TAXATION (ACCRUAL RULES AND OTHER REMEDIAL MATTERS) BILL

Commentary on the Bill

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CONTENTS

The Accrual Rules

Taxation of financial arrangements 3

Other Changes to the Income Tax Act 1994

Averaging of tax-free allowances 31
GST as part of the cost of fringe benefits 33
Guarantee fees paid to non-residents 35
Limiting deductions under certain arrangements 37
Trading stock - variances 38
Remedial amendment - low income rebate 39
Charitable donee status 40

Changes to the Tax Administration Act 1994

Application of shortfall penalties to duties 43
Tax in dispute and remission provisions 44
Arrangements for extensions of time 46
Binding rulings 47
Time bar waivers 53
Tax recovery agreements 55
Non-recovery of small amounts of civil penalties 59

Changes to Other Acts

GST on overseas mail delivery in New Zealand 63
Remedial amendments to the Student Loan Scheme Act 1992 64

The Accrual Rules

TAXATION OF FINANCIAL ARRANGEMENTS

(Clauses 6-11, 15, 18, 20-23, 27-42, 45-46, 47(2)-(15), 47(20)-(25), 47(27), 47(29)-(31), 47(33)-(47), 49-52, 54(1)(d), 54(1)(h), 54(2), 54(3), 55-57, 60-62, 65-67, 96, 105-106, 108)

Summary of proposed amendments

These amendments will give effect to some of the changes outlined in the Government discussion document *Taxation of Financial Arrangements*, released in December 1997. The aim of the amendments is to resolve problems, anomalies and inadequacies in the accrual rules that have been identified over recent years. The basic policy objectives underlying the rules will not change. The objectives are sound and essential to the protection of the tax base.

Most of the amendments in this bill are aimed at simplification and clarification of the law. They should improve the administration and application of the accrual rules and make the rules more workable. The main proposals in this category are to:

- expand the list of transactions not subject to the accrual rules;
- remove the legislative distinction between different parties to a transaction to simplify the calculation of income and expenditure; and
- limit the definition of "finance leases" and bring them within the accrual rules.

Application date

The amended accrual rules apply only to financial arrangements entered into on or after the date of enactment. The accrual rules will be set out in two divisions. The current accrual rules will apply to financial arrangements entered into before enactment of the amendments. These rules will be contained in Division 1, that is, sections EH A1 to EH 15. Definitions unique to the operation of the current accrual rules, such as "core acquisition price", "holder", and "issuer", will be moved to section EH 11. The rules will be set out in the new drafting style being used to rewrite the Income Tax Act.

Division 2 will be inserted after section EH 15 and will contain the amended accrual rules. These rules will generally apply to financial arrangements entered into on or after the date of enactment.

Taxpayers will have the option of moving all financial arrangements onto the new rules if they perform a transitional calculation under section EH 14. However, if the arrangement is not subject to the accrual rules in Division 2, because, for example, it is a small variable principal debt instrument, the transitional calculation will require the taxpayer to treat the arrangement as transferred at market value. The taxpayer must therefore do a base price adjustment.

Although most of these new rules apply to financial arrangements entered into on or after the date of enactment, there are several exceptions to the general application date. The following additions to the list of excepted financial arrangements will apply from 1986, when the accrual rules came into effect, unless a taxpayer has taken a contrary position in tax returns already filed:

- cash basis persons providing on demand loans without interest, discount or premium;
- employment contracts;
- interests in group investment funds;
- interests in joint ventures;
- interests in partnerships;
- travellers cheques; and
- warranties over goods or services.

These additions to the definition of "excepted financial arrangement" clarify the original intent of the rules and bring the law into line with existing practice of taxpayers and Inland Revenue.

Other exceptions to the general application date relate to transfers of debts at a substantial discount to an associate of the debtor, and the disclosure requirements. These amendments will apply from the date of enactment, regardless of when taxpayers entered into the financial arrangements.

Key features

Policy features

- The definition of "financial arrangement" governs the type of arrangements that are within the accrual rules. This definition will be clarified and the definition of "excepted financial arrangement", which excludes certain transactions from the rules, will be expanded.
- The accrual rules currently distinguish between holders (usually lenders) and issuers (usually borrowers). This distinction will be removed, to simplify the calculation of income and expenditure.
- The allowable deduction available under the base price adjustment to holders of financial arrangements will be removed.
- The cash basis concession will be extended to all parties to financial arrangements, and the thresholds under which the cash basis rules apply will be raised to $1,000,000.
- The treatment of assignments of income and defeasances of debt will be clarified.
- The debt remission rules will remain in place, and opportunities to avoid the rules will be closed down.

- Leases with financing characteristics will be brought within the rules.
- A transfer of a financial arrangement, necessitating a base price adjustment, will be deemed to occur on the death of a party to a financial arrangement and on the distribution of the arrangement to a beneficiary under a will or on intestacy.
- The disclosure requirements will be repealed.
- When they leave New Zealand, temporary residents who are cash basis persons will no longer be required to do a base price adjustment for any financial arrangement they held when they became resident, and continue to hold when they become non-resident.

Rewriting the accrual rules

As well as implementing policy changes, the accrual rules in Division 2 will be rewritten in plain language. The new drafting style minimises complexity, repetition and the use of redundant words. Wherever possible, the bill uses words that are commonly used. To assist readers, descriptive subsection headings will be included and a list of terms defined in section OB 1 will be included at the end of each section. Flowcharts and readers' notes will also be included in the legislation, although they are interpretational aids only.

Amounts arising under the accrual rules will be treated as income derived or expenditure incurred. The term "income derived" is used in the accrual rules to refer to income arising from applying the spreading methods (including by way of a transitional adjustment calculation under section EH 14 or section EH 41), the cash basis adjustment or the base price adjustment. An additional provision will be added to section CE 1 to treat the "income derived" under the accrual rules as gross income for the purpose of the core provisions.

Background

The accrual rules were introduced in 1986. The main purpose of the rules is to standardise the timing of recognition of income and expenditure associated with financial arrangements. This provides a better measure of income, reducing economic distortions and opportunities for tax avoidance. Before the introduction of the accrual rules, expenditure from debts could be deducted well in advance of the period in which income from the same transaction was recognised. This was a major threat to the tax base. The rules that were introduced were consistent with accrual methods used in financial markets and, where appropriate, reflected accounting treatment.

In the early 1990s, the Consultative Committee on the Taxation of Income from Capital (the Valabh Committee) made many suggestions to improve the operation of the accrual rules. This bill contains several amendments arising from the proposals of that committee.

The Government's initial proposals for change were set out in the discussion document *The Taxation of Financial Arrangements*, released in December 1997. The discussion document generally focused on simplification of the accrual rules. That approach recognised that although the policy objectives underlying the rules are sound, the rules are complex and in some cases difficult to apply.

Main changes from the proposals in the discussion document

The final proposals contained in this bill reflect feedback from the tax community on the discussion document. The main changes from the proposals set out in the discussion document are:

- withdrawal of the proposal to clarify that gross income or expenditure will be solely attributable to an excepted financial arrangement only to the extent the income or expenditure could be expected to arise without the support of the wider financial arrangement;
- extensions of the option to treat excepted financial arrangements as financial arrangements to facilitate varying business practices;
- increases in the thresholds originally proposed;
- adopting the definition of "legal defeasance" in *Financial Reporting Standard 26* for tax purposes;
- removal of the proposal to treat amounts remitted on the winding up of an insolvent company as having been remitted immediately before the winding up; and
- withdrawal of the proposal to extend the definition of "finance lease" to real property.

Section DJ 1(c) provides that no deduction is allowed for any expenditure or loss recoverable under any insurance or right of indemnity. The discussion document proposed that deductions for "in-substance" defeasances that may be characterised as an indemnity should not be restricted by section DJ 1(c). However, as a drafting matter it appears difficult to characterise the difference between indemnity, in-substance defeasance and financial arrangements. The proposal has therefore been withdrawn.

Work is continuing in a number of areas, including the appropriate treatment of security arrangements, extending the availability of the market valuation method as a method of accrual, and the integration of accrual determinations and binding rulings. These issues will be consulted on further and the necessary amendments included in a future taxation bill.

Detailed analysis

Division 1

Subpart EH contains the provisions relating to the taxation of financial arrangements. The Subpart will be broken down into two divisions. Division 1 contains the current accrual rules that will be re-enacted with minor modification to reflect the new legislative style. These modifications include subsection headings and a list of defined terms at the end of each section. The rules will be self-contained and will apply to financial arrangements entered into before the date of enactment. A number of changes will be introduced to ensure that the rules in Division 1 are self-contained. The old terms that have been repealed or amended (such as "acquisition price" and "qualified accruals rules") will continue to be relevant to Division 1. These terms will be moved from section OB 1 to section EH 11. Provisions that relate only to the current accrual rules, such as sections OB 7 and GD 11, will also be moved into Division 1.

Two remedial amendments will be made. Section EH 3(6)(a) refers to "trustee income or beneficiary income under the trust rules and sections HI 1 to HI 5". Sections HI 1 to HI 5 deal with Maori Authorities. The "and" between "trust rules" and "sections HI 1 to HI 5" will be replaced with "or". The section is meant to exclude trusts, as well as Maori Authorities, from the cash basis concession. Therefore the two provisions should not be inter-related.

Section EH 4(7)(a)(ii) applies if a person is released from an obligation to make a payment under a financial arrangement by operation of any of the Inland Revenue Acts. The purpose is to ensure no remission income will arise. Section EH 4(7)(a)(iii) applies if a person is released from an obligation to make a payment under a social assistance suspensory loan. There is currently an "and" between these subparagraphs. The provision in subparagraph (ii) has application beyond debts associated with loans from the Government for social assistance purposes. The two provisions should not, therefore, be related. The "and" will be replaced with an "or".

Transfer of financial arrangement to associate of the debtor

A new section EH 5A will be inserted into Division 1 to reflect the proposed rules for debt parking. This section contains the provisions relating to the transfer of a debt at a substantial discount to an associate of the debtor. This provision will apply to transfers of debts after the date of enactment for financial arrangements entered into before that date.

The definition of "remitted" has been amended to account for transfers of debt to an associate of the debtor. This will trigger a base price adjustment for the debtor. The base price adjustment will be amended to take into account payments made on behalf of the debtor. Section EH 5A (4) will deem a new interest-free loan to have been extended by the associate to the debtor for the amount paid for the debt.

Transitional adjustment

Division 1 applies to financial arrangements entered into before the changes in this bill are enacted. Taxpayers will be able to elect, under section EH 14, to apply the accrual rules in Division 2 to those arrangements. This will be useful if they wish to account for all arrangements on a similar basis. The election will apply to all the financial arrangements to which they are a holder or issuer. In the year they elect to move onto the new rules, they will be required to calculate a transitional adjustment for each financial arrangement. The result of the adjustment will be their income or expenditure from the financial arrangements in that year.

Differences between the old and new accrual rules that could result in an adjustment to income or expenditure include:

- extension of the cash basis concession;
- changes to the remission income rules; and
- extension of the market valuation method.

Terminology in other provisions of the Act

References in other provisions of the Act have been changed to reflect the new terms used in Division 2 of Subpart EH. For example, references to "holder" and "issuer" will generally be changed to "party", and references to "acquisition price" will be changed to "consideration". Where consequential amendments are made, section EH 15 will guide taxpayers who are parties to a financial arrangement subject to the current rules when applying other provisions in Inland Revenue Acts if the terminology has been amended. If a holder or issuer of a financial arrangement to which the rules in Division 1 apply is required to apply other provisions of the Act, those other provisions will be applied as they were before the amendments in this bill were made.

Division 2

Division 2 contains the amended accrual rules that will apply to financial arrangements entered into after the date of enactment.

