

Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Bill

Commentary on the Bill

Rt Hon Bill Birch
Minister of Finance
Minister of Revenue

First published in March 1998 by the Policy Advice Division of the Inland Revenue Department, P O Box 2198, Wellington.

Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Bill
ISBN 0-478-10326-3

CONTENTS

The Tax Credit System	3
Trading Stock Tax Reform	16
Other Amendments to the Income Tax Act	
Taxation of Property Obtained Without Colour of Right	30
Consolidation Rules and Section LE3 Holding Companies	31
Excess Imputation Credit Conversion Rate	33
Taxation of Specified Superannuation Contributions	34
Depreciation	35
Confirmation of Annual Income Tax Rates for 1998/99	38
Amendments to Other Acts	
Notice of Proposed Adjustment	39
Privacy Provisions in the Student Loan Scheme Act 1992	40

The Tax Credit System

THE TAX CREDIT SYSTEM

(Clauses 3, 5-8, 10, 16-18, 22-23, 25, 27-33, 35, 37, 39, 40, 45)

Summary of proposed amendments

The bill amends the Income Tax Act 1994 and Tax Administration Act 1994 to give effect to the implementation of the tax credit system for the taxation of superannuation fund and life office savings.

Existing tax rules for superannuation and life insurance products levy tax at the fund and life office level at a flat and final rate of 33%. The proposed tax credit system provides a mechanism that, as far as practicable, allows people who save through superannuation fund membership and life insurance policies to pay tax on their earnings from those investments at their correct tax rate. As a result, funds will pay less tax and can credit the benefit to the accounts of savers.

Annuity providers will also be able to use the tax credit system.

Application date

The tax credit system will be available from 1 April 1998.

Key features

- The tax credit system is designed to provide the mechanism that allows people who save through superannuation fund membership and life insurance policies to pay tax on their return from savings at their correct tax rate.
- Policyholders and members (including members who are superannuation funds) will be able to elect to receive tax credits by filing a notice of election to the electing fund.
- An electing fund's income tax liability will be reduced by the amount of refundable credits generated as a result of attributing tax credits. The amount of the refundable credits is the difference between the tax rate the fund pays and the tax rate at which tax credits are attributed to electing savers.
- Electing funds will be required to operate a tax credit account. Its purpose is to record which tax paid by the fund belongs to electing savers and non-electing savers and therefore the amount of tax paid that can be attributed to electing savers.
- The tax credit account will operate in a manner similar to an imputation credit account. It will record as credits the amount of tax paid by the fund and record as debits the tax paid by the fund on behalf of non-electing savers, tax credits attributed to electing savers, and cash refunds of tax.

- Superannuation funds that elect to receive tax credits from another superannuation fund will be able to receive tax credits at different tax rates.
- Life insurers and superannuation funds will be able to offer tax credits for their annuities or pension business.
- When tax credits are attributed to an electing saver, the amount of the tax credits will be grossed up to determine the amount of the attributed taxable income.
- Annuitants and recipients of pensions will be able to elect to receive tax credits by filing an election notice to the annuity provider. By electing to receive tax credits, annuitants will benefit from having the investment income component of their annuity taxed at a lower rate, which should result in a higher annuity payment.
- Annuity providers will be required to determine the income component of the annuity or pension for electing savers. This amount will be treated as schedular gross income and taxed at a lower tax rate. The income component calculated for each electing annuitant will be treated as attributed income and the tax paid on that income attributed as tax credits.
- The attributed income will be treated as gross income in the hands of the electing saver. As a result, the attributed income will be included in the taxable income of the electing saver and taken into account in providing social assistance for which taxable income is used as a basis for targeting, such as family support.
- The attributed tax credit will be treated as an imputation credit in the hands of the electing saver.

Background

Under current tax rules, income of life offices and superannuation funds is subject to a final tax of 33%. The effective tax rate¹ currently applicable to many scheme members and policyholders is 24% (1997/98 income year), reducing to 21.75% (1998/99 income year) and 21% (1999/2000 and subsequent income years).

Hence under the current rules low tax rate savers are over-taxed on their savings through superannuation scheme membership and life insurance policies. The problem arises from the interaction of three factors:

- The income of life offices and superannuation funds is not easily attributable to investors each year.
- That income is taxed at a proxy flat rate.
- That rate does not necessarily match the saver's effective marginal tax rate.²

¹ Effective tax rate: the income tax rate payable on the last dollar of one's income, taking into account only the low income rebate.

² Effective marginal tax rate: The income tax rate payable on the last dollar of one's income. The calculation of this rate includes the tax-like effect of income targeting of Government transfers occurring outside the tax system (that is, the withdrawal of these transfers as income rises).

In response, the Government set up the Working Party on the Taxation of Life Insurance and Superannuation Fund Savings to identify and develop suitable policy options to address this problem.

The working party identified three options for further Government consideration:

- a tax credit system;
- a revised rate proxy; and
- a qualifying fund regime.

The Government decided its preferred option was the tax credit system. In August 1997 the Government released the discussion document *The tax credit system: taxing superannuation funds and life office savings through tax credits*, which described how a tax credit system might work.

The final design of the system reflects the Government's extensive consultation with the superannuation fund and the life industry. The design incorporates flexible rules which funds may use, in order to reduce their compliance costs.

Detailed analysis

Superannuation funds and life insurers

Funds will continue to be taxed at 33% under the existing rules, but electing funds will receive refundable credits, which will be credited against their income tax liability.

Elections

The new section LH 2 allows superannuation funds and life offices that pay tax in New Zealand to offer tax credits to their members (including superannuation funds) and policyholders. The new section 78B of the Tax Administration Act requires funds that offer tax credits to their savers to notify Inland Revenue at least five working days before their return due date (ignoring extension of time arrangements) for the first income year tax credits are offered. The notification is valid until it is revoked by the fund.

Tax credit account

The new subpart MJ sets out the tax credit account rules.

Electing funds will be required to maintain a tax credit account (TCA). A fund may operate multiple TCAs, or a TCA may apply to only part of a fund's business. The fund must notify Inland Revenue whether it proposes to operate multiple TCAs or whether a TCA will apply to only part of the business. If a fund uses multiple TCAs, or a TCA applies to only part of its business, an actuary or the fund's external auditor must certify which tax payment and liabilities apply to each TCA.

The TCA will operate in a similar way to an imputation credit account, with tax payments (including imputation credits received) being credited to the account.

