held unit trusts, co-operative companies and building societies.

Loss carry-forward provisions

- the minimum continuity of ownership required for a company to carry-forward its losses will be increased from 40% to 66%

- the aggregate of the lowest economic interests of each shareholder in a company in the period from the beginning of the year of loss to the end of the year the loss is used to offset group profits, will be used to determine whether the minimum continuity threshold has been satisfied

- losses incurred in the 1991/92 and prior years that would have been eligible for offset in the 1991/92 income year, will be eligible for carry forward into the 1992/93 income year and beyond provided that:

    - 40% continuity of ownership is retained from Budget night under the existing carry-forward rules in section 188 (as modified from Budget night)

    - 66% continuity of ownership is retained from the beginning of the 1992/93 year, computed using the new rules

Loss-offset provisions

- in respect of losses incurred in the 1991/92 income year onwards, the rule under which the income of one or more profit companies will be able to be offset against the current year or carried-forward losses of a loss company in any income year will be as follows. Offset will be allowed if the profit and loss companies are at least 66% commonly owned by the same group of shareholders at all times from the beginning of the income year of the loss company in which the losses were incurred (or from Budget night if 1991/92 is the year of loss) to the end of the loss company's income year that corresponds to the income year of offset. Where the losses to be utilised relate to the 1990/91 and prior income years the loss and profit companies would have to be members of the same group in the income year of loss and at all times from Budget night to the end of the income year of offset

- losses eligible for offset in any year will be those incurred in that year and those eligible for carry-forward under the loss carry-forward rules

- the losses of a loss company will be able to reduce or extinguish the income of one or more profit companies in the same (66% commonly-owned) group by a combination of assessable/deductible subvention payments and simple election.

The current loss carry-forward and loss-offset provisions in section 188 and 191 of the Act will apply in respect of the current 1991/92 income year except for the changes summarised below that will apply from Budget night:

- an additional requirement before carried-forward losses can be utilised in the current income year is that, in the period from Budget night to the end of a loss company's 1991/92 income year, the current 40% continuity threshold must be satisfied taking account of the lowest percentage of rights referred to in section 188(7) of each shareholder in that period

- a loss company and one or more profit companies must be members of the same ordinary or specified group of companies at all times from Budget night to the end of the loss company's 1991/92 income year, before the 1991/92 income of the profit companies can be offset against the eligible carried-forward or current year losses of the loss company.

Chapter 9 : Transfer of Imputation Credits

Introduction

Imputation credits may be attached to dividends to enable company tax paid to be credited against a shareholder's tax liability on the dividends. This avoids double taxation of income earned through companies and ensures that such income is taxed at the shareholder's marginal tax rate.

Imputation credits are of no value, however, to shareholders who are not subject to full New Zealand tax because, for example, they are non-resident or tax-exempt. Consequently, there is an incentive to divert imputation credits away from these shareholders and towards shareholders who can use the credits to reduce their tax liabilities.

There are anti-avoidance rules in the imputation regime to prevent credit transfers in these circumstances. Deficiencies in those rules have become apparent, however, with some very large transactions taking place during the last financial year. This has resulted in a substantial reduction in tax collections.

The imputation regime also contains a shareholder continuity rule. This requires a company to have 75% continuity of ownership before it can carry forward credit balances in its imputation credit account to future years. Deficiencies in this rule provide companies with opportunities to sell their imputation credits without being concerned about breaching the continuity of ownership requirement.

The measures discussed in this chapter are designed to remedy these defects. Two further measures are also discussed. The first involves an extension of the anti-dividend stripping rules to encompass debentures treated as equity (section 192 and section 195 debentures). The second measure is concerned with allowing refunds of income tax overpaid before a change in the ownership of a company.

Amendments to imputation anti-avoidance rules

The Government has decided to correct defects that it has identified in the imputation anti-avoidance rules. The following measures are therefore being taken:

- debentures that are subject to section 192 or section 195 of the Income Tax Act will be treated as shares. These are limited categories of debentures that are treated as equity under the Act because they exhibit significant equity features or are issued in substitution for equity. Currently, the anti-avoidance rules apply only to schemes involving shares. This means that the rules may be circumvented by using debentures that are treated in the same way as shares under the Act, but which are not shares in a legal sense

- the rules are being clarified to ensure that they apply in cases where shares are held by trustees of a trust. Currently, because the rules apply only with respect to shares and shareholders, it is unclear whether they can apply with respect to beneficiaries of trusts where the trustees hold the shares.