Purpose provision

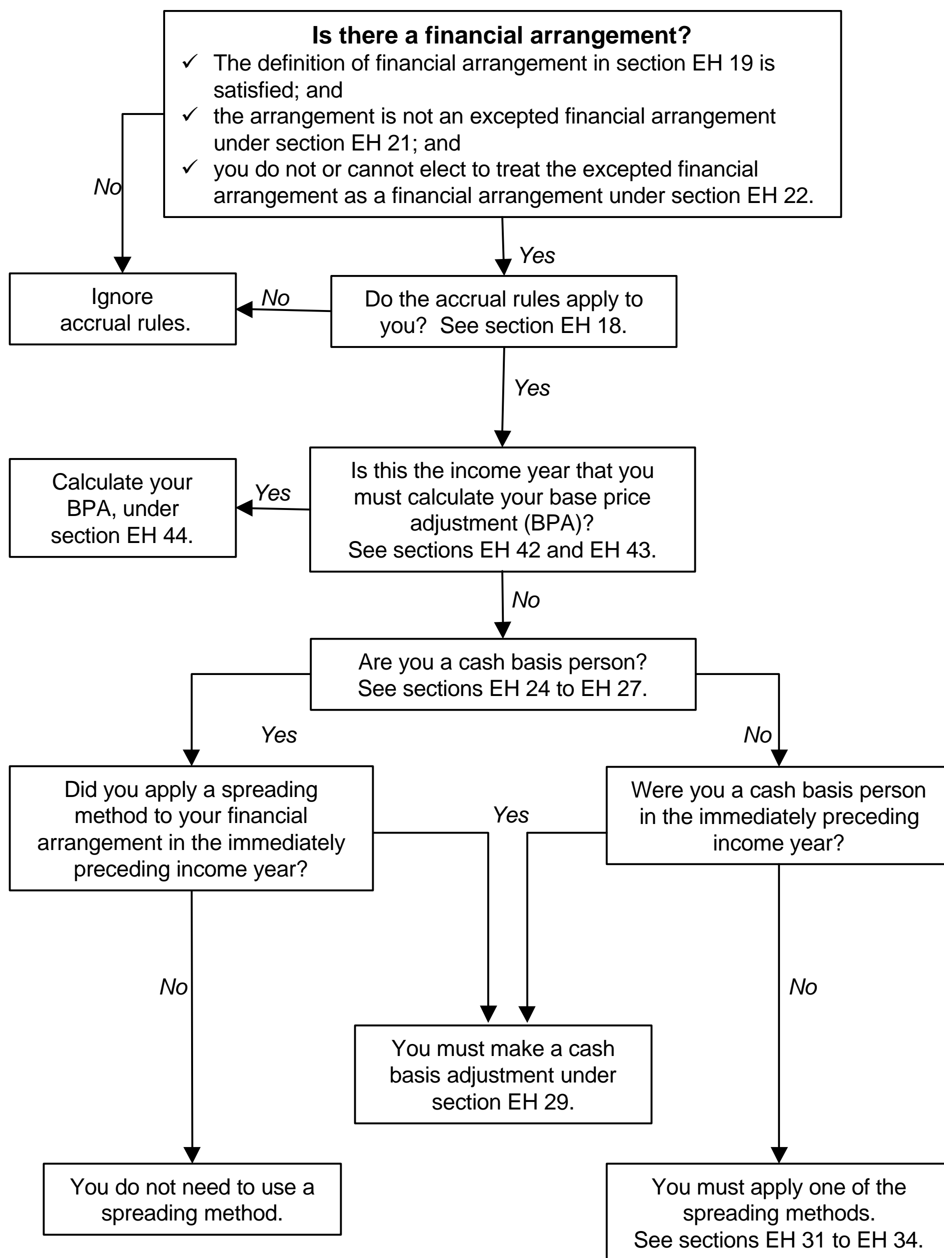
A purpose provision has been included at the beginning of the new accrual rules. The provision aims to assist taxpayers and other users of the legislation understand the general intent of the accrual rules, which is to allocate a fair and reasonable amount of expected income or expenditure from a financial arrangement over its term. The provision may also assist in the resolution of any unforeseen ambiguities.

Application of the accrual rules

No major changes will be made to the rules governing the persons to whom the accrual rules apply.

A minor amendment, in section EH 18(1)(c), ensures non-resident trustees are subject to the accrual rules. Trusts are generally taxed on the basis of the residence of the settlor. The residence of the trustee is disregarded for New Zealand tax purposes. A trustee, whether resident or non-resident, is liable to income tax on all trustee income that the trustee derives from New Zealand if the settlor is a New Zealand resident. This ensures consistent treatment between non-resident trustees deriving foreign-sourced and New Zealand-sourced income from financial arrangements.

FIGURE 1: WHETHER THE ACCRUAL RULES AND THE SPREADING PROVISIONS APPLY



This flowchart illustrates the process to follow to determine whether the accrual rules or the spreading methods apply.

Definition of "financial arrangement" and "excepted financial arrangement"

Definitions are generally found in section OB 1. However, the definitions of "financial arrangement" and "excepted financial arrangement" will be moved into Subpart EH, since they are fundamental to the application of the accrual rules.

The definition of "financial arrangement" is cast in wide terms to include debt instruments, debt substitutes and derivatives. A wide definition is necessary because of the range of financial instruments and derivatives available in the marketplace, many of which are substitutable for debt.

A consequence of the wide definition of "financial arrangement" is that it is necessary to exclude some arrangements from the rules. They are excluded because of the need to maintain the debt/equity boundary, for compliance cost reasons or because some transactions are subject to other rules set out in the Income Tax Act.

The wide definition of "financial arrangement" will be retained, together with a definitive list of exclusions. However, the definition will be redrafted to improve its clarity and to make some minor amendments relating to terminology.

Subparagraph (iii) of the current definition relates to the concept of a wider financial arrangement and lists arrangements that are included in the definition of financial arrangement (such as assignments and defeasances). This subparagraph will be repealed. Arrangements that fall within the scope of the subparagraph are already within the scope of the general definition, so the subparagraph is unnecessary.

Subsection (2) of the proposed definition excludes from the definition partial or complete legal defeasances[1] and absolute assignments, not only of financial arrangements but also of excepted financial arrangements. The exclusion is necessary because legal and economic, or in-substance, defeasances, are similar in effect and thus difficult to exclude from the rules by way of refining the core definition. The arrangements will be excluded from the definition because an absolute assignment or legal defeasance merely terminates existing rights or obligations for the assignor or the defeasor. However, this exclusion will not prevent the assignee or defeasance counter party from becoming a party to a financial arrangement.

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[1] In *Financial Reporting Standard No 26, Accounting for the Defeasance of Debt* (*FRS 26*) a defeasance is a "legal defeasance" if the release of the debtor from the primary obligation for a debtor is either:

(a) acknowledged formally by:
  (i) the creditor; or
  (ii) a duly appointed trustee or agent of the creditor; or
(b) established by legal judgement.

This definition will be incorporated into the Income Tax Act 1994.

Section EH 21 defines “excepted financial arrangement”. The list of excepted financial arrangements will be expanded to exclude certain transactions for compliance cost reasons. For example, small prepayments for goods and services, and private or domestic foreign exchange borrowings will be excluded from the accrual rules. Other arrangements will also be included in the definition of “excepted financial arrangement” to clarify the original intent of the rules. For example, it will be made clear that interests in group investment funds, partnerships and joint ventures are not financial arrangements.

At present, taxpayers can elect to treat short-term agreements for the sale and purchase of property as financial arrangements. This rule will be extended to prepayments for property or services of less than $50,000, short-term options, travellers’ cheques and variable principal debt instruments of less than $50,000. The election will be made by returning income or expenditure in respect of the arrangement on an accrual basis in the income year the election is made.

Composite financial arrangements

A consequence of the broad definition of “financial arrangement” is that groups of inter-related financial arrangements which may not be financial arrangements on their own may fall within the definition. Inter-related arrangements are those in which there is a degree of interdependency between the transactions. It is appropriate that they be covered by the rules if they have the same effect as debt instruments or debt substitutes.

The calculation of income or expenditure in respect of composite financial arrangements is governed by a provision in the accrual rules (section EH 2 of the current rules). This provision will be re-enacted as section EH 20 with only two minor changes. The provision requires that when a composite financial arrangement includes an excepted financial arrangement, the amounts “solely attributable” to the excepted financial arrangement are excluded from the accrual rules. Income or expenditure will generally be “solely attributable’ to an excepted financial arrangement if it could have been expected to arise, or be incurred, without the support of the wider financial arrangement.

The discussion document proposed that the operation of section EH 2 be clarified. However, submissions expressed concern that the proposed clarification would create a new concept and add uncertainties to the existing provision, so the proposed amendment has been withdrawn.

The “solely attributable” rule will be amended, however, so that the rule will not apply to arrangements that are excepted financial arrangements for compliance cost reasons only. Those excepted financial arrangements are small variable principle debt instruments, short-term agreements for sales and purchase of property or services, short-term options, private or domestic purpose options over property, private or domestic purpose agreements for sales and purchase of property or services, private or domestic foreign currency loan to cash basis debtors, small prepayments for goods and services and travellers’ cheques.

An amendment will be made to ensure the "lowest price" concession[2] for agreements for the sale and purchase of property or services (ASAP) will not apply if the ASAP is part of a composite financial arrangement. A composite financial arrangement containing a group of inter-related arrangements cannot be properly characterised as an ASAP (even though some of the constituent arrangements are ASAPs). Therefore the lowest price concession should not apply. This amendment will be achieved in the definition of "consideration" in section EH 45.

Cash basis concession

The accrual rules currently provide an exemption from the spreading provisions for cash basis holders. A cash basis holder is a natural person who holds financial arrangements with a total face value of less than $600,000 and the income from those financial arrangements is less than $70,000.

The cash basis concession will be extended to all parties to a financial arrangement who are natural persons because there will no longer be a distinction between holder and issuer under the accrual rules.

The three thresholds for the cash basis concession will be increased. The concession is available to persons with financial arrangements having a total face value of not more than $1,000,000. Under the income and expenditure threshold a person will be a cash basis person if the absolute value of the person's income or expenditure, calculated under the accrual rules, from the financial arrangements, is less than $100,000. The absolute value of the person's income and expenditure means the income will not offset the expenditure.

Example

A person is a party to two financial arrangements. Using the yield to maturity method, the income from one financial arrangement is $50,000 and the expenditure from the other financial arrangement is $20,000. The absolute value of the person's income and expenditure is $70,000. The income and expenditure threshold is not breached. If the deferral threshold is not breached the person will be a cash basis person.

Another person also has two financial arrangements. Using the straight line method, the income from one arrangement is $60,000 and the expenditure from the other financial arrangement is $50,000. The absolute value of the person's income and expenditure is $110,000. The income and expenditure threshold is breached and the person is therefore not a cash basis person.

[2] The "lowest price" provision in the definition of "consideration" ensures that increases in the value of property that are the subject of the agreements for the sale and purchase of property, for example, are not included as interest income under the accrual rules.

A person will not be a cash basis person if the deferral threshold is breached. A breach will occur if a natural person creates a deferral of income or an acceleration of expenditure of $40,000 or more in aggregate. The amount of deferral is in respect of all financial arrangements to which the person is a party. The formula in section EH 24(3) sets out how the amount deferred will be calculated. It compares the income calculated under the accrual rules with the income calculated on a cash basis, and the expenditure calculated on a cash basis with the expenditure calculated on an accrual basis. If the total deferral across all financial arrangements is more than $40,000 the threshold will be breached.

Other aspects of the cash basis concession remain largely the same even though the concession is being amended to reflect the removal of the holder/issuer distinction. As currently happens, the cash basis concession will apply to the estate of a deceased person. The concession will apply to the estate in the year of death and the subsequent four years if the deceased was a cash basis person at the time of death and the estate continues to fall under the cash basis thresholds.