Refunds of tax, tax credits attributed to electing savers and the tax paid in relation to non-electing savers will be treated as debits.

The TCA will operate on an income year basis. The TCA must not be in debit as at the fund's balance date. If it is, further income tax is payable, although funds will have 63 days from balance date to pay this further tax without incurring penalties.

Life insurers will still be required to maintain an imputation credit account and a policyholder credit account. The amount of any credit in the policyholder credit account that is used to meet the policyholder base income tax liability will be treated as a credit to the TCA. This amount is credited to the TCA on the last day of the life insurer's income year. Cash refunds of tax at the policyholder level as a result of refundable credits will be debited to the TCA.

No continuity of ownership rules will apply to the TCA.

The new section MJ 10 inserts a specific rule to deal with arrangements to defeat the intention of the tax credit system.

Allocation of income by funds to savers

The new section LH 5 allows funds to use one of the following methods to allocate income to all savers in the fund each income year:

- change in surrender value;
- change in unit price or value; or
- a method approved by an actuary or external auditor in accordance with commercially acceptable practices.

The method used to allocate income must be used consistently across all savers.

The allocated income will be used to calculate the amount of a fund's estimated income tax liability that is paid in relation to non-electing savers. They will continue to be taxed at 33% at the fund level. The amount of tax paid in relation to them is referred to as the non-electing savers' debit. This calculation is required by the new sections MJ 4 (superannuation funds) and MJ 7 (life insurers). The fund will have until the date it files its tax return for that year to make this calculation. The amount calculated will be debited to the TCA on the last day of the fund's income year.

The reasons for using "estimated income tax liability" is that the TCA needs to have either a zero or a credit balance as at the end of the fund's income year. Funds will not have calculated their actual tax liability by this date to ensure that the TCA has a zero or credit balance. By using an estimated income tax liability, the fund should be able to calculate whether any further tax is payable without penalty in the 63-day period.

Refundable credits

The new sections LH 9 (superannuation funds and life insurers) and LH 15 (second superannuation funds) provide for refundable credits.

Electing funds will be able to meet their tax liability by means of refundable credits. Refundable credits arise because the fund pays tax at 33% and the tax credits are attributed to electing savers at 21.75% (1998/99 year) or 21% (1999/2000 and subsequent years).

If the refundable credits result in a refund of tax, the actual cash refund is limited to the credit balance in the TCA when the refund is paid. The actual amount refunded must be debited to the TCA when the refund is paid.

Attribution of income and tax credits to electing savers

The new sections LH 6, LH 7, LH 12 and LH 13 deal with the attribution of tax credits and income to electing savers.

An electing fund may at any time attribute tax credits and income to electing savers. An attribution of tax credits and income is deemed to take place on the date specified in the tax credit certificate as the date on which the notice is sent. The amount of tax credits attributed must be debited to the TCA, and for calculating the fund's tax payment an attribution can be deemed to be made on the last day of the income year, if made within six months after the end of that income year.

Tax credits must be attributed across all electing savers on the same basis that income is allocated to savers.

The income attributed to electing savers is calculated by dividing the tax credits attributed to them by either 21.75% (1998/99 year) or 21% (1999/2000 and subsequent years). This ensures that the attributed income has sufficient tax credits to meet the tax liability on that income if the saver is a low tax rate saver.

The new section 30C of the Tax Administration Act will require an electing fund to provide savers with a tax credit certificate which shows the amount of attributed income and tax credits and the date on which the certificate was sent.

This section will also require a copy of the tax credit certificate sent during a year (1 April to 31 March) to be provided to Inland Revenue by 31 May following the end of that year.

Savers

Elections

The new section LH 3 will allow individual resident savers and superannuation funds to elect whether they wish to receive attributed income and tax credits from electing funds. Electing savers will be required to provide electing funds with their IRD number. Except for that requirement, the proposed legislation does not contain specific rules relating to elections. A saver may revoke an election at any time. It is a matter between savers and funds as to the rules relating to election dates and revocation of elections. If a saver does not provide an IRD number, the election is invalid.

Elections by superannuation funds

Superannuation funds that invest in other superannuation funds can be electing savers and therefore are able to receive attributed tax credits and income. Section LH 11 allows a superannuation fund to give notice to have tax credits and income attributed at different rates.

Under this provision, a superannuation fund can have tax credits and income attributed from another superannuation fund on the following basis:

- at 33%;
- at 21.75% (1998/99 year) or 21% (1999/00 and subsequent years); or
- a mixture of the two rates based on the profile of the investing superannuation fund's savers.

The amount of tax credits attributed from a superannuation fund to another superannuation fund will be recorded as a debit in the attributing fund's TCA and a credit in the receiving fund's TCA. Under section MJ 8, the entries to the TCA for the attributing fund (second superannuation fund) will need to differentiate between the tax credits attributed at the different rates so that a refundable credit is claimed only in respect of those tax credits attributed at the lower tax rate.

When attributed income and tax credits are derived

Section EB 1 will be amended to provide that savers will derive the amount of attributed income and tax credits in the income year in which the tax credit certificate is sent (the date shown on the tax credit certificate).

The new section CO 1 provides that attributed income is gross income. Attributed income will be treated as a dividend for the purposes of the low income rebate. Attributed income will be taken into account in providing social assistance for which taxable income is used as the basis for targeting, such as family support, independent family tax credit, student allowances, student loan repayments and child support.

Tax credits will be treated as imputation credits. Credits that cannot be used by savers to reduce their income tax liability will be converted to a loss and carried forward to future years.

Annuity providers

Superannuation funds and life insurers

The new section LH 16 will allow life insurers and superannuation funds to offer tax credits in respect of policyholders' annuities and superannuation fund members' pensions.

Under section LH 18, annuity providers will be able to use one of the following methods to calculate the amount of income to be attributed to an electing annuitant

each year. Except for the last method, the amount to be attributed each year will be calculated at the time an annuity elects to receive tax credits. The methods are:

- a flat percentage split between capital and income components of the annuity if an actuary certifies the split as being reasonable for that policy or group of policies with the same age and gender characteristics;
- determining the income component on the basis of the income assumptions that applied when the annuity contract was entered into; or
- determining the income component each year on the basis of an actuarial calculation at the end of the income year.

The same method must be used each year.

When the original income assumptions have been lost, the income to be attributed may be calculated using new income assumptions based on the remaining period of the annuity.