- the rules are being amended so that they may apply in cases where a company issues new shares and then pays out credited dividends on those shares. In some cases this might result in an inappropriate transfer of imputation credits, for example, where shares are issued for a short term with redemption occurring after credited dividends had been paid out

- the rule aimed at imputation credit "streaming" schemes, where a company streams imputation credits towards particular categories of shareholder, is also being amended to ensure that it can apply in cases involving bonus issues of shares. The operation of the anti-streaming rule with respect to bonus issues is currently unclear

- the Commissioner of Inland Revenue will be given a power to deny imputation credits to shareholders in cases where they are a party to an imputation credit streaming arrangement. Current legislation is defective in that it only allows the Commissioner to debit the imputation credit account of the company involved in streaming the credits. However, this may not always be an effective method of penalising the parties to the arrangement. For example, assume that there is a change in the ownership of a company after it has streamed dividends to a particular group of shareholders. In these circumstances, debiting the company's imputation credit account will only reduce the amount of the debit that would occur in any event by virtue of the ownership change. A more effective approach would be to deny the credits to the shareholders.

Amendments to shareholder continuity rule

The shareholder continuity rule is defective in that it allows imputation credit rich companies to be acquired over several years. Also, several changes are necessary to ensure that the continuity requirement is consistent with other continuity of ownership rules in the Act.

The shareholder continuity rule for the imputation regime will be amended to ensure that it is consistent with the continuity rule for loss carryforwards. One consequence of this amendment is that the continuity rule will be relaxed to require 66% continuity of ownership rather than the current 75%. The imputation continuity rule will differ from the loss continuity rule in that shares bearing a fixed rate of dividend and debentures that are subject to section 195 of the Income Tax Act will be taken into account. It is necessary to take these instruments into account for imputation continuity purposes because imputation credits can be attached to dividends payable on them.

The other difference between the imputation and loss continuity rules will be the definition of the continuity period during which the required level of shareholder continuity must be maintained. Under the imputation continuity rule, the continuity period will commence when the credit to the company's imputation credit account originally arises and will end when the credit is used, for example, because it is attached to a dividend. The continuity period for the purposes of loss carryforwards will commence at the beginning of the income year when the loss was incurred and end at the end of the income year when the loss is offset against company income.

The current continuity of ownership rules in the foreign dividend withholding payment regime and in the provisions governing the establishment of branch equivalent tax accounts mirror those that are currently in the imputation regime. These continuity rules will therefore be amended to reflect the changes to the imputation continuity rules.

Other changes

The non-application of the imputation anti-avoidance rules to debentures subject to sections 192 or 195 has highlighted defects in the provisions that attack dividend stripping schemes. Broadly, these schemes involve the conversion of taxable dividends into non-taxable capital gains. Since the anti-dividend stripping rules apply only to schemes involving shares, section 192 or 195 debentures may be used for dividend stripping purposes. This defect will be remedied by extending the operation of the anti-dividend stripping rules to section 192 and section 195 debentures.

An amendment will also be made to allow refunds of income tax that was overpaid before a change in share ownership that breaches the imputation continuity rule. Current legislation denies refunds in these circumstances. The refund is to be limited to the lesser of the amount of tax overpaid or the debit to the company's imputation credit account on the change in ownership. This will ensure that refunds are not available where a company has already attached imputation credits arising from the overpaid tax to dividends paid to shareholders.

Application date

The application date of the above amendments is as follows:

- the amendments to the imputation anti-avoidance rules will apply from the date of the Budget to arrangements entered into on or after that date. The amendments will apply from the beginning of the imputation year commencing on 1 April 1992 to arrangements entered into prior to the date of the Budget

- the amended shareholder continuity rule will apply from 1 April 1992

- the amendments to the anti-dividend stripping rules will apply from the date of the Budget

- the amendment to allow refunds of income tax overpaid before a change in company ownership will apply from the beginning of the 1988/89 income year when imputation was introduced. This measure should be beneficial to taxpayers.

Summary

- Defects in the imputation regime anti-avoidance and shareholder continuity rules currently provide opportunities for imputation credits to be streamed or transferred to particular groups of taxpayers.

- The imputation regime anti-avoidance rules are being amended to address the defects that allow imputation credits to be streamed or transferred in schemes using section 192 or section 195 debentures or trusts, or involving the issue of new shares or bonus shares.

- The imputation regime continuity of ownership rule is being amended to ensure that it is consistent with other continuity of ownership rules in the Act.

- The anti-dividend stripping rules in section 99(5) and section 198 are being extended to encompass debentures treated as equity under the Act (that is, section 192 and section 195 debentures).