ELECTION TO USE A SPREADING METHOD

Section EH 28 will provide that cash basis persons may elect to use a spreading method to calculate income or expenditure in respect of the financial arrangements to which they are a party. In the year of election a cash basis adjustment will be performed for each financial arrangement, and income or expenditure in respect of those arrangements will be returned for that year.

BECOMING OR CEASING TO BE A CASH BASIS PERSON

Becoming a cash basis person, or ceasing to be one, requires a cash basis adjustment, as set out in section EH 29. Taxpayers must make an adjustment for all financial arrangements to which they are a party, apart from those arrangements that are already subject to the new method. For example, if they were a cash basis person and breached one of the thresholds, they would be required to perform a cash basis adjustment for all financial arrangements apart from those that were already subject to one of the spreading methods.

The adjustment compares the income or expenditure that would have resulted had the new method been applied from the time the person became a party to the financial arrangement, with the income or expenditure that did result from using the old method. The result of the cash basis adjustment will be the person’s income or expenditure from the financial arrangement in that year.

BASE PRICE ADJUSTMENT

The base price adjustment is a “wash-up” calculation that is generally performed when a financial arrangement is sold, matures, is remitted or transferred. The current rules contain a separate base price adjustment for cash basis holders. Under the amended accrual rules the new base price adjustment, in section EH 44, will apply to both accrual and cash basis taxpayers.

Methods of calculating income or expenditure

Taxpayers who are a party to a financial arrangement to which the cash basis concession does not apply must spread the income or expenditure over the term of the financial arrangement. The spreading methods available are set out in section EH 30 to EH 37.

The flowchart in figure 2 is being included in the legislation to illustrate the process that should be followed to determine which spreading method to use.

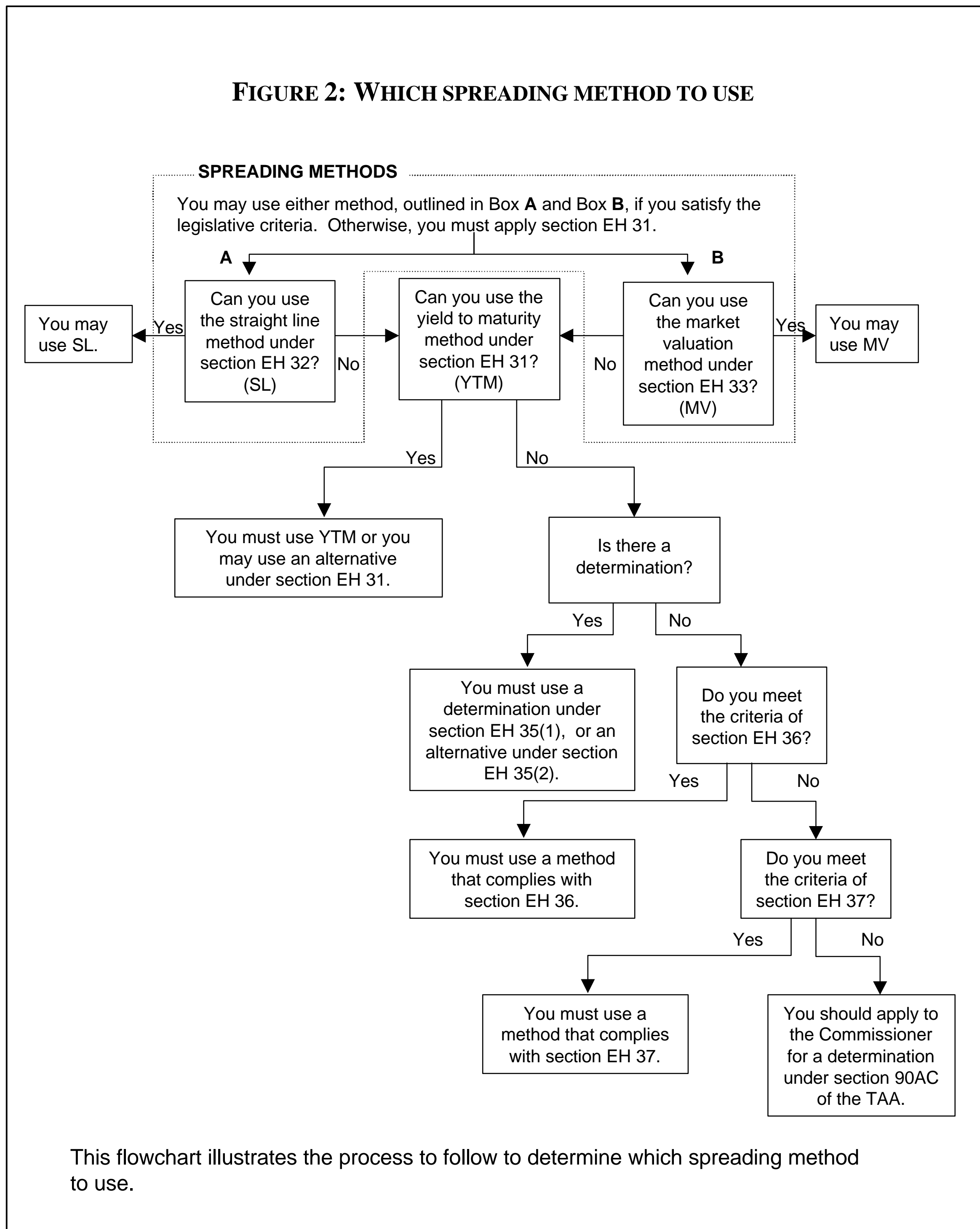


FIGURE 2: WHICH SPREADING METHOD TO USE

This flowchart illustrates the process to follow to determine which spreading method to use.

YIELD TO MATURITY

The yield to maturity method is applied if expected cashflows and payment dates for a financial arrangement are certain. No substantive changes will be made from the current provision.

STRAIGHT LINE METHOD

The straight line method spreads the income or expenditure of a financial arrangement on a straight line basis over the term of a financial arrangement. The only change that will be made to this provision is an increase in the threshold. The straight line method will be able to be used if the person is a party to financial arrangements that have a total value of $1,500,000 or less.

MARKET VALUATION METHOD

At present, the market valuation method can only be used if Inland Revenue has approved a market in that instrument. This requirement will be relaxed so that the market valuation method may also be used if taxpayers can show that the market value used is reliable. Those who adopt the market valuation method will have to maintain records to show the reliability of the market from which the valuation is obtained. The change will be of most benefit to dealers in financial arrangements, since the use of market valuation rules is restricted for other taxpayers.

The availability of the market valuation method is restricted to ensure that taxpayers are not entitled to bad debt deductions (by way of declining market prices) for capital losses that would otherwise be denied. The market valuation method is, however, available to all taxpayers for some arrangements with no risk of principal losses - forward contracts for foreign exchange and futures contracts. This group of arrangements will be extended to include exchange traded options.

METHOD PRESCRIBED BY DETERMINATION

If the yield to maturity method cannot be applied to a financial arrangement the Commissioner can issue determinations setting out an appropriate accrual method. Section EH 35 will deal with determination methods and alternatives available to taxpayers.

IN THE ABSENCE OF A DETERMINATION

Taxpayers who do not prepare financial accounts or who do not include income or expenditure of certain financial arrangements for financial reporting purposes will have to use a method to calculate income or expenditure for tax purposes that conforms with commercially acceptable practice. The method must also allocate a fair and reasonable amount to each income year over the term of the financial arrangement.

CONSISTENCY REQUIREMENTS AND CHANGE OF SPREADING METHOD

Taxpayers must use a method of calculating income or expenditure consistently for a particular class of financial arrangement. Taxpayers are generally required to apply the same spreading method to a financial arrangement for its entire term. When a change of method is not explicitly prohibited by the consistency requirements, taxpayers will be able to change method only if there is a good commercial reason for doing so (section EH 40). They will be required to keep a record of the reason for the change under section 22A of the Tax Administration Act 1994.

Taxpayers changing methods must do a transitional adjustment, under section EH 41, in the year of change.

However, they will not be able to change methods if a financial arrangement is subject to either the market valuation or straight line methods. Those methods must be applied to financial arrangements consistently until the financial arrangement is subject to the base price adjustment.

Base price adjustment – holder/issuer distinction

The distinction between a holder (usually a lender) and an issuer (usually a borrower) will be removed. The distinction is not relevant for many derivative arrangements such as forward contracts or options and, it is not always obvious which party to an arrangement is a holder or issuer. In some cases, the actual categorisation is arbitrary and the rules are difficult to apply.

Removing the distinction will lead to a rewrite of the base price adjustment, so that one formula can apply to all parties to a financial arrangement, and to changes in terminology such as the use of "consideration" rather than "acquisition price". The rewrite of the base price adjustment calculation is not intended to change the effect of the current law, except in relation to the treatment of non-contingent fees.

TIMING OF THE BASE PRICE ADJUSTMENT

Section EH 42 will set out the events that will require a base price adjustment. In addition to the sale, transfer, maturity or remission of a financial arrangement, the new accrual rules will set out special circumstances in which a base price adjustment is required. These circumstances include:

- a non-resident leaving the tax base;
- a debtor whose debt is sold to an associate at a discount;
- an in-kind, or *in specie*, distribution of a financial arrangement by a company in liquidation; and
- for an assignor or defeasor, an absolute assignment or legal defeasance of a debt.

Dispositions on death of a taxpayer

There is uncertainty as to if and when a base price adjustment should be done on the death of a party to a financial arrangement. An amendment will ensure that a transfer of a financial arrangement necessitating a base price adjustment will occur:

- on the death of a party to a financial arrangement; and
- on the distribution of a financial arrangement to a beneficiary under a will or on intestacy.

Exceptions from performing a base price adjustment

Taxpayers are required to carry out a base price adjustment when they cease to be New Zealand residents. To ease compliance burdens on them, temporary residents who are cash basis persons will be excluded from the requirement to perform a base price adjustment provided they become non-resident for tax purposes within three years of initially obtaining tax residence. This relief will apply only to financial arrangements to which they were a party before first becoming a New Zealand resident (section EH 43(1)).

Section EH 4(9)(d) of the current rules requires persons who become non-resident to carry out a base perform price adjustment for any financial arrangement to which they are a party. This also applies if they continue to carry on a business in New Zealand through a fixed establishment. An amendment will be made so that a base price adjustment will not be necessary if a New Zealand resident becomes non-resident and the financial arrangement relates to a business carried on by the person through a fixed establishment in New Zealand (section EH 43(2)).

Under subsection EH 43(3) taxpayers who are a party to a debt that has been legally defeased but are not the defeasor will not have to carry out a base price adjustment. This is because their rights or obligations under the financial arrangement defeased have not been terminated.

Base price adjustment formula

The amendments to the base price adjustment in section EH 44 and the new definition of “consideration” in section OB 1 are intended to standardise and simplify the base price adjustment. The main policy changes include:

- the removal of the holder/issuer distinction;
- the extension of the consideration rules to cover finance leases;
- the exclusion of income or expenditure associated with non-contingent fees (again through the definition of consideration);
- inclusion of amounts remitted by operation of law in the variable “amounts remitted”; and
- amendments to allow for the effect of debt parking arrangements.

Example

A commercial property is sold for $1,500,000 under a sale and purchase agreement, subject to certain planning consents being obtained.

A deposit of $150,000 is paid on 20 December 1999, when the agreement is entered into. The balance of $1,350,000 is payable in two equal instalments due 3 and 6 months after the date of possession.

Under the agreement, possession passes to the purchaser on the date the sale becomes unconditional; the purchaser has no other prior rights. On 3 March 2000 the planning consents are obtained and the sale becomes unconditional.

The purchaser's balance date is 31 March.

For the purpose of recognising the expenditure incurred in the 1999 and 2000 income year of this agreement for the sale and purchase of property, the taxpayer may apply Determination G17B. By applying that Determination, the taxpayer will determine the value of the property passing under the agreement. The value of the property is determined, on the basis of discounted cash flows, to be $1,435,999. This is part of the "consideration" of the agreement for the sale and purchase of property. The other form of consideration is the cash payment of $1,500,000.