The new sections CL 3 and CM 19 and the amendments to section CM 15 deal with the taxation of the income component of the annuity. The sum of the attributed income to electing annuitants will be treated as schedular gross income³ of the annuity provider and taxed at 21.75% (1998/99 year) and 21% (1999/00 and subsequent years). Hence it will be excluded from the gross income of the life insurer and superannuation fund.

Under new section LH 19, the amount of tax paid on this schedular gross income must be attached as tax credits to the attributed income.

An annuity provider is not required to maintain a TCA in respect of its annuity business. However, if a superannuation fund maintains one TCA for all of its business, the tax credits attributed to electing annuitants must be debited to the TCA. Tax paid by the annuity provider on annuity income cannot be credited to the life office's imputation credit account, policyholder credit account or tax credit account.

An annuity provider must provide an electing annuitant with a tax credit certificate each year showing the attributed income and the tax credits and the date on which the certificate was sent.

A copy of the tax credit certificates sent during any year (1 April to 31 March) must be provided to Inland Revenue by 31 May following the end of that year.

Electing annuitants

The new section LH 17 will allow annuitants and pensioners to elect to receive attributed income and tax credits from annuity providers. Because the investment income of the annuity will be taxed at a lower tax rate, annuitants should receive a higher annuity payment.

³ Under section BC 3, schedular gross income is treated if it were the only gross income of the taxpayer.

The attributed income and tax credits will be treated as gross income of the annuitant and therefore taxable.

Tax credits will be treated in the same manner as imputation credits.

Electing annuitants will derive the attributed income and tax credits in the income year in which the tax credit certificate is sent.

Transitional rules

As the tax credit system will apply from 1 April 1998, funds will be able to offer tax credits from that date. A fund must notify Inland Revenue at least five working days before its return due date (ignoring extension of time arrangements) that it has offered tax credits from that date.

Except for funds that have a standard balance date, the new sections FB 7, FB 8 and FB 9 will require funds offering tax credits from 1 April 1988 to apportion their taxable income, tax liability, annuity income component and tax payments on the number of days from 1 April 1998 to the end of their income year over the number of days in their income year. Only those tax payments relating to the post-1 April 1998 period will be able to be credited to the TCA. The non-electing savers' debit will also be calculated using these apportioned amounts.

For attributions of tax credits made or deemed to be made by the fund on or before 31 March 1999, the specified tax rate will be 21.75%.

For attributions of tax credits made or deemed to be made by the fund on or after 1 April 1999, the specified tax rate will be 21%.

Example 1: How the tax credit system works for a superannuation fund

X Fund offers tax credits from the beginning of its 1999/2000 income year, 1 April 1999. X Fund is a superannuation fund with ten members, five of whom have elected to receive tax credits. The fund completes its annual financial accounts and tax return on 1 June 2000 and decides to attribute \$105 of tax credits to its electing members. The appropriate electing fund tax rate is 21%. The difference between the top rate and this rate is therefore 12%.

Taxable income of X Fund	\$1,000
Estimated tax liability for the income year	\$ 330
Pre-tax income allocated to electing members for the year	\$ 500
Pre-tax income allocated to non-electing members for the year	\$ 500
Tax payments during income year	\$ 330

Tax credit account

		1 April 99 balance	\$0
		7 July 99 provisional tax	\$110
		7 Nov 99 provisional tax	\$110
		7 Mar 00 provisional tax	\$110
31 Mar 00 non-electing members ⁴	\$165		
31 Mar 00 tax credits attributed	\$105		
		1 April 00 balance	\$60
30 Sept 00 cash refund	\$60		

X Fund tax return

Taxable income	\$1,000
Tax liability (33%)	\$ 330
Less refundable credits ⁵	<u>\$ 60</u>
Tax to pay	\$ 270
Less tax payments	<u>\$ 330</u>
Cash refund	\$ 60

If X Fund paid provisional tax of only \$270, there would be no cash refund of tax.

Electing member's taxable income and tax credits

An individual member's share of the allocated income is \$100. Using this as a basis for apportioning tax credits to each member means his or her share of the tax credits is as follows:

$$\frac{100}{500} \times \$105 = \$21$$

This means the member's attributed income is:

$$\begin{array}{l} \text{Tax credits: } \$21 = \$100 \\ \text{Tax rate } \quad 0.21 \end{array}$$

The fund sends a tax credit certificate to the five savers on 1 August 2000. The tax credit certificate specifies the date sent as 1 August 2000. The electing members will be required to return the attributed income and tax credits in their 2000/01 tax return. By 31 May 2001 the fund must provide copies to Inland Revenue of the tax credit certificates issued in the year 1 April 2000 to 31 March 2001.

⁴ $\frac{\text{Income allocated to non-electing members}}{\text{Income allocated to all members}} \times \text{Estimated income tax liability: } \frac{500}{1000} \times 330 = \165

⁵ Refundable credits: $\frac{\text{Tax credits} \times \text{Difference in rate}}{\text{Tax rate}} = \frac{105 \times 0.12}{0.21} = \60

Example 2: How the tax credit system works for a life insurer

Y Ltd offer tax credits from the beginning of its 1999/2000 income year, 1 April 1999. The company has ten policyholders, five of whom have elected to receive tax credits. The company completes its annual financial accounts and tax return on 1 June 2000 and decides to attribute tax credits to its electing policyholders. The appropriate electing fund tax rate is 21%. The difference between the top rate and this rate is therefore 12%.

Taxable income (life office tax base)	\$1,000
Income tax liability (life office tax base)	\$ 330
Taxable income (policyholder tax base)	\$1,000
Estimated income tax liability (policyholder tax base)	\$ 330
Pre-tax income allocated to electing policyholders	\$ 500
Pre-tax income allocated to non-electing policyholders	\$ 500
Tax payments during income year	\$ 330

Imputation credit account

		1 April 99 balance	\$0
		7 July 99 provisional tax	\$110
		7 Nov 99 provisional tax	\$110
		7 March 00 provisional tax	\$110
31 March 00 s.ME 7 election	\$330		

Policyholder credit account

31 March 00 s.ME18(3)(a) election	\$330	31 March s.ME 7 election	\$330
-----------------------------------	-------	--------------------------	-------

Tax credit account

31 March 00 non-electing savers ⁶	\$165	31 March 00 s.ME18 (3)(a) election	\$330
31 March 00 tax credits attributed	\$105		
		1 April 00 balance	\$60
30 Sept 00 cash refund	\$60		