- An amendment is to be made to ensure that refunds can be made of income tax overpaid before a change in the ownership of a company.

- The amendments to the imputation anti-avoidance rules will apply from Budget night to arrangements entered into on or after that date, and from 1 April 1992 in relation to arrangements entered into before that date.

- The application dates of the other measures are as follows:

  - amendments to continuity of ownership rules: 1 April 1992

  - amendment to anti-dividend stripping rules: date of the Budget

  - allowance of refunds for tax overpaid before an ownership change of the company: commencement of the 1988/1989 income year.

Chapter 10 : Tax Recovery

Introduction

This chapter provides more information on the Government's decision to replace section 276 of the Income Tax Act with a better targeted tax recovery provision. That new provision will enable the Commissioner to recover tax from the directors and shareholders of a company that has entered into an arrangement or transaction to deplete the company's assets so that it is unable to fully meet its tax liabilities.

Problems with the existing recovery provision

Section 276 is intended to enable the Commissioner to recover the tax payable by a company that has ceased to carry on a business or has been wound up (the "original company"), from any new company set up by the shareholders of the original company.

That is, it is intended to prevent schemes in which the assets of the original company are stripped out into a new company owned by the same shareholders, leaving the original company with insufficient assets to meet its tax liabilities.

Section 276(3) seeks to achieve this objective by deeming the new company to be an agent of the original company and hence to be liable for all of the tax payable by the original company.

Both practitioners and officials have identified a number of deficiencies in the operation of this recovery provision.

Practitioners are particularly concerned about the extremely broad application of the current recovery provision. Not only does it give the Commissioner the power to recover tax from new companies which have the same directors and shareholders as the original company that engaged in asset stripping, but it also enables him to recover the outstanding tax from other companies within the same corporate group as that original company.

This means that a company in a corporate group is potentially liable for the outstanding tax arising from the asset stripping activities of any other company in that corporate group, even if they were not engaged in those activities and had little or no power to prevent those activities. It also means that companies that take over another company must be aware of any past liabilities of the company being purchased, but also of the past liabilities of all companies with substantially the same shareholders, throughout the company's entire history. In practice, many companies may find this difficult, if not impossible, to achieve.

Accordingly, practitioners have argued that the application of section 276 should be targeted at those in control of the company at the time the taxable transactions occurred in order to ensure that the remedy for the mischief is directed at those responsible for the mischief.

Officials are also concerned that the current tax recovery provision:

- does not prevent asset stripping activities. Deficiencies in the wording of section 276 still enable companies to strip out their assets so that the company is unable to meet its tax liabilities. This is typically accomplished by a dividend strip followed by the sale of the company prior to commencement of winding up. This prevents the application of section 276 to the shareholders of the new company since they will not be the same as the shareholders of the original company at the commencement of winding up
- only gives the Commissioner access to the assets of existing and new companies with substantially the same shareholders as the original company.

The new recovery provision

In order to rectify these deficiencies, section 276 of the Income Tax Act is to be replaced with a better targeted provision. That provision will allow the Commissioner to recover tax from directors and shareholders of companies that have entered into arrangements or transactions to deplete the assets of the company so that it has been unable to meet its tax liability.

Unlike the current section 276, the new tax recovery provision will enable the Commissioner to recover tax from those directors and shareholders regardless of whether or not they also have an equity interest in another company.

The new recovery provision will be triggered by arrangements or transactions that have been entered into to deplete the company of its assets so that it has insufficient funds to fully meet its tax liabilities. However, it will not be triggered by formal arrangements (under insolvency proceedings) or informal arrangements (under section 414A of the Income Tax Act) between the Commissioner of Inland Revenue, the company and its other creditors, which result in the Commissioner accepting less than the full amount of tax outstanding.

Recovery of the outstanding tax that results from these asset stripping arrangements will be sought from those taxpayers that were directors and shareholders of the company at the time the arrangement was entered into.

The new recovery provision will only be applied to those entities who had sufficient control of the company to have been able to influence the company's decision to enter into the arrangement or transaction, since those taxpayers are the ones most likely to engage in asset stripping for their benefit. This will include associated parties whose combined shareholding gives them a controlling interest in the company.

Directors will be made jointly and severally liable for the full amount of the shortfall in tax that results from action taken to strip the company of its assets.

Similarly, shareholders who had a controlling interest in the company at the time the arrangement was entered into, and who have benefited from that arrangement, will also be subject to the recovery provision. However, in this instance they will only be liable for recovery of tax up to the value of their shareholding in the company, plus a penalty. This will ensure that those major shareholders who were not a party to the arrangement will not be too adversely affected by the company's decision to enter into that arrangement, but at the same time will be deterred from being a party to such arrangements by the penalty.