Determination G17B, in turn, relies on Determination G3 (alternatively, G11A could be used) and Determination G1A to allocate an amount of expenditure to the 1999 income year. The expenditure allocated to the 1999 income year in accordance with those Determinations is $12,916.

On the maturity of the financial arrangement, in the 2000 income year, a base price adjustment is calculated. The base price adjustment formula is:

consideration – income + expenditure + amounts remitted

where -

consideration	=	the consideration paid to the person **less** the consideration paid by the person
	=	the present value of the property transferred to the person **less** the cash payment made by the person
	=	$1,435,999 – $1,500,000
	=	-$64,001
income	=	0
expenditure	=	expenditure incurred in previous income years
	=	$12,916
amounts remitted	=	0

The result of the base price adjustment is, therefore, -$51085. This amount is thus expenditure incurred in the 2000 income year.

ASSESSABILITY AND DEDUCTIBILITY OF ACCRUAL INCOME OR EXPENDITURE

The main area of change with the removal of the holder/issuer distinction is the removal of the automatic deduction (a deduction not subject to a nexus or business test) currently available for holders of financial arrangements for a negative amount arising from the base price adjustment calculation.

The automatic deduction for holders will be removed because it:

- is consistent with the rewrite of the Income Tax Act 1994, which will separate the timing rules from assessability and deduction provisions;
- means that both parties to a financial arrangement will be treated in a consistent way; and
- reduces incentives on taxpayers to structure transactions to take advantage of the right to an automatic deduction.

A negative amount arising from the base price adjustment will be expenditure incurred that will be subject to the core deductibility tests. A positive amount is income derived. This will continue to be treated as gross income under section CE 1(1).

Two additional tests will be introduced to overcome the unintended effects of removing the automatic deduction in the base price adjustment. If the outcome of the base price adjustment is negative (expenditure) and the amount arises because of an overstatement of income derived in previous income years, the amount will be deductible regardless of the core deductibility tests. If the outcome of the base price adjustment is positive (income) and the amount arises because of expenditure incurred in prior years but the expenditure was not allowed as a deduction, the amount will not be treated as income under the base price adjustment.

Forgiveness of debt

The accrual rules treat debts that do not have to be repaid as income if they are forgiven. Forgiveness is a benefit to the person who is no longer required to discharge its obligations. The forgiveness of debt rules also act as a clawback for deductions previously taken by taxpayers. The tax laws will be made more robust to ensure that taxpayers cannot structure transactions to avoid recognising forgiveness of debt income.

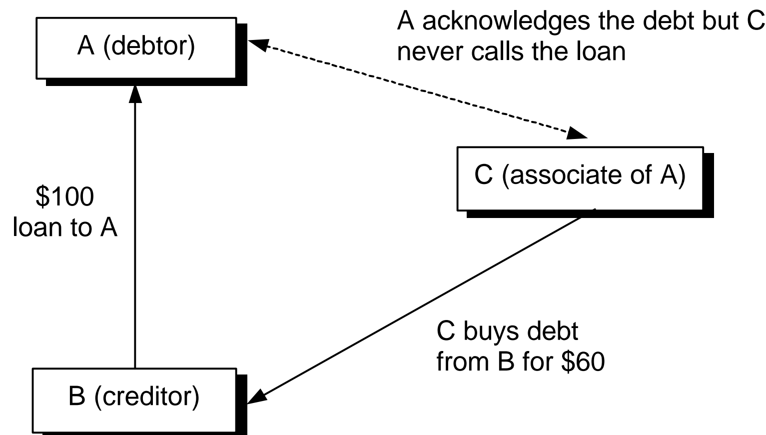
NATURAL LOVE AND AFFECTION

Under the accrual rules a debt that is remitted or forgiven will give rise to assessable income to the debtor. However, if a natural person forgives a debt in consideration of natural love and affection, the amount forgiven is treated as if it had been paid for the purposes of the accrual rules. Thus the amount will not give rise to remission income to the debtor. The Act will be clarified (section EH 49) so that forgiveness of debt in consideration of natural love and affection will apply if:

- a creditor forgives a debt (whether in a will or otherwise) because of the natural love and affection that the creditor has for the debtor, or
- a creditor forgives a debt owing by a trust because of natural love and affection that the creditor has for the beneficiaries of that trust.

Figure 3 shows an example of how a debt could be sold or transferred to an associate of the debtor to circumvent the debt remission rules. In the example, A owes money which it cannot repay to B. Rather than forgiving the debt (which would give rise to remission income for A) B sells the debt, at a discount, to an associate of A (in this case C).

FIGURE 3: DEBT PARKING



B has received $60 for A's debt and extinguished its rights under the arrangement. Had this money come direct from A (as full and final settlement of the debt) remission income of $40 would have arisen to A. However, because C is an arm's length party from B, no remission income arises under current law. The difference between this type of arrangement and the sale or assignment of the debt from B to an unrelated third party is that, although A's debt under the arrangement is still outstanding, A no longer expects to have to repay the loan.

Rules will be introduced (section EH 50) relating to transfers of debts to persons associated with the debtor. If a creditor sells a debt to an associate of the debtor at a discount of 20% or more, of the consideration remaining payable under the debt, the debt will be treated as being forgiven by the creditor. Both the original creditor and debtor will carry out a base price adjustment, and a new financial arrangement will be created between the debtor and the debtor's associate. For the purpose of the base price adjustment the debtor will be treated as paying the discounted price (in the example $60). The debtor's associate is treated as providing an interest-free loan of $60 to the debtor, so there is no income or expenditure to spread under the new financial arrangement. Under the new financial arrangement, if the debtor repays an amount in excess of the amount the debtor's associates' paid the original creditor, the excess will be an allowable deduction to the debtor and gross income to the debtor's associate.

AMOUNTS REMITTED

When taxpayers perform a base price adjustment they must take into account any amount they have remitted. This ensures that the amount they remitted does not contribute to a negative outcome under the base price adjustment, since a negative outcome may be deductible for tax purposes. The current rule is incomplete, however, because only an amount remitted by the taxpayer is included in the base price adjustment. The amounts remitted through operation of law are not included in the base price adjustment. The base price adjustment will be amended to include amounts remitted through operation of law.

Allowable deductions – bad debts

Section EH 51, by and large, replicates the current section EH 5. It is extended to allow bad debt deductions for dealers or providers of goods and services when credit is extended under an agreement for the sale and purchase of property or services.

Security arrangements

Sections EH 52 and EH 53 will consolidate the provisions relating to security arrangements.

Agreements for the sale and purchase of property or services

The rules applying to trade credits will be integrated with the rules for agreements for the sale and purchase of property. These rules will also be extended to apply to the provision of services.

The integration is done by widening the definition of "property" for the purpose of the accrual rules. This will result in the rules for agreements for the sale and purchase of property or services covering all agreements in which the subject is property, except if the property is foreign exchange or financial arrangements. The current provisions for trade credits will be repealed.

As a result of the integration, the bad debt provisions will be extended to taxpayers in the business of dealing in the goods or services that are the subject of the agreements for the sale and purchase of property or services.

In addition, there will be only one excepted financial arrangement for short-term agreements for the sale and purchase of property or services. The measurement period to determine short-term agreements for the sale and purchase of property or services will run from the date the contract was entered into. If the date of contract cannot be determined with reasonable certainty the measurement period will run from the earlier of the date the purchaser makes any payment to the vendor or the date the first right in the property is transferred or any services are performed. The same measurement rule will apply to short-term options.

Interest accumulation rules will be included in the definition of "consideration" to enable the accrual rules to apply if payment is made before property is transferred.

The rules for agreements for the sale and purchase of property were intended to deal with actual transfers of property. They were not intended to apply if the property concerned is being used only as a pricing index. If there is a cash settlement option in a property agreement, this is an indication that the property is being used as a pricing index. The agreement should then be treated as a forward contract. The rules for an agreement for the sale and purchase of property or services will apply only if the agreement is to be settled by physical delivery of property or the performance of services.

It will be made clear that an agreement for the sale and purchase of property or services that provides for a cash settlement option is a forward contract, and a futures contract is a forward contract traded on a recognised futures exchange.

The treatment of fees

The treatment of fees incurred in relation to a financial arrangement is dependent upon whether the fees are contingent or non-contingent. Contingent fees must be spread over the term of the financial arrangement. Currently, non-contingent fees up to 2% of the core acquisition price do not have to be spread. This threshold will be removed so that all non-contingent fees will not be spread. The treatment of fees will be reflected in the definition of "consideration paid" or "received" under a financial arrangement.

Relationship between the accrual rules and other provisions of the Act

Currently, section EH 8 governs the relationship between the accrual rules and the rest of the Act. Section EH 23 will be drafted to clarify that the accrual rules determine the amount and the timing of income and expenditure relating to financial arrangements, while the core provisions of the Act determine the assessability or deductibility of income or expenditure.

At present, it is unclear whether section EH 8(1) precludes the transfer pricing provisions from applying. It will be made clear in the definition of "consideration" that the transfer pricing rules are intended to have overriding effect to determine the amount of consideration paid or received in applicable cross-border financial arrangements.

Finance leases

Currently, all leases are excepted financial arrangements. The specified lease rules, however, treat leases which are essentially financing transactions in a similar manner to a sale of the lease asset financed by a "loan" from the lessor to the lessee. Such leases are financing arrangements and are essentially similar to deferred property settlements. Therefore leases with financing characteristics will be included within the scope of the accrual rules.

From the date of enactment, leases with financing characteristics will be known as "finance leases". The definition of "excepted financial arrangement" will be amended to exclude leases, other than finance leases, from the accrual rules. The definition of "specified lease" will be amended so that the definition applies only to leases entered into before the date the legislation is enacted.

The definition of "finance lease" will be narrower than the current definition of "specified lease". A lease of personal property (other than bloodstock and livestock) will be a finance lease if it meets any of the following criteria:

- The lease asset is transferred to the lessee at the end of the lease term.
- The lessee or associate has the option to acquire the lease asset for an amount that is substantially lower than the market value of the lease asset on the date of acquisition
- The term of the lease is longer than 75 percent of the remaining useful life of the lease asset.

Rules similar to those governing the tax treatment of hire purchase agreements will be introduced to deal with finance leases. As with the hire purchase rules the finance lease rules, other than those dealing with the calculation of interest income or expenditure, will be contained in Subpart FC.

SPECIAL RULES FOR FINANCE LEASES

New section FC 8A will stipulate that the leasing of an asset under a finance lease is treated as a sale. The lease asset is sold for the *lessor's disposition value* (the cash price of the asset). Likewise, the lessee is treated as purchasing the asset for the *lessee's acquisition cost* (again, usually the cash price). The result of the deemed sale is that any profit is recognised by the lessor in the year of sale, and the lessee is entitled to claim depreciation if appropriate. The lessor is explicitly denied a deduction for depreciation.

New section FC 8B(2) will be inserted to ensure that if title transfers to the lessee at the termination of the lease, the transfer of title will not have any tax consequences. If the asset reverts to the lessor at the end of the lease, the consideration for the transfer is the guaranteed residual value (GRV). The GRV is defined as an amount equal to the value of the lease asset that the lessee agrees to pay the lessor at the expiry of the lease.

If a lease is terminated early, the lease asset is treated as being sold to the lessor for the amount by which the outstanding balance of the loan exceeds any additional payment made as a result of early termination.

Both sections FC 8B(3) and FC 8C(1) will apply despite the requirements in section EG 19(7) in the depreciation rules. Section EG 19(7) enables the Commissioner to treat property sold, in certain circumstances, at its market value at the time of sale. This is not appropriate for finance leases because such leases will be treated as financing transactions, and the deemed sale price will be treated as part of that transaction. Section FC 8D will deal with sales of assets by the lessor following expiry of the lease. If an asset is sold for more or less than the guaranteed residual value, and a payment is made to or by the lessee, an adjustment is made to the deemed sale price to ensure that the value of the asset transferred is reflected in the financing transaction.

FINANCE LEASES AND THE ACCRUAL RULES

The new finance lease rules and the amendment to the excepted financial arrangement definition to exclude operating leases will mean that:

- The interest element of a finance lease is recognised as income or expenditure over the term of the agreement using the yield to maturity or alternative accrual methods.
- On termination or expiry of the lease there is a base price adjustment to ensure that all income or expenditure is recognised.

FINANCE LEASES AND WITHHOLDING TAXES

At present, the interest component of lease payments must be computed by a resident lessee in order for withholding taxes to be paid. Non-resident withholding tax or approved issuer levy must be deducted in relation to actual payments because the accrual rules do not apply for non-resident withholding tax purposes. Lease payments must therefore be divided into principal and interest by using, for example, actuarial tables. This approach continues under the finance lease rules.

The only special rule inserted in the Act to deal with the integration of the finance lease rules with the withholding tax rules will be to deem income derived by the lessor from the deemed loan to be interest. This ensures that the amount is subject to the withholding tax.

Other amendments

BRANCH EQUIVALENT INCOME

An amendment to the branch equivalent income calculation (section CG 11(5)) will clarify the amount a controlled foreign company must use to value the consideration for a financial arrangement. The section will apply if there was no attributed foreign income or loss in the previous accounting period. The valuation is necessary to enable taxpayers to apply the accrual rules to calculate the net income or loss of the foreign company. The consideration is the market value or the absolute value of the formula provided.

Section CG 11(5)(a) will be repealed, since it does not give the appropriate result.

COMMERCIAL BILLS

Section CE 3(1)(b), relating to commercial bills, will be repealed. A specific anti-avoidance rule (section GC 14A) will be introduced to act as a deterrent to taxpayers entering into arrangements to avoid non-resident withholding tax or approved issuer levy. The provision is designed to prevent non-residents avoiding non-resident withholding tax on redemption payments by disposing of the bills to a resident immediately before maturity of the bills. The provision does this by making a resident liable for tax on the redemption payment.

HIRE PURCHASE RULES

A new section (section FC 10(6A)) will be inserted into the hire purchase rules. The section treats the income of a lessor from the loan under a hire purchase agreement as interest. This is to clarify the relationship between the accrual rules and interest for the purpose of the withholding tax rules.

NON-MARKET TRANSACTIONS

Section GD 11 is aimed at transactions that attempt to defeat the intent and application of the accrual rules. The requirement that there be a connection between the parties will be removed, and the section will be extended to apply if an arrangement is issued, acquired, varied, sold or otherwise transferred.

CONSOLIDATED GROUPS

Amounts remitted amongst members of a consolidated group will be exempt from remission income only if the financial arrangement was held by members of the same group at all times during the term of the arrangement. This amendment to section HB 2(1)(a) is aimed at preventing taxpayers using the consolidation rules to avoid remission income.

CONSEQUENTIAL AMENDMENTS

A substantial number of consequential amendments will be made to remove terms such as “holder” and “issuer”. These changes are not intended to affect the way the taxation law applies.

Amendments to the Tax Administration Act 1994

RECORD KEEPING

A new section 22A will be inserted. This section will require taxpayers to keep:

- Sufficient records to verify market prices if they use the market valuation method to work out income or expenditure in any year. At present, taxpayers can use the market valuation method only if the Commissioner has approved the market. Markets will still be approved by the Commissioner, which will help to minimise compliance costs.
- Records of why valuation methods have been changed. It is not intended that taxpayers have the ability to switch method from year to year simply because another accrual method provides more favourable tax outcomes. If, however, there are valid reasons for change - for example, a company is taken over and the new owner has different accounting policies - this is allowed.

DISCLOSURE OF FINANCIAL ARRANGEMENTS

The disclosure requirements for inter-related financial arrangement contained in section 60 of the Tax Administration Act 1994 will be repealed.

DETERMINATION MAKING POWERS

Extensions to the determination making powers will be made to:

- enable the consideration for the transfer of property to be calculated if there are substantial prepayments (accumulation provisions);
- allow the Commissioner to determine the consideration for which a finance lease asset is transferred if it is inappropriate to use the cash price.

In the latter case, the determination would refer to “discounted value”. This may occur, for example, if the payment terms are more favourable to the lessee than outright acquisition of the asset.

COMPARATIVE TABLE OF AMENDMENTS TO THE ACCRUAL RULES IN THE TAXATION (ACCRUAL RULES AND OTHER REMEDIAL MATTERS) BILL AND THE INCOME TAX ACT 1994/TAX ADMINISTRATION ACT 1994

As inserted by Taxation (Accrual Rules and Other Remedial Matters) Bill 1998	*Corresponding sections in current Income Tax Act*
Division One	
EH A1	New
EH A2	New
EH 1	EH 1 - EH 1(3) and (4) amended
EH 2	EH 2
EH 3	EH 3 - EH 3(1) amended
EH 4	EH 4 - EH 4(1), EH 4(9)(c) amended
EH 5	EH 5
EH 5A	New
EH 6 - EH 10	EH 6 - EH 10
EH 11	OB 1 definition re-enacted
EH 12	OB 7 re-enacted
EH 13	GD 11 re-enacted
EH 14	New
EH 15	New
Division Two	
EH 16	New
EH 17	New
EH 18(1)(a)	New
(b)	EH 9(e)(i) reversed
(c)	New
(d)	Proviso EH 9(b)
(e)	EH 9(c)
EH 18(2)(a)	EH 9(e)(i)
(b)	EH 9(e)(ii)
(c)	EH 9(b) and (c) amended
(d)	EH 9(f)
(e)	EH 9(f)
EH 19(1)	OB 1 definition amended
(2)	New
(3)	OB 1 definition amended
EH 20(1)	EH 2 amended
(2)	New
EH 21(1)(a), (c), (d), (f), (l), (n), (p), (q), (r), (s)	OB 1 definition
(b), (e), (g), (h), (j), (k), (m), (t), (u), (v)	New
(i), (o)	OB 1 definition amended
(2)	New
(3)	New
EH 22	EH 10 extended and amended
EH 23	EH 8
EH 24(1) - (5)	EH 3(1) amended
(6)	EH 3(2)(b)
EH 25(1)	EH 3(6) amended
(2)	EH 3(6) amended
(3)	EH 3(6) amended
(4)	EH 3(7) amended
EH 26	EH 3(8)
EH 27	EH 3(9) amended
EH 28	New

As inserted by Taxation (Accrual Rules and Other Remedial Matters) Bill 1998	*Corresponding sections in current Income Tax Act*
Division Two continued	
EH 29	EH 3(4) and (5) amalgamated
EH 30 (1) and (2)	EH 1(1) amended
(3)	New
(4)	EH 1(8)
EH 31	EH 1(2)
EH 32	EH 1(3) and EH 1(4)(a) amended
EH 33	EH 1(6) amended
EH 34	New
EH 35	EH 1(5)(a)
EH 36	EH 1 (5)(b)
EH 37	New
EH 38	New
EH 39	EH 1(7) amended
EH 40	New
EH 41	EH 1(4)(b) extended and amended
EH 42(1)	EH 4(1), EH 4(9)(c), EH 4(9)(d) amended
(2)	OB 1 definition - maturity
(3) - (6)	New
EH 43(1) - (3)	New
EH 44(1)	EH 4(1), EH 4(2) amalgamated and amended
(2)	EH 4(3) amended
(3)	New
(4)	New
EH 45	OB 1 definition - acquisition price amended
EH 46(1) and (2)	GD 11(3)
(3) - (5)	EH 4(5)
EH 47	GD11(2)
EH 48	EH 4(7)
EH 49	EH 4(6) amended
EH 50	New
EH 51(1)	EH 5(4)
(2)	EH 5(1)
(3) and (4)	EH 5(2)
EH 52 (1)	EH 5(3)
(2)	EH 5(5)
EH 53	EH 4(8)
EH 54	EH 6 (1) - (3)
EH 55	New
EH 56	EH 4(9)(ba)

As inserted by Taxation (Accrual Rules and Other Remedial Matters) Bill 1998	*Corresponding sections in current Tax Administration Act 1994*
22A	New
44A	New
90AA	New
90AB	90(3)
90AC (1) and (2)	90(1)
(3)	90(2)
(4)	Proviso 90(1)
(5)	90(1)(d)
(6)	90(6)
90AD (1)	90(7)
(2)	90(8)
(3)	90(9)
90AE	Proviso 90(6)

Other Changes to the Income Tax Act 1994

AVERAGING OF TAX-FREE ALLOWANCES

(Clause 5)

Summary of proposed amendment

An amendment relaxes the tax-free allowance averaging legislation, so employers can base allowances on fair and reasonable estimates of work-related expenditure likely to be incurred by employees for related pay periods.

Application date

The amendment will apply from 1 April 1999.

Key features

Section CB 12(3), which governs the averaging of tax-free allowances, will be replaced by a new provision that allows employers to base average tax-free allowances on fair and reasonable estimates of work-related expenditure likely to be incurred by employees for related pay periods.

Background

The Income Tax Act 1994 allows employers to calculate average tax-free allowances payable to employees. The legislation is intended to provide employers with the low-cost alternative of paying an average tax-free allowance, rather than having to reimburse each individual item of employee work-related expenditure.

At present, employers use a variety of methods to determine the amounts of employee work-related expenditure to be reimbursed by way of average tax-free allowances. In general, average tax-free allowances paid by employers are reasonable estimates of actual work-related expenditure. However, an Inland Revenue review of the law has identified that a strict interpretation of the legislation does not allow for employers to take this approach.

Under the current legislation, employers should carry out extensive employee surveys and use complex mathematical formulas to calculate the average tax-free payment they may make to each employee. If strictly followed, this would pose serious difficulties for employers. Even when information concerning total employee work-related expenditure is available (and in many cases, it may not be) the legislation's compilation and calculation requirements impose a very heavy compliance cost burden upon employers.

The legislation will be amended by removal of its exacting survey and calculation requirements. Instead it will allow employers to base averages upon fair and reasonable estimates of work-related expenditure likely to be incurred by employees for related pay periods.

GST AS PART OF THE COST OF FRINGE BENEFITS

(Clauses 12, 13 and 47(16) and (32))

Summary of proposed amendment

The amendment provides that GST is to be taken into account in valuing all fringe benefits except when the good or service being provided is exempt from GST.

The absence of a GST content on goods and services other than motor vehicles is inconsistent with the underlying policy that benefits should generally be valued at the price the employee would have paid (a GST-inclusive amount) had he or she purchased them directly. There are no policy grounds to support this inconsistency.

Application date

This measure applies to fringe benefits provided on or after 1 April 1999.

Key features

The FBT rules are being amended to provide that the calculation of the value of a fringe benefit is GST-inclusive if the employer is a registered person who can claim input tax in relation to the fringe benefit provided or the good or service provided is subject to GST. This requires amendments to the terms "amount", "cost", "price", "fee", and "sale at retail" in sections CI 2 and CI 3. Consequential amendments are being made to the terms "input tax" and "registered person".

This measure will not affect all fringe benefits; only those that include a GST element will have an increase in the value of the benefit. It will not increase the cost of providing subsidised loans to employees because this is an exempt activity for GST purposes.

The benefits affected are the goods and services an employer produces and provides to employees at a subsidised price or at no cost. Also affected are the goods and services an employer purchases and provides at a subsidised price or at no cost to employees.

Example of impact of amendment

An employer wishes to provide a fishing rod, cost $100 (including GST) to an employee. The table on the next page illustrates the various ways to achieve this, presuming the employee's marginal tax rate is 33%.

Description of cost	*FBT (current rules)*	*Additional salary*	*FBT under proposed change*
Actual cost of rod	**$100**	**$100**	**$100**
GST content	$11	$11	$11
GST input credit	($11)	n/a	($11)
Cost price of rod (under FBT rules)	$89	n/a	$100
GST output tax based on cost price of rod for FBT purposes[2]	$10	n/a	$11
Bonus paid after tax	n/a	$100	n/a
Income tax	n/a	$49	n/a
Fringe benefit tax	$44	n/a	$49
Total cost to employer	**$143**	**$149**	**$149**
Total revenue collected	**$54** FBT plus GST on rod	**$60** Income tax plus GST on rod	**$60** FBT plus GST on rod

[2]Under the GST Act fringe benefits provided to an employee must be treated as a taxable supply by the employer.

The example shows that by calculating the cost price on a GST-exclusive basis, less than the appropriate level of tax is paid, and employers may lower their overall tax bill by providing fringe benefits rather than paying equivalent wages. In the example, the saving to the employer was $6 on the $100 rod. This result was not intended, from a policy perspective, because the total cost to the employer and the total revenue collected should be the same regardless of the way employers pay their employees.

Background

FBT was introduced in 1985 to reverse the effect of certain court decisions, which established that non-cash benefits that could not be converted to cash were not subject to income tax. FBT was essential to support the PAYE base and to protect the revenue base, since employers were switching from providing monetary remuneration to remuneration in kind. FBT also increases the equity of the tax system, since equity requires that all forms of remuneration, including non-cash benefits, are taxed consistently. Also, because the incidence of non-cash benefits tends to increase with income, not taxing fringe benefits was eroding the progressive nature of the tax system.

In the *Atlas Copco*[3] case the cost price of a motor vehicle was held to be GST-exclusive if the business could claim a GST input credit. The law was later amended to confirm that the cost price for motor vehicles was GST-inclusive. This amendment did not cover other goods or services that employers purchase or produce and then provide to their employees at a discount or for free.

[3] *CIR v Atlas Copco Ltd* (1990) 12 NZTC 7,327

GUARANTEE FEES PAID TO NON-RESIDENTS

(Clauses 14 and 47)

Summary of proposed amendments

The amendments will ensure that guarantee fees paid to non-residents are liable to the same final withholding tax that an insurance premium paid to a non-resident insurer is subject to under section CN 4.

Application date

The amendments will apply from the date of introduction of the bill.

Key features

Section CN 4 and associated definitions in OB 1 are being amended to ensure that guarantee fees paid to non-residents are subject to the withholding tax treatment under that section. The amendments are of a clarifying nature and are intended to protect the New Zealand tax base.

The main amendments are:

- The definition of "insurance" in section OB 1 applying for purposes of sections CN 4, OE 4 and associated definitions in section OB 1 is amended to include a separate and explicit reference to a guarantee against risk.
- A new definition of "insured person" is inserted in section OB 1 and applies for the purposes of sections CN 4 and OE 4. An insured person will be defined as a person who incurs a premium for a contract of insurance, regardless of whether the person is also the one who can make a claim under the contract.
- The definition of "premium" in section OB 1 applying for purposes of sections CN 4 and OE 4 is amended to include a specific reference to a guarantee fee.

An example of the amendment's application would be to a guarantee fee paid by a New Zealand resident company to a non-resident parent company (or another non-resident associate) in return for the non-resident parent guaranteeing the repayment of a loan made by a lender to the New Zealand company. The guarantee fee would be subject to the withholding tax treatment under section CN 4.

The amendments recognise that there is no distinction between insurance and guarantees at a conceptual level as both relate to protection against risk.

The amendments will also confirm that guarantee fees come within the insurance exclusion provision in the business profits articles in New Zealand's double tax agreements.

Background

Section CN 4 generally provides that a non-resident insurer (without a fixed establishment in New Zealand) deriving insurance premiums from New Zealand is subject to a 3.3% tax on the amount of the gross premiums. The person paying the premium is required to deduct the amount of this tax from the premium and pay it to the Commissioner.

Section OE 4(1)(o) stipulates the type of insurance premiums that are deemed to be derived from New Zealand. A "premium" is defined in section OB 1 for the purposes of sections CN 4 and OE 4 as meaning a premium payable in respect of a contract of insurance. "Insurance" is defined for these purposes to mean insurance or guarantee against any loss, damage, event or risk of any kind other than life insurance.

LIMITING DEDUCTIONS UNDER CERTAIN ARRANGEMENTS

(Clauses 16, 17, 24, 25, 26, 51 and 59)

Summary of proposed amendments

The amendments counter a weakness in the current tax law involving expenditure on films and petroleum mining exploration whereby arrangements can be structured to claim, in effect, two deductions for one amount of expenditure.

Application date

The amendments apply to expenditure incurred on films and petroleum exploration, under these arrangements, from the date of introduction of the bill.

Key features

The bill inserts two new sections in subparts DM and EO. Both amendments remove the taxation benefits of the arrangements in question but leave the normal deductions provided for films and petroleum exploration activities in place.

If an arrangement involving two deductions (or equivalent effect) has been entered into, deductions for film or petroleum exploration expenditure are reduced to the extent of any proceeds from disposal of property under the arrangements in question.

The proceeds of sale of property are defined to exclude income derived from films and from the disposal of petroleum mining assets under section CJ 3, to allow deductions to the extent that such income is derived.

The Commissioner's power to assess taxpayers under the proposed amendments will not be limited by the time bar. Use of money interest may apply as a result of any adjustments made.

Background

Under current law, investors can enter into arrangements, usually through a group of companies, and claim two tax deductions for what is, in effect, one amount of expenditure. The first deduction is for expenditure on films or petroleum exploration. The second deduction is claimed in relation to the disposal of property under the arrangement.

(Clause 19)

Summary of proposed amendment

The trading stock rules are being amended to ensure that variances between budgeted and actual costs of production that are allocated to closing stock are taken into account in an income year.

Application date

The amendment will apply from the 1998–99 income year.

Key features

The amendment replaces section EE 5 (3A). It ensure that variances between budgeted and actual costs of production that are allocated to closing stock under section EE 5 (3) are taken into account in an income year.

Background

Many businesses adopt trading stock valuation systems that involve the use of standard cost accounting. Standard cost accounting systems can use predetermined rates for production overhead and other direct and indirect costs that are allocated to trading stock. At year-end, therefore, a variance from the actual production costs is likely to arise. The variance will arise if a taxpayer has higher or lower costs than those budgeted for.

The tax issue arising from this relates to the timing of a deduction for a variance. The policy proposed when the trading stock reforms were introduced was that variances should be allocated between cost of goods sold (this portion of cost is allowed as a deduction) and closing stocks (this portion is carried forward to future periods). It was intended that variances be treated as annual adjustments.

A new section, EE 5(3A), was inserted into the Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Bill to ensure the annual adjustment occurs as intended. However, the provision, as currently drafted, does not achieve its purpose. It is not specific enough about the variance, and the section refers to the entire variance rather than the part of the variance allocated to closing stock. Nor does it allow for variances that arise because less is spent on trading stock than is budgeted.

The proposed amendment is intended to rectify these drafting problems.

REMEDIAL AMENDMENT – LOW INCOME REBATE

(Clause 43)

Summary of proposed amendment

Section KC 1(2) will be amended to correct an error. The term "absentee" will be replaced with "non-resident". Section KC 1(2) currently refers to a taxpayer who is an absentee for part of an income year. Because an absentee is a person who is not resident for any part of an income year, the term which should have been used is "non-resident".

Application date

The amendment will apply to the 1999-2000 and subsequent income years, the date the previous amendment is to apply from.

CHARITABLE DONEE STATUS

(Clause 44)

Summary of proposed amendments

The Mission Without Borders (NZ), Humanitarian Aid Account is to be given charitable donee status.

Application date

The amendment will apply from the 1999-2000 income year.

Key features

The Mission Without Borders (NZ), Humanitarian Aid Account is being added to section KC 5, which lists the organisations that qualify for charitable donee status.

Background

Mission Without Borders (NZ) has established an account for moneys to be used outside New Zealand for humanitarian purposes. This account, which is to be known as the Mission Without Borders (NZ), Humanitarian Aid Account, is being added to the list of organisations that qualify for charitable donee status. Donations to qualifying organisations entitle individual taxpayers to a rebate of 33 $^{1}/_{3}$% of the amount donated, to a maximum for all donations of $500 a year. Donations by companies (not being a close company) qualify for a deduction from net income. The amount allowable as a deduction depends on the amount of the company’s net income.

Changes to the Tax Administration Act 1994

APPLICATION OF SHORTFALL PENALTIES TO DUTIES

(Clause 54 1(e))

Summary of proposed amendment

The definition of "return period" is being amended to clarify that it covers tax returns provided for a particular transaction or transactions but not tied to a particular period.

Application date

To ensure there is no argument about the return period to which payment of duties relates, the application date of this measure is that of the compliance and penalty legislation generally, the income year beginning 1 April 1997.

Key features

The definition of "return period" in section 3 is being amended to provide that the return period in relation to a tax return that relates to transactions is the day on which the tax return is due. For example, stamp duty is a transaction tax, so the tax return for stamp duty has no period to which it relates. This amendment provides a return period for these taxes so that various offsetting provisions in section 141 can apply and shortfall penalties can be imposed, since the requirements of section 141(3) are now met. Section 141(3) requires a shortfall penalty to be imposed in relation to a return period, a tax type and a tax position.

Background

Section 141 requires a tax shortfall calculation each time a taxpayer incurs a shortfall penalty. A shortfall penalty is a penalty imposed on a taxpayer under any of sections 141A to 141K for taking an incorrect tax position or for doing or failing to do anything specified or described in those sections. "Tax shortfall" is a defined term, and the definition sets out how the tax shortfall is to be calculated. A shortfall penalty is imposed for the return period to which the tax return relates.

It is arguable that for taxes such as stamp and cheque duty, which have no return period because the returns relate to one-off transactions, shortfall penalties cannot be imposed. Furthermore, without a return period the various offsetting provisions in section 141 cannot apply.

TAX IN DISPUTE AND REMISSION PROVISIONS

(Clauses 54 1(c), 92-93, 95, 97-99, and 102)

Summary of proposed amendment

Several amendments to the rules on tax in dispute, use of money interest, and remission confirm their application to disputes and remission requests received after the rules came into effect but for periods, such as income years, that predate their introduction.

Other amendments confirm that these provisions apply regardless of section 1(2), which provides that the Tax Administration Act 1994 applies only to tax on income derived on the 1995-96 and subsequent income years.

Key features

- The definition of "late payment penalty" in section 3 is expanded to cover late payment penalties regardless of the period to which they relate, allowing application of the current remission provisions to these penalties.
- A provision is inserted into the Parts relating to disputes and remissions and use of money interest to ensure that this legislation applies to periods before the Tax Administration Act 1994 came into effect.
- This will allow, irrespective of the income year or tax type to which any tax in dispute relates, for the correct tax in dispute and the associated use of money interest rules to apply, unless the dispute has begun and the taxpayer and Inland Revenue agree, before the enactment of this bill, that the old rules apply.
- It will also ensure that the use of money interest rules introduced as part of the compliance and penalty legislation apply from 1 April 1997 to calculate the interest payable on deferrable and non-deferrable tax.
- If a dispute relates to 1995-96 or an earlier income year and begins on or after 1 April 1997, the use of money interest rules introduced as part of the compliance and penalty legislation will apply from the beginning of that dispute rather than the original due date.

Background

The compliance and penalty legislation introduced new remission provisions that provided clear rules for remitting civil penalties (other than shortfall penalties). It was intended that the remission provisions would apply to remissions relating to the 1994-95 income year and earlier years, but as a result of the application of the savings provision in section 1(2) this has not happened.

This amendment ensures that taxpayers in similar positions receive similar remission treatment regardless of whether the remission relates to a penalty imposed in the 1994-95 or earlier income years. Having one set of remission provisions applying to all penalties was proposed in the second Government discussion document on the proposed compliance and penalty legislation.

Likewise there is doubt as to the application of the current tax in dispute rules, and use of money interest, to disputes relating to periods before the Tax Administration Act 1994 took effect. These amendments clarify the application of these current rules to those periods.

ARRANGEMENTS FOR EXTENSIONS OF TIME

(Clauses 47(26) and 58)

Summary of proposed amendments

Two amendments are being made to the provisions relating to the extension of time arrangements for furnishing income tax returns. First, the provision allowing the Commissioner to cancel an extension of time arrangement is being amended to make clear that the Commissioner can cancel an arrangement previously granted if tax agents do not meet their return filing percentage obligations.

Second, the term "linked to a tax agent", which allows taxpayers so linked to have the extended terminal tax due date, 7 April for standard and late balance dates, is being limited to agents with extension of time arrangements.

Application date

The measures will apply from date of enactment.

Key features

Section 37(4A) is being amended to make it clear that the Commissioner has the power to cancel tax agents' extension of time arrangements during an income year if they do not meet their return filing percentages.

The definition of "linked to a tax agent" in section OB 1 of the Income Tax Act 1994 is being amended to refer to tax agents with an extension of time arrangement. Clients of a tax agent without an extension of time arrangement do not require the later terminal tax date because their returns are due on 7 June and 7 July following the end of the income year.

Background

The Tax Administration Act 1994 was recently amended to provide that taxpayers with an agent who have an extension of time arrangements would have a terminal tax date of two months after the general terminal tax dates. These measures address additional policy issues arising from the terminal tax date change.

BINDING RULINGS

(Clauses 54, 67-90 and 99)

Summary of proposed amendments

The changes are aimed at improving the operation of the binding rulings system while maintaining the original policy intent and design features.

The main proposals concern the continuation of binding rulings as a result of legislative change and a review of the publication requirements. The various other amendments are of a more minor nature.

Application date

The amendments apply from the date of enactment.

Background

The binding rulings legislation, enacted by amendment to the Tax Administration Act 1994, took effect from 1 April 1995. The primary aim of binding rulings is to permit taxpayers to conduct their business and investment activities with a degree of certainty as to the tax implications of particular transactions.

A post-implementation review of the rulings system has identified areas to be improved.

Key features

- Binding rulings will continue to apply after a legislative change if that change does not materially affect the ruling. To enable taxpayers to determine whether a ruling is still valid they will be able to apply for a status ruling.
- Binding rulings will continue to apply if an assumption used in the ruling proves to be incorrect if the assumption is not material to the ruling.
- Product rulings will not be published until two months after the applicant receives the ruling. Product and public rulings will no longer be required to be published in the *Gazette* but will be published in other tax-oriented publications.
- It will be clarified that binding rulings are not disputable decisions and cannot be challenged through the dispute resolution process.

- Private binding rulings are being permitted on repetitive arrangements. This will improve certainty for taxpayers who regularly enter into similar transactions.

Detailed analysis

Continuation of binding rulings after legislative change

Section 91G states that a ruling terminates if the taxation law on which the ruling has been given is repealed. This occurs even if the provision is replaced with a substantially similar provision that does not alter the tax treatment of the arrangement. Therefore rulings have to be re-issued, which can result in compliance and administrative costs and defeats the purpose of binding rulings, which is to provide certainty.

The policy rationale of section 91G was that the intent of Parliament should always take precedence over a binding ruling. Binding rulings were to terminate, therefore, following a change to the legislation that materially affects that ruling. Immaterial changes were not intended to terminate binding rulings. This intent is not adequately reflected in the legislation, however. Section 91G has been redrafted to ensure that only material changes to a taxation law will affect the status of a binding ruling.

This change means that taxpayers will be responsible for monitoring the rulings they have obtained. In some cases, however, the effect of a change in the law on a ruling may not be clear to taxpayers. To overcome this problem the Commissioner will be able to issue rulings on the effect of legislative change on an existing ruling. These will be known as "status rulings" and will be provided for by new sections 91GA, 91GB, 91GC and an amendment to section 3. This service will be charged for at the regular rate.

Scope of product rulings

Product rulings are Inland Revenue's interpretation of how the taxation law applies to a particular product rather than how it applies to a person or class of persons in relation to an arrangement. The ruling, therefore, defines the product and specifies the tax treatment. It applies to taxpayers whose identities and tax attributes are not known to Inland Revenue.

It was not intended that product rulings should state how the law applied to a person or class of persons. However, the legislation in this area is ambiguous. In practice, Inland Revenue has issued product rulings that include comment on the tax treatment of the unknown parties entering into that product.

Section 91FC will be clarified so product rulings can be issued on the way the taxation law applies to the unknown parties to products. This will apply only if the tax characteristics of the persons entering into the arrangement do not affect the content of the ruling.

Effect of incorrect assumptions

The rulings legislation allows the Commissioner to set out the facts and assumptions on which rulings are based. As the law currently stands, if the facts of an arrangement are materially incorrect, a ruling will not apply. In contrast, the legislation does not provide a materiality threshold in relation to incorrect assumptions contained in binding rulings. Assumptions are generally made about future events. If an assumption proves incorrect the whole binding ruling is invalid, despite the fact that the incorrect assumption may not be relevant to the remainder of the ruling.

Sections 91EB and 91FB are being amended so that a ruling does not apply if it contains assumptions about future events or facts that prove to be materially incorrect. This is consistent with the rules applying to facts.

However, a separate category, called "conditions" in the legislation, is retained in these sections. These conditions would not be subject to a materiality threshold.

Arrangement not seriously contemplated

The Commissioner is required to make rulings only on arrangements that are seriously contemplated. It is not clear, however, at what point an arrangement that is the subject of the binding ruling has to be "seriously contemplated". It could be either the time of application or the time the ruling is to be issued. If the latter, it may be possible for taxpayers to use the rulings process as a means of testing proposals which are not fully developed in order to see whether they fit with the Commissioner's interpretation of the law.

Section 91E amends the law to clarify that an arrangement that is the subject of a binding ruling must be "seriously contemplated" at the time of application for a ruling.

The proposed approach would not prevent minor amendments being made to an arrangement whilst a ruling application is being considered.

Timing of publication of product rulings

Product rulings are published in full because they may affect many people, and it is in the public interest for taxpayers to be aware of Inland Revenue's interpretation of the law.

Section 91FH introduces a requirement that product rulings be published two months after a ruling is issued. This is because the publication of rulings could limit the competitive advantage that a new product generates. Introducing this time period means there is a suitable compromise between the public's interest in gaining information and an applicant's right to benefit from the development of new products.

Vehicle for publication of rulings

The requirement on Inland Revenue to publish product and public rulings in the *Gazette* in section 91DA and 91FH is being dispensed with. It is cheaper and more effective for rulings to be published in tax-orientated publications that are widely available in hard copy and on the Internet.

Binding rulings and disputable decisions

Section 138E is being amended to make it clear that binding rulings are not disputable decisions. The policy behind the binding rulings system is clear that no separate appeal rights to the courts were to be provided. It should not be possible, therefore, to challenge rulings through the dispute resolution process.

Repetitive arrangements

Sections 91E (1) and 91EC are being amended so that private binding rulings will be permitted on repetitive arrangements, such as hire purchase agreements. This extension to the scope of binding rulings will improve certainty for taxpayers who regularly enter such transactions and reduce compliance costs.

Extension of binding rulings

Section 91FI, which allows extensions to rulings, will be repealed. There are no advantages in extending a ruling as opposed to completing a fresh application.

Conflicting rulings

The conflicting binding rulings provisions in section 91DB(2), 91EA(2) and 91FA(2) are unnecessary and will be repealed. Where conflicting rulings exist, the taxpayer has the choice of which ruling to apply.

Content of a binding ruling

Sections 91DA, 91EH and 91FH will be amended to include an explicit requirement to state in a binding ruling how the taxation law applies to an arrangement (and an applicant for private rulings). This reflects current practice.

Duration of a binding ruling

Sections 91DA, 91DC, 91DD, 91DE, 91E, 91EB, 91EH, 91EI, 91F, 91FB, 91FH, and 91FJ will be clarified to make it explicit that binding rulings can be issued for income years as well as for specific periods. This reflects current practice.

Minor mistakes in binding rulings

Typographical errors and minor mistakes in rulings that have been issued will, with the consent of the taxpayer, be corrected without the need to withdraw the original ruling and reissue a new ruling. This is enacted by inserting new section 91GD.

Disclosure requirements for private binding rulings

The binding rulings legislation requires holders of private rulings to disclose to Inland Revenue whether they have complied with the content of a ruling and whether any material changes to the arrangement identified in the ruling have occurred.

The disclosure provisions in section 91EJ for private rulings will be repealed. This will reduce compliance costs on taxpayers.

Prospective applicants

The application provisions in section 91EC will be amended to allow for applications to be made on behalf of applicants not yet in existence (for example, an arrangement to be entered into by a yet to be incorporated company). This reflects commercial reality and current practice.

Identification of applicants in product rulings

The amended section 91FH (1) will require applicants for product rulings to be identified in the ruling. Currently, the provisions relating to product rulings require the disclosure of the name of the applicant in the application, but there is no requirement that the name of the applicant be contained in the ruling. This is contrary to the original policy intent and current practice.

Incorrect rulings

Sections 91DC, 91EA and 91FA will be amended to make it clear that a binding ruling has not been applied if a taxpayer has filed a return on the basis of a ruling and has then issued a notice of proposed adjustment (NOPA) within the specified time period. The issuance of the NOPA effectively retracts the ruling, and the Commissioner will not, in these circumstances, be bound to apply it.

Tax due and payable

Section 91E(4)(d)(i) states that the Commissioner cannot make a ruling when the matter on which a binding ruling is sought concerns tax that is due and payable. This section has the potential to cause problems because of the operation of provisional and other tax credit regimes. In relation to provisional tax, for example, while it is due and payable in three instalments throughout the year, the tax has not been assessed at the date it is paid. The instalment acts as a tax credit until the actual income tax liability has been determined.

The provision was not intended to prevent rulings being made in relation to taxpayers who had, for instance, provisional tax payments due and payable. This would substantially limit the ability of the Commissioner to rule on completed transactions.

Section 91E(4)(d)(i) will be amended to clarify that all provisional taxpayers may apply for binding rulings, even though the matter may concern a provisional tax payment.

Audit undertaken

Once an audit which encompasses an arrangement that is the subject of an application for a binding ruling has been undertaken, section 91E(4)(g) provides that the Commissioner cannot make a ruling on that arrangement. This restriction applies because the binding rulings system should not overlap with the dispute resolution process.

It is unclear from this section what constitutes an "audit", since the term is not defined in the Act. The original policy was that it incorporates all verification activities carried out by Inland Revenue. Section 91E(4)(g) will be clarified so that all types of audit activity carried out by Inland Revenue come within the scope of the provisions.

Private rulings and the dispute resolution process

The policy intent behind the binding rulings legislation is that it should not overlap with existing dispute resolution procedures. Section 91E (4) will be amended to clarify that a binding ruling cannot be sought on an arrangement that is within the scope of a NOPA.

Outstanding money owing

The Commissioner will be able to decline to rule if an applicant has outstanding debts relating to earlier binding ruling applications. Sections 91E (3), 91F (3) will be amended and a new section 91J will be added to allow this.

TIME BAR WAIVERS

(Clause 91)

Summary of proposed amendment

The amendment confirms that income years and GST periods that began before 1 October 1996 may be the subject of a waiver under section 108B. As part of the dispute resolution process, that section allows taxpayers to sign a waiver to extend by six months, before its expiry, the four-year period that generally applies to amended assessments.

Application date

The amendment will apply from 1 October 1996, when the current section 108B came into effect.

Key features

The current section 108B is to be re-enacted with the addition of a clarification that income years and GST return periods that began before 1 October 1996 may be included in a taxpayer's time bar waiver.

Background

The Commissioner may amend an assessment to increase the amount of income tax or GST payable within four years from the end of an income year in which a taxpayer provides a return.

The Tax Administration Amendment (No. 2) Act 1996 introduced section 108B to the principal Act. Section 108B allows taxpayers, before expiry of the period of four years applicable under section 108 or section 108A, to sign a waiver to extend the four-year time bar by up to six months.

The amendment re-enacts this policy and confirms the original intended policy that the waiver may relate to income years and GST return periods that began before 1 October 1996.

Before 1 October 1996, section 108 of the Tax Administration Act provided that the four-year limitation period ran from the end of the income year in which the return was assessed. There was no provision for a waiver to extend the period in which a reassessment could be issued. In 1996, as part of the disputes resolution legislation, section 108 was redrafted to provide that the Commissioner could issue a reassessment to increase the tax liability only if the assessment was made within four years from the end of the income year in which the tax return was furnished. This had the effect of shortening the time available to the Commissioner to issue a reassessment by up to one year. At the same time, section 108B was introduced to

provide that the taxpayer could extend this four-year period by six months to allow the dispute to be resolved before the issue of a reassessment, thus avoiding unnecessary litigation.

Inland Revenue, together with a large number of taxpayers and their advisers, considers the effect of these provisions is that the reference in section 108B to section 108 is to be taken as referring to the equivalent former provisions. This was the intended effect and operation of section 108B. A contrary view (that section 108B applies only to income years and GST return periods that began on and after 1 October 1996) has been expressed.

The amendment is to clarify the law by confirming the intended policy position that section 108B applies to all income years and GST return periods.

TAX RECOVERY AGREEMENTS

(Clauses 4, 48, 54, 63, 100, 101, 103)

Summary of proposed amendments

The amendments enable tax recovery agreements made with other countries to have effect in New Zealand. Tax recovery agreements provide a mechanism by which participating countries can call on each other's tax administration to recover tax from absconding debtors.

Application date

The amendments will apply from the date of enactment.

Although the amendments will enable tax recovery agreements to have effect, New Zealand's first such agreement (negotiated with the Netherlands) is not expected to enter into force until mid-1999.

Key features

A new Part XA, entitled "Tax Recovery Agreements", is being inserted into the Tax Administration Act 1994, and section BH 1 of the Income Tax Act 1994 is being amended. Together these amendments, and several other minor consequential changes, will permit tax recovery agreements to be given force of law in New Zealand by way of Order in Council, and provide a further legislative framework for the operation of those agreements. They will enable the Commissioner to exercise his usual powers of collection in relation to foreign tax claims that are the subject of a tax recovery agreement or request the other state to collect outstanding New Zealand tax. The amendments will also allow tax recovery provisions to be included within new or existing double tax agreements (DTAs).

Practical application of a recovery agreement will be a straightforward process of debt collection. A typical case where New Zealand is called upon to collect foreign tax will involve:

- New Zealand will receive a request for assistance in recovery, accompanied by relevant documentation, from a foreign state with which New Zealand has a relevant agreement.
- New Zealand will review the request to ensure that it complies with the provisions of the agreement and the empowering legislation.
- New Zealand will pursue recovery action, in the same way it would were the claim a New Zealand tax debt.
- Following recovery (assuming the action is successful) the recovered amount will be paid over to the foreign state.

Almost all of the key matters to be covered by the legislation will be included within the new Part XA of the Tax Administration Act 1994:

- Application of Part XA

  Section 173A will provide that Part XA applies to tax recovery agreements negotiated between the government of a territory outside New Zealand and the government of New Zealand.

- Definitions

  Section 173B will contain several new definitions relevant to Part XA. These include "contested tax", used in section 173G which will stipulate certain limitations on recovery action concerning contestability and age of tax claims. Section 173B will also include a definition of "tax recovery agreement" and "competent authority".

- Empowerment

  Section 173C will provide that tax recovery agreements may be given effect by Order in Council, in a similar manner to section BH 1 of the Income Tax Act 1994 in relation to DTAs. However, whereas DTAs override anything in the Income Tax Act 1994 or any other enactment, section 173C will provide that the extent to which tax recovery agreements override domestic law will be limited, in their application, by the provisions of Part XA.

- Taxes that may be recovered

  A new section 173D will provide that recoverable taxes are limited to those that are imposed by the laws of New Zealand and the other country, and are prescribed in the relevant tax recovery agreement.

- Essential documentation requirements

  A new section 173E will stipulate the documentation that must accompany requests for assistance in recovery. This will include, for example, written particulars of the amount of the tax claim; the extent, if any, to which the requesting party considers that the tax claim is uncontested; a declaration that the request meets the terms of the relevant agreement; and a certified or notarized copy of the instrument permitting enforcement in the other country.

  Other documentation may be required under each agreement, although section 173E lists the essential documents that would be expected to accompany each request for assistance in recovery.

- Enforcement powers

  A new section 173F will provide that the Commissioner may exercise his usual powers of collection in carrying out recovery action under a tax recovery agreement. However, the section provides that New Zealand use of money interest and penalties will not apply.

- Limitations on assistance in recovery

  A new section 173G will set out certain limitations on the recovery of foreign tax by the Commissioner, concerning the age of tax claims and whether they are contested.

  Under a tax recovery agreement the Commissioner will generally be obliged to collect uncontested tax claims (subject to the conditions of each individual treaty and the boundaries set out in the empowering legislation). The Commissioner will not, however, be obliged to collect a contested tax claim.

  Nevertheless, even if a tax claim is contested, in certain circumstances the Commissioner may choose to carry out recovery action - for example, when it is determined that the taxpayer may leave New Zealand, or take steps concerning the existence or location of assets, in an attempt to prevent recovery action. The Commissioner may do this only after consulting with the other country.

  The new section will provide that, to be recoverable under a tax recovery agreement, a tax claim must not have been outstanding as an uncontested tax liability longer than six years before the entry into force of the relevant agreement.

  The new section will also provide that the Commissioner is not obliged to comply with a request for assistance that has been made after a period of 15 years from the date that the tax claim first became uncontested. The rationale for this rule, which is modelled on a draft OECD proposal, is that a 15-year time period is considered to be sufficient to avoid an obligation to collect old claims, yet is also sufficient for disputes to be settled domestically before foreign assistance is required.

- Process when objection raised

  A new section 173H will provide a process which persons may follow if they believe that recovery action should not be taken.

  They may present their case to the New Zealand competent authority and request that the competent authority of the other state be informed. The New Zealand competent authority must then, without undue delay, endeavour to resolve the matter with them or the other competent authority. This approach replicates the mutual agreement procedure that is usually included in tax treaties.

- Right of appeal

  A new section 173I will provide a person who believes that recovery action should not be taken with a right of appeal to the District Court.

- Commissioner's certificate

  A new section 173J will provide that, if the Commissioner determines assistance in recovery of a foreign tax claim may be given, he may produce and sign a certificate stating that the request complies with Part XA. In proceedings relating to recovery of the tax claim the certificate will be, in the absence of proof to the contrary, sufficient evidence of the matters certified.

Tax recovery agreements may be negotiated on a stand-alone basis, as is the case with the Netherlands treaty, or as part of new or existing DTAs. The amendment to section BH1 of the Income Tax Act 1994 will extend the purpose of a DTA to include giving assistance in the recovery of tax claims. This is to allow for tax recovery provisions to be included within DTAs. However, whereas DTAs override anything in the Income Tax Act 1994 or any other enactment, any DTA which contains a tax recovery agreement will be subject to the conditions set out in Part XA.

Other, consequential, amendments will include deeming the meaning of “tax” and “income tax” to include taxes prescribed in a tax recovery agreement, and the insertion of a definition of the term “contested act of assistance”, used in sections 173H and 173I.

Background

Tax recovery agreements are becoming common internationally. Globalisation has prompted a rapid increase in international co-operation in economic and fiscal matters, including co-operation in tax administration. The OECD has recommended that Member countries consider adoption of tax recovery agreements, and is now developing a model agreement for likely inclusion into the OECD Model Tax Convention.

It is expected that the New Zealand Government will enter into a tax recovery agreement only if the participating foreign state meets certain fundamental requirements. For example, it will need to have a system for the assessment and collection of tax that is acceptable to New Zealand and have a legal system that gives appropriate recognition to due process concerns.

New Zealand will maintain a close working relationship with the competent authority of the foreign state. Therefore should complications arise at any stage of the collection process, the competent authorities will be able to develop a resolution that conforms to the requirements of the empowering legislation and the relevant agreement.

NON-RECOVERY OF SMALL AMOUNTS OF CIVIL PENALTIES

(Clause 102)

Summary of proposed amendment

The $20 threshold below which the Commissioner may not recover outstanding tax will be extended to cover late payment penalties, shortfall penalties, and late filing penalties. This is achieved by removing a provision that prevents this threshold applying to civil penalties.

Application date

The amendment applies from the date of enactment.

Key features

Section 174 is being amended to allow the Commissioner not to recover civil penalties, which means removing the full recovery requirement under section 174(2). Civil penalties will not be recovered if the amount is less than $20.

Background

The restriction on writing-off small amounts of civil penalties was carried over from the previous legislation and stemmed from a concern that those who have not complied in some way should not benefit from having small amounts of their tax liability remitted. In practice, the provision imposes both compliance and administrative costs, with little revenue benefit to offset those costs.

Since identifying this issue the Commissioner has applied the care and management criteria provided under section 6A of the Tax Administration Act to prevent undue imposition of compliance costs. However, given the specific statutory provision on this matter, the Government considers it is more appropriate for the issue to be resolved by legislation.

The proposal to increase to $20 the civil penalty write-off will provide a direct compliance cost benefit to taxpayers in this circumstance.

Changes to Other Acts

GST ON OVERSEAS MAIL DELIVERY IN NEW ZEALAND

(Clauses 109-110)

Summary of proposed amendment

The amendment zero-rates fees charged to overseas postal organisations for mail delivery services in New Zealand. It aligns the delivery of overseas mail with the delivery of other goods and services entering New Zealand.

Application date

The amendment applies to fees charged for overseas mail delivery services provided to overseas postal organisations from the date of enactment.

Key feature

The bill inserts a new paragraph to section 11(2) of the Goods and Services Tax Act 1985. The amendment specifically zero-rates delivery service fees charged to overseas postal organisations for the delivery of overseas mail inside New Zealand.

Background

Agreements between international postal authorities deem that the consumption of the delivery of international mail occurs at the time the letter is posted. To tax the fees charged to overseas postal organisations would be against the intention of the Goods and Services Tax Act 1985, since consumption occurs outside New Zealand.

Under current law, the provider of overseas mail delivery services in New Zealand cannot zero-rate the fees charged to overseas postal organisations. This means the delivery of overseas mail is treated differently from the delivery of other goods and services entering New Zealand.

This amendment aligns the legislation with the correct policy treatment of fees charged for overseas mail delivery services in New Zealand. This policy, until recently, had been to zero-rate these fees.

REMEDIAL AMENDMENTS TO THE STUDENT LOAN SCHEME ACT 1992

(Clauses 111-114)

Summary of proposed amendments

The Student Loan Scheme Act 1992 is being amended to:

- Ensure that the terminal repayments of borrowers with a tax agent will be due at the same time as their terminal income tax. This amendment follows that made to the Income Tax Act 1994 earlier this year which extended the terminal tax due date for taxpayers with an agent who has an extension of time arrangement by two months.
- Correct two drafting errors made in the Student Loan Scheme Amendment Act (No. 2) 1998 in relation to the interest write-off and refund provisions.

Application date

The amendment to the payment dates will apply from the 1997-98 income year.

The corrections will apply from the original application dates of the relevant legislation.