⁶ $\frac{\text{Income allocated to non-electing policyholders}}{\text{Income allocated to all policyholders}} \times \text{Estimated income tax liability (policyholder tax base)} = \frac{500}{1000} \times 330 = \165

Y Ltd tax return

TCS Ltd	
Life Office tax liability	\$330
Tax to pay	<u>\$330</u>
	Nil
Policyholder tax liability	\$330
Less refundable credit ⁷	\$ 60
Tax to pay	\$270
Tax paid	\$330
Cash refund	\$ 60

Electing policyholder's attributed income and tax credits

The individual electing policyholder's share of the allocated income is \$100. Using this as a basis for apportioning tax credits to each policyholder means his or her share of the tax credits is as follows:

$$\frac{100}{500} \times 105 = \$21$$

This means the policyholder's attributed income is:

<u>Tax credits:</u>	<u>\$21</u>	=	\$100
Tax rate	0.21		

Example 3: How the tax credit system works if an electing member is a superannuation fund

Z Fund is a superannuation fund which has ten members. Four of the members are superannuation funds and the balance are individual members. The appropriate electing fund tax rate is 21%. The difference between the top rate and this rate is therefore 12%.

Of the funds:

- Fund one does not elect to receive tax credits.
- Fund two elects to receive tax credits at 33%.
- Fund three elects to receive tax credits at 21%.
- Fund four elects to receive tax credit based on a 50/50 split.

Of the individuals, three have elected to receive tax credits.

⁷ Refundable credits $\frac{\text{Tax credits} \times \text{Difference in rate}}{\text{Tax rate}} = \frac{105 \times 0.12}{0.21} = \60

Z Fund's taxable income	\$1,000
Fund two share of allocated income	\$ 100
Fund three share of allocated income	\$ 100
Fund four share of allocated income	\$ 100
Income allocated to electing individual	\$ 300
Income allocated to non-electing members	\$ 400
Tax payments	\$ 330

Tax credit account

		1 April 99 balance	0
		7 July 99 provisional tax	\$110
31 March 00 non-electing savers ⁸	\$132	7 Nov 99 provisional tax	\$110
31 March 00 Fund two tax credit attributed to Fund	\$33	7 March 00 provisional tax	\$110
31 March 00 Fund three tax credit attributed to Fund	\$21		
31 March 00 Fund four tax credit attributed to fund	\$27		
31 March 00 tax credits attributed to members (individuals)	\$63		
		1 April 00 balance	\$54
1 Sept 00 cash refund	\$54		

Z Fund's tax return

Taxable income	\$1,000
Tax liability	\$ 330
Less refundable credits ⁹	\$ 54
Tax to pay	\$ 276
Less tax payments	\$ 330
Cash refund	\$ 54

⁸Income allocated to non-electing members x Estimated income tax liability: $\frac{400 \times 300}{1000} = \132
Income allocated to all members

⁹Refundable credits $\frac{\text{Tax credits} \times \text{Difference in rate}}{\text{Tax rate}}$:
Fund three $\frac{\$21 \times 0.12}{0.21} = \12
Fund four $\frac{\$10.50 \times 0.12}{0.21} = \6
Individuals $\frac{\$63 \times 0.12}{0.21} = \36
Total $\$54$

The share of income allocated to each individual and fund is \$100. Using the allocated income as a basis for apportioning tax credits, the member/fund share of the tax credit is:

Fund two	\$33.00
Fund three	\$21.00
Fund four	\$27.00
Each individual	\$21.00

Funds two, three and four will treat the tax credits as a credit to their tax credit account on the date specified in the tax credit certificate. The attributed income of \$100 will be treated as gross income of the fund and individual members.

Example 4: How the tax credit system will work for an annuity provider

A Ltd offers tax credits from the beginning of its 1999/2000 income year, 1 April 1999. The company has ten annuitants, all of whom elect to receive tax credits. Each annuitant receives an annuity of \$1,000. The company determines that the annual income component of each annuity is \$400.

Taxable income of life office tax base	\$5,000	
Total annuity income on all electing annuitants	\$4,000	
Amount subject to 33%	\$1,000	\$ 330
Annuity income (schedular gross income subject to 21%)	\$4,000	<u>\$ 840</u>
Tax to pay		\$1,170

The amount of annuity income attributed to each annuity is also deducted from the policyholder tax base calculation. The tax credits attributed to each annuity are calculated by multiplying the attributed income by the tax rate.

Therefore each annuitant's attributed income is \$400, with tax credits of \$84.

TRADING STOCK TAX REFORM

(Clauses 11, 12, 13, 19, 20, 24, 33(3) and (4), 38, 43, 44)

Summary of proposed amendments

The tax treatment of trading stock (or inventory) affects all businesses deriving income from manufacturing or producing goods, or trading in goods. Businesses must include in their tax returns the annual change in the value of their trading stock. At present, that involves applying an amalgam of rules, only some of which are set out in legislation. The remainder are matters of administrative practice or common law. The reforms will clarify the rules, make them more consistent and will measure income more accurately. They aim to improve the coherence of income tax law by codifying the tax rules applying to trading stock, in turn reducing compliance costs.

New rules for valuing trading stock were first proposed in a Government discussion document last year. Since then, there has been wide consultation on the proposals and many have been modified to reduce compliance costs for taxpayers. The amendments in this bill contain the detail of the reform, which while broadly consistent with the proposals in the discussion document, is now more closely aligned with financial reporting requirements.

Application date

The amendments will apply from the 1998/99 income year except for the rule that requires members of a wholly-owned group of companies to transfer shares at cost and amendments to the Tax Administration Act. These amendments will apply from the date the legislation is enacted.

Key features

- Trading stock will be valued at either cost or market selling value (if it is lower than cost).
- Cost will be valued using “generally accepted accounting principles” for inventory as they apply to trading stock. This amount will be adjusted for any variance between actual costs incurred and costs budgeted for.
- Replacement price and discounted selling price can be used to approximate cost if the methods are used for financial reporting purposes.
- Special provisions for obsolete and slow moving stock will be repealed. Transitional measures will be introduced to spread any income arising from repeal of the obsolescence provisions over a three-year period.
- The market selling value should allow for obsolescence. Certain direct selling costs may be deducted in calculating market selling value, if they have been taken into account for financial reporting purposes.

- There will be simplified rules for “small taxpayers”, who are defined as those with an annual turnover of less than \$3 million. For stock valued at cost, small taxpayers will apply the current level of cost absorption to manufactured stock unless they absorb more costs in financial statements. The direct and indirect costs of production currently required to be absorbed are set out in *Public Information Bulletin* No. 82. Small taxpayers will be able to use market selling value for stock which has a value above cost, if they do so consistently from year to year.
- Excepted financial arrangements will be valued at cost only. Transfers of excepted financial arrangements within a wholly-owned group of companies will be deemed to occur at the vendor’s cost. Taxpayers must apply a cost-flow method of assigning costs to excepted financial arrangements that are trading stock or revenue account property. Excepted financial arrangements which are worthless may be valued at nil.

Background

Despite the central importance of trading stock in calculating income subject to tax, there has been no major legislative review of trading stock rules since their original enactment in the Land and Income Tax Amendment Act 1939.

The trading stock reforms arise out of a review of the current rules by the Committee on the Taxation of Income from Capital (the Valabh Committee). This was a Consultative Committee appointed by the Government in December 1989 to hear public submissions on matters concerning the design and implementation of the reforms outlined in the *Consultative Document on the Taxation of Income from Capital*. The *Final Report* of the Committee was released in 1992.

The rules for the valuation of trading stock are currently set out in section EE 1 of the Income Tax Act 1994 and allow valuation at cost price, market selling value or the price at which it can be replaced. The Commissioner of Inland Revenue may agree on a lower value for stock affected by obsolescence or other special circumstances under section EE 1(7). The requirements for cost absorption of manufactured stock and certain formulas for the write-down of trading stock under section EE 1(7) are set out in *Public Information Bulletin* No. 82.

Under the current rules, taxpayers may value their stock at market value to utilise trading losses or foreign tax credits, and they have written down values for obsolete and slow moving stock, using formulas based on the age of the stock. There is no requirement for consistency, so taxpayers may value their stock to achieve the lowest income tax liability possible in any one year. The purpose of the reforms is to ensure taxpayers value their income from trading stock more accurately and consistently. However, the rules must also balance this objective with keeping taxpayers’ compliance costs to a minimum.

The discussion document *Trading Stock Tax Rules* was released on 24 April 1997 to allow further consideration to be given to the practical impact that changes to the trading stock rules will have on taxpayers. In particular, the Government was interested in their comments on the compliance cost aspects of the proposals. The

proposals in the discussion document were generally based on the Valabh Committee's recommendations.

Seventy-nine submissions were received on the discussion document from manufacturers, retailers, tax agents and professional associations. The proposals contained in the discussion document have been reviewed and refined in the light of submissions received. Reducing compliance costs for taxpayers has been the major focus, although this has to be weighed against finding a more accurate method of measuring income. Many submissions expressed concern at the lack of simplified rules for small taxpayers required to value trading stock.

The broad thrust of the proposals remains unchanged, although much of the detail of the proposed reforms differs from the proposals in the discussion document. The result is that the proposed reforms have moved further away from the recommendations of the Valabh Committee, and have become more closely aligned with Financial Reporting Standard No. 4 *Accounting for Inventories* (FRS-4).

The most significant modification to the proposals is that taxpayers will now not have to incur the compliance costs involved in preparing separate valuations for tax purposes for stock valued at cost. Instead they will use financial reporting standards to value stock at cost for tax.

In addition, special rules are now proposed for "small taxpayers", those with an annual turnover of less than \$3 million. They will continue to use the current rules for cost absorption for manufactured stock valued at cost, unless they absorb more costs for financial reporting purposes. There are also more flexible applications of other valuation methods.

These and other changes have been made to simplify the rules, reduce compliance costs and increase flexibility so that taxpayers can readily apply the rules to a diverse range of circumstances.

Detailed analysis

Trading stock tax reform focuses on the rules for valuation of trading stock. The change in the value of trading stock is included in gross income each year by allowing a deduction for the value of opening stock, and bringing into gross income the value of closing stock. Opening stock and closing stock are defined.

Compliance standards

Trading stock tax reform recognises that taxpayers have different requirements for financial reporting, depending on their size. Most taxpayers are required to comply with the Financial Reporting Act 1993, meaning they must prepare financial statements in accordance with "generally accepted accounting practice". Exempt companies with an annual turnover of less than \$1 million do not have to comply with the Financial Reporting Act.

Therefore most taxpayers will incur the compliance costs of preparing financial statements and valuing their inventory for financial reporting purposes. The amendments recognise this and require this group of taxpayers to comply with

“generally accepted accounting principles” for closing stock valued at cost. “Generally accepted accounting principles” are defined to mean “generally accepted accounting practice” for inventory, as it applies to trading stock.

Smaller taxpayers often prepare accounts primarily for tax purposes. They may not incur the compliance costs of preparing financial reports. There are simplified rules set out for small taxpayers.

A threshold of \$3 million annual turnover has been set, below which small taxpayer rules apply. This threshold attempts to set a level above which taxpayers will be sophisticated enough to prepare more detailed valuations of their trading stock. In addition, taxpayers with a \$3 million or greater turnover are generally required to comply with the Financial Reporting Act. The threshold for small taxpayers applies to the taxpayer and subsidiaries or related entities using the definition of subsidiary provided in the Financial Reporting Act. This definition means a subsidiary within the meaning of the Companies Act 1955 and the Companies Act 1993 and includes entities classified as subsidiaries in any applicable financial reporting standard. Statement of Standard Accounting Practice No. 8 *Accounting for Business Combinations* (SSAP-8) contains a definition for an in-substance subsidiary, meaning an entity (other than a subsidiary) which is controlled by another entity. In-substance subsidiaries will be counted in the \$3 million turnover threshold for small taxpayers.

The rules are divided into two categories: rules for small taxpayers and rules for other taxpayers. If small taxpayers prepare financial statements for financial reporting purposes, they are required to comply with the same rules as for other taxpayers.

Valuation methods

Closing stock must be valued using a cost valuation method, or when market selling value is less than cost, market selling value may be used. Replacement price and discounted selling price may be used to approximate cost if a taxpayer uses these methods in financial statements. Taxpayers may use one or more valuation methods to value their closing stock. However, it is generally expected that they will apply the same cost valuation method to groups of similar or related items of trading stock. The cost valuation methods used must be consistent with those adopted for financial reporting purposes.

The valuation options are similar to the requirement to measure inventories at the lower of cost and net realisable value in FRS-4. However, taxpayers are not required to measure whether trading stock has a market selling value less than cost. If they choose to do so, they may value all stock at cost. If stock is valued at net realisable value for financial reporting purposes, taxpayers may use market selling value, if it has a value less than cost, or cost.

Small taxpayers may choose to value trading stock using market selling value when this value is above cost, if they do so consistently from year to year. This option will be particularly useful for farmers valuing cash crops. In this situation, the market selling value is easily obtainable, whereas calculating the costs of producing the crop may be a complicated and compliance cost intensive exercise.

Excepted financial arrangements that are trading stock will be valued at cost.

There is no change to the rules for valuation of livestock.

Cost

Those taxpayers other than small taxpayers valuing stock at cost must include all costs required by “generally accepted accounting principles”, as defined. This proposal will give effect to the current practice of valuing trading stock for accounting purposes and making adjustments for tax purposes. The rationale is that taxpayers will not have to incur the compliance costs of preparing separate tax valuations.

The costs to be included are those of putting trading stock in its present location and condition, which is a requirement of FRS-4. Taxpayers must allocate these costs to closing stock using methods acceptable under “generally accepted accounting principles”. FRS-4 requires separate disclosure of the value of each sub-classification of total inventories classified in a manner appropriate to the entity.

The reference in the definition of “generally accepted accounting principles” to “generally accepted accounting practice” means FRS-4 plus the general principles from the *Statement of Concepts for General Purpose Financial Reporting*. Materiality is one of these general principles.

The requirements of FRS-4 are applicable to the extent that they apply to trading stock as defined in tax law. The definition of trading stock for tax purposes is different from the definition of inventories in FRS-4. For example, consumable stores and supplies are included in inventory but are excluded from the definition of trading stock for tax purposes.

As the reference to “generally accepted accounting principles” includes materiality, this is incorporated in the tax law. The proposed legislation qualifies it to make clear that materiality must be applied to trading stock separately. It will not be acceptable to exclude material costs from the valuation of trading stock on the basis that these amounts are offset by other amounts included in another part of the financial statements.

Taxpayers who comply with FRS-4 in their financial reports will use the amounts adopted for financial reporting purposes for trading stock valued at cost for tax purposes, subject to the adjustment for actual costs if budgets have been used for financial reporting purposes. FRS-4 allows unallocated overheads as a result of low production to be expensed. In addition, variances from standard costs are to be accounted for as revenue or expense when standards have been properly set or maintained. All of these variances must be apportioned between the relative values of the cost of goods sold and closing stock for tax purposes. This approach was recommended by the Valabh Committee because tax valuations at cost should reflect the actual costs incurred in the production process.

The apportionment can be done to closing stock on a global basis and is not required to be further apportioned to raw materials, work in progress and finished goods or other sub-classifications of trading stock. For operations with multiple activities or products, variances may be allocated according to a fair and reasonable method of

apportionment, such as apportioning based on the value of the stock on hand compared with the value of the cost of goods sold, as demonstrated in Example 2.

Example 1: Valuation of manufactured stock at cost

Company A is a footwear manufacturer. It started operations in the 1998/99 income year. It manufactures many different sizes of shoes which it sells for the same price. Accordingly, Company A considers itself to be a single product manufacturer and does not differentiate its costs between different sizes of shoes.

The factory building for Company A is on a different site from the sales and administrative functions of the company.

Company A has incurred the following expenditure in the 1998/99 income year:

	\$
Direct materials	1,650,000
Direct labour	1,810,000
Indirect materials	445,000
Utilities (heat, light and power) incurred in factory	325,000
Indirect factory labour costs	135,000
Factory plant depreciation	225,000
Factory plant repairs and maintenance	80,000
Factory rent	200,000
Consumables used	190,000
Sales and administrative expenditure	960,000
Consumables on hand	<u>60,000</u>
	6,080,000

Company A manufactured 160,000 pairs of shoes during the income year and has 20,000 pairs unsold at balance date. This was in line with budgeted production.

Company A had budgeted on total expenditure of \$6,000,000 (excluding consumables on hand). Sales and administrative expenditure remained on budget. In other words, Company A incurred an unfavourable budget variance of \$20,000 on production. Company A had used standard costs and these had been reviewed regularly and revised to reflect actual costs.

The turnover of Company A for the 1998/99 income year was \$8,400,000.

Cost absorption

For financial reporting purposes, Company A absorbs all budgeted production overheads to the extent that they relate to putting the trading stock in its present location and condition. Accordingly, it absorbs direct materials, direct labour, indirect materials, utilities (heat, light and power) incurred in factory, indirect factory labour costs, factory plant depreciation, factory plant repairs and maintenance, factory rent and consumables used. The budgeted total required to be absorbed was \$5,040,000 (being actual production costs of \$5,060,000 less the unfavourable variance of \$20,000). The unfavourable variance can be expensed for financial reporting as

Company A had complied with paragraph 5.17 of FRS-4 by revising its standard costs on a regular basis.

For tax purposes, Company A would be required under section EE 5(1) to adopt the same level of cost absorption as it does for financial reporting purposes when determining the closing value of its trading stock. It will not absorb the sales and administrative expenditure as it is not required to be absorbed for financial reporting.

Calculation of value of closing stock

The calculation of the cost of sales and value of closing stock is as follows:

	Financial Reporting Purposes \$	Tax Purposes \$
Absorbed costs (per financial statements)	5,040,000	5,040,000
Add unfavourable budget variance	0	20,000
Divide by actual production (units)	160,000	160,000
Gives cost per unit	31.50	31.625
Cost of sales (140,000 x cost per unit)	4,410,000	4,427,500
Closing stock (20,000 x cost per unit)	630,000	632,500

Budget variance

Section EE 5(3) requires Company A to prorate the unfavourable budget variance between the cost of goods sold and the closing stock. For financial reporting purposes, Company A will be able to add the \$20,000 unfavourable budget variance to the cost of sales to get a total of \$4,430,000.

Consumables

Because the level of unexpired portion of the consumable aids (\$60,000) is above the \$58,000 threshold stated in Determination E10, Company A will be required under section EF 1 to include the \$60,000 as gross income and be allowed a deduction for that amount in the 1999/2000 income year. For financial reporting purposes, the \$60,000 cost of consumables on hand will be included in inventory.

Example 2: Allocation of budget variance across multiple products

Company B manufactures children's toys. During the 1998/99 income year, Company B made three types of toys: X, Y and Z.

Whilst Company B had budgeted production costs of \$200,000, the actual costs incurred were \$240,000. In other words, Company B had an unfavourable budget variance of \$40,000. Section EE 5(3) requires Company B to prorate the budget variance between the cost of sales and the goods on hand at balance date. Company B has decided to prorate the variance based on the sales value of the products sold.

	Sales value \$ per unit	Units sold	Units on hand	Goods sold \$	Goods on hand \$
Product X	7	10,000	3,500	70,000	24,500
Product Y	8	12,000	2,250	96,000	18,000
Product Z	12	7,000	1,750	<u>84,000</u>	<u>21,000</u>
Total				250,000	63,500
Value of total sold	250,000				
Value of total on hand	63,500				
Allocation proportion	0.2025		<u>(63500)</u>		
			(63,500 + 250,000)		

Thus 20.25% of the total variance is to be allocated to closing stock. This means that Company B will absorb \$8,100 (20.25% x \$40,000) of the budget variance into the value of closing stock. The balance of the variance, being \$31,900, is attributable to goods sold.

For stock that is separately identifiable, taxpayers have the choice of calculating cost by specific identification or using cost-flow methods of assigning costs. The acceptable cost-flow methods for trading stock are first-in first-out (FIFO) method and weighted average cost method. These methods are consistent with financial reporting requirements. Weighted average cost-flow methods which are acceptable for financial reporting purposes will be acceptable for tax. Cost-flow methods of assigning costs must be used for stock that is not separately identifiable or for excepted financial arrangements that are trading stock or revenue account property.

Valuation of joint products and by-products is not expressly referred to in the legislation. Taxpayers should follow the requirements of “generally accepted accounting principles”.

Small taxpayers will be required to include the current level of cost absorption, set out in *Public Information Bulletin* No. 82, for manufactured and produced stock. For stock acquired for resale, taxpayers will be required to include in cost, the purchase price, transport and insurance costs. They may include customs duty. Small taxpayers will be allowed to include a lesser level of costs than other taxpayers because of the compliance costs of requiring a higher level of cost absorption. However, small taxpayers who include more costs for financial reporting purposes or tax purposes should include these additional costs consistently.

Small taxpayers are not required to allocate costs to sub-classifications of trading stock. They may allocate all costs to closing stock valued at cost, on a global basis. This approach simplifies cost allocation for small taxpayers and is consistent with the *Framework for Differential Reporting*.

Discounted selling price

The discounted selling price method is used by many retailers in line with Inland Revenue policy set out in *Public Information Bulletin* No. 82. This method is now specifically provided for in the new reforms. The discounted selling price method was contemplated for retailers. However, other taxpayers such as the meat industry use a variation of the method and this is allowed in the new rules if it is used for financial reporting purposes. Taxpayers other than small taxpayers will only be permitted to use the discounted selling price method when they do so for financial reporting purposes.

Broadly, the discounted selling price of trading stock is the amount equal to the retail selling price or market selling value of stock, less the gross margin applicable to that stock. Gross profit margins must be calculated for a department or category of stock for retailers and a category of stock for other taxpayers. “Department” and “category” have their ordinary meanings. In the case of the meat industry, a category of stock would be, at a minimum, a species of animal. Therefore, gross profit margins will have to be calculated for sheep, beef, venison and so on.

The term “retailer” carries its ordinary meaning. It will also cover stock sold at retail by manufacturers in, for example, “factory” shops.

Some small taxpayers will be able to apply a single gross profit margin to all stock on hand at the end of the income year. The gross profit margin will be the overall margin for the business. This method will apply only to taxpayers with a turnover of less than \$1 million. Other small taxpayers will use the same methods as other taxpayers for application of discounted selling price.

Replacement price

Replacement price is predominantly a method for small taxpayers who do not prepare financial statements. It may be used by small taxpayers who prepare financial statements as well as by others if they use it for financial reporting purposes. The method is not expected to be used by many taxpayers other than small taxpayers, since FRS-4 appears to provide for its use only for raw materials.

Replacement price is a proxy for cost. It is the purchase price that a taxpayer would pay on balance date. However, if a purchase price is not available on balance date because, for example, the goods are out of season, the last price paid during the income year may be used.

Small taxpayers may use the last price paid during the income year under all circumstances.

Market selling value

The market selling value option may be used when market value is less than cost. Currently, market selling value can also be used when it is greater than cost, which

introduces a degree of flexibility that is not desirable. It allows taxpayers to:

- use credits that cannot be refunded or carried forward to other income years (such as foreign tax credits); or
- soak up losses which might otherwise disappear following a breach of the shareholder continuity requirements.

Under the new rules, the starting point for determining the market selling value of finished goods is the gross amount that a taxpayer will normally receive from selling trading stock in the ordinary course of business. For work in progress this amount is reduced by the costs of completing the goods. Market selling value is defined to be exclusive of goods and services tax.

Sales in the ordinary course of business will include clearance sales. However, the ordinary course of business will not include sales that are not at arm's length, such as sales made to employees at cheap rates. "Balance date" sales held for a short period over balance date, to establish a lower market selling value for tax purposes will also not be regarded as having been made in the ordinary course of business.

Direct costs of selling the stock which have not yet been incurred may be taken into account in calculating market selling value if these expected costs have been taken into account for financial reporting purposes. This a key feature of the net realisable value concept in FRS-4. The direct selling costs are specified as:

- transport and insurance costs;
- sales commissions; and
- discounts to purchasers.

The costs are those commonly deducted for financial reporting purposes, which are readily verifiable, although they are not exactly the same as those listed in the commentary to FRS-4.

Market selling value must be calculated on an item-by-item basis. If there are multiple items of stock on hand to be valued, the market selling value will be the sum total of the individual items, less discounts allowed.

Example 3: Calculation of market selling value

Company C manufactures value-added timber furniture products for export markets.

At balance date Company C has a range of completed furniture ready for export. Due to an oversupply in the world furniture market, Company C has chosen to value a portion of its finished stock on hand at balance date at market selling value for tax purposes, as this is less than cost.

Export sale contracts usually sell goods on a c.i.f. (cost, insurance, freight) basis. Company C has appointed a number of overseas agents to negotiate sales on a commissions basis (4% of the purchase price) on its behalf.

Company C has a number of preferential customers that make up a substantial majority of its sales. It offers these customers a purchase discount of 5% from purchase price.

Company C is able to substantiate that the market selling value of the portion of its completed furniture on hand at balance date to be valued at market selling value is \$1,125,000 (excluding GST).

The anticipated costs of selling the completed furniture are (excluding GST):

Transport	\$ 55,000
Insurance	\$ 27,500
Sales commissions	\$ 45,000
Discounts to purchasers	<u>\$ 56,250</u>
	\$183,750

For tax purposes under section EE 12(2), these anticipated costs of selling the furniture can be deducted from the market selling value. Accordingly, Company C may value its furniture on hand at balance date at \$941,250 (\$1,125,000 - \$183,750).

There are differences between the concept of market selling value and net realisable value. Net realisable value requires an estimate of the future proceeds of sale. Some taxpayers have used formula write-downs on an ageing basis to estimate the future proceeds of sale. This will not be acceptable for tax purposes as market selling value is based on the actual selling price of goods. Therefore if goods will be offered for sale at a certain price, that is the market selling value, and not a value which takes into account when the goods will be sold.

The current section EE 1(7) will be repealed. Stock affected by obsolescence may be valued using market selling value if the offering price is less than cost. Obsolescent stock that is being sold for a price that is less than the original retail price but more than cost must be valued at cost. To allow write-downs below cost for such stock results in unrealised losses being taken into account for tax purposes when such losses will only occur if stock is sold below cost.

Taxpayers will be required to have reasonable evidence to substantiate market selling values. Evidence includes offering prices of goods and actual sales for a reasonable period before and after balance date.

Taxpayers may have difficulty determining and substantiating market selling value in some circumstances. This may arise when there is no open or active market in the good, or when the stock has not sold for some time and the taxpayer has reason to believe the goods will not sell at their current offering prices. If this information is not available, the taxpayer may substantiate the market selling value by obtaining an independent valuation. The valuation must be for tax purposes, using the definition of market selling value and not a net realisable value concept set out in FRS-4.

Only the items of stock that have a market selling value below cost should be valued using the market selling value option. Excess stocks on hand should not be valued

below cost if they will be sold for more than cost. To do so does not provide an accurate reflection of a taxpayer's income for tax purposes, although it may be appropriate for financial reporting purposes.

Small taxpayers may use the market selling value option for trading stock that has a value in excess of cost. The rationale is to provide an alternative to a cost valuation when this may be difficult to calculate. In particular, this appears to be a difficult issue for farmers valuing cash crops. If small taxpayers choose to use the market selling value option in these circumstances, they must do so consistently from year to year.

Transitional spreading provision for income arising from the repeal of section EE 1(7)

The repeal of section EE 1(7) will mean that taxpayers who have used formulas to write down stock under that provision will be required to value stock at cost, unless they can substantiate a lower market value. Transitional spreading rules will allow them to spread any income arising from the repeal of section EE 1(7) over a three-year period. Spreading will be available for the 1998/99 income year and the two succeeding income years.

Valuation of excepted financial arrangements

The proposed rules for excepted financial arrangements are:

- Taxpayers must value all excepted financial arrangements that are trading stock at cost.
- Transfers of excepted financial arrangements that are trading stock or revenue account property between members of a wholly-owned group of companies will be at cost if the market value of the excepted financial arrangement is less than cost.
- Taxpayers must use cost-flow methods of assigning costs (either the first-in first-out [FIFO] method, or a weighted average method) to excepted financial arrangements that are trading stock or revenue account property. Specific identification may not be used.

The rules for valuation of excepted financial arrangements that are trading stock have not changed in any significant way from the proposals in the discussion document. The primary category of excepted financial arrangements is shares. However, the rules apply to all excepted financial arrangements, including options and short-term trade credits.

The application of a cost-flow method to shares will only apply to a type of share, for example, all shares held in Company D. Cost-flow methods will not apply across a portfolio of shares, as a whole.

New technical rules that apply to excepted financial arrangements are:

- Taxpayers will be able to write down the value of their worthless excepted financial arrangements that are trading stock.
- The dividend rules will not apply to transfers of excepted financial arrangements that are trading stock or revenue account property between members of a wholly-owned group of companies.
- Excepted financial arrangements that are trading stock or revenue account property that have been transferred within a wholly-owned group of companies will be deemed to be sold and repurchased at market value when the company holding the shares ceases to be a member of that group. This rule is similar to the current section EE 1(6) in relation to group companies.

Consistency requirements

Consistency requirements in the valuation of trading stock are a key feature of these reforms. The principle underpinning the requirement for consistency for tax purposes is that taxpayers should not be able to manipulate their gross income by applying different tax accounting treatments across income years. Changes in the method of valuing trading stock at cost can distort income for both accounting and tax purposes.

Financial Reporting Standard No. 1 *Disclosure of Accounting Policies* (FRS-1) sets out consistency and disclosure requirements. FRS-1 states in its commentary that accounting policies adopted by an entity are normally consistent from one period to another, and are to be applied to all items of a similar nature. It provides that the statement of accounting policies must state whether or not the accounting policies used are consistent with those used in previous periods. If there have been changes in the measurement system, the assumptions, or the accounting policies used, full disclosure of the changes is required.

All but small taxpayers must comply with these requirements. Small taxpayers who comply with “generally accepted accounting principles” must comply with FRS-1.

Other small taxpayers must be consistent from year to year in five matters:

- the extent to which indirect production costs are included in the cost of manufactured or produced trading stock;
- the cost-flow method of assigning costs;
- the cost valuation method chosen;
- the method of calculating discounted selling price; and
- the use of market selling value when it is above cost.

Small taxpayers may change their method of calculating the value of closing stock if there are sound commercial reasons for the variation. Tax benefits are not considered to be a sound commercial reason. In the event of a change in method, small taxpayers must notify particulars of the variation and the reasons for it by the due date for filing their tax return for the income year in which the change occurs.

Record-keeping

The current record-keeping requirements in the Tax Administration Act require only statements of quantities and values of trading stock to be kept, including stocktaking records. In order to support the consistency requirements, under the new rules taxpayers must keep records of valuation methods and their application. The records will show how the value of trading stock was calculated.

To avoid unnecessary compliance costs, if taxpayers use the same methods from year to year, they will not have to keep additional records. However, if they change valuation methods or apply them differently, taxpayers must record the change.

Definition of trading stock

The definition of trading stock has been amended only as far as it applies to new Part EE (except section EE 19, which re-enacts section EE 2 providing that insurance receipts are gross income).

The new definition of