Shareholders who do not have a controlling interest in the company will not be subject to the new recovery provision unless they benefited to such an extent from the arrangement that it seems reasonable to conclude that they were actually a party to that arrangement.

In order to facilitate the recovery of tax, the Commissioner will be given access to all of the assets of those directors or shareholders that are subject to the recovery provisions, including any equity interests they may have in other existing or new companies.

Implementation of the proposed amendments will ensure taxpayers pay their fair share of tax and complement the other base maintenance measures. The proposed amendment will prevent corporates who engage in imputation credit streaming and loss trading from evading tax and eliminating their exposure to anti-avoidance legislation by stripping out the assets of their companies, and selling those companies prior to wind-up.

Application date

The new recovery provision will have effect from Budget night. In view of the inter-related nature of section 276 with the Companies and Insolvency Acts, however, the proposed legislative amendments will be referred to Select Committee.

Summary

- The existing tax recovery provision in the Income Tax Act (section 276 refers) is considered to be deficient by both practitioners and officials.
- In order to rectify these deficiencies, section 276 of the Income Tax Act is to be replaced with a better targeted provision which allows the Commissioner to recover tax from directors and shareholders of companies that have engaged in arrangements or transactions to deplete the assets of the company so that it has been unable to meet its tax liabilities.
- The new recovery provision will apply with effect from Budget night.

Chapter 11 : Gaming-machine duty

Introduction

Gaming-machine duty is to be set at 5.5% on the turnover of gaming machines starting from 1 October 1991. The duty will apply to about 6,000 gaming machines owned by approximately 1,200 societies. These gaming machines are operated from clubs and hotels.

Gaming-machine turnover means the amount in money or money's worth, in whatever form, that is paid or payable to play a game of chance by means of a gaming machine.

Both the Lotteries Commission and the TAB are dutiable at 5.5% of gambling turnover (or 5% in some cases for the TAB). Gaming-machine turnover has not been subject to duty. The proposed gaming-machine duty will remove this anomaly. This measure will broaden the gambling revenue base. As such, it fits into the Government's overall strategy of maintaining broad revenue bases to facilitate lower tax rates.

How the system will operate

The Department of Internal Affairs will continue to administer gaming machine regulations and conduct random audits of gaming-machine operators. The Department of Inland Revenue will be responsible for the collection of gaming-machine duty. Similar arrangements exist for both lottery and totalisator duty.

The legislation enacting the collection of gaming-machine duty will form part of the Gaming Duties Act 1971. In addition it will contain assessment and recovery provisions. These provisions are currently considered unnecessary for totalisator and lottery duty.

The Department of Internal Affairs has a register of gaming-machine licence holders. This information will be made available to the Inland Revenue Department to speed up implementation of the collection system.

Each gaming-machine operator will be required to furnish the Commissioner of Inland Revenue with a return providing details of the operator's gaming-machine(s) turnover and the gaming-machine duty payable. This will be calculated from gaming-machine meter readings. Returns will cover the period of the previous calendar month or part thereof.

Payment of gaming-machine duty will be required by the twentieth day of the following month. As gaming-machine duty will be calculated on turnover beginning with the calendar month of October this means that the first payments will be made in November.

Cancellation of a gaming-machine licence will require the former licence holder to provide a statement within 7 days for the Commissioner of Inland Revenue.

The legislation will provide for assessments to be issued where:

- a return has not been furnished by the due date (default assessment)
- a return has been filed but the gross turnover has been understated.

The legislation will allow for the disclosure of audited turnover data held by the Department of Internal Affairs to be supplied to the Inland Revenue Department for revenue-gathering purposes.

Gaming-machine licence holders will have the right to object to the Commissioner of Inland Revenue within 28 days of the date of notice of assessment. If the objection is not wholly allowed then the objection may, within 2 months after the date of notice of disallowance, be taken to the Taxation Review Authority.

The Commissioner will rank as a preferential creditor in the collection of gaming-machine duty. The Commissioner will be entitled to deduct unpaid duty from any amount payable to a gaming-machine operator.

Summary

- A gaming-machine duty will further the Government's objective of maintaining a broad revenue base to facilitate lowering of tax rates.
- The gaming-machine duty will be calculated on turnover beginning 1 October. The first gaming-machine duty payments will be due by 20 November 1991.
- Gaming-machine operators will be advised in due course on how the new legislation affects them.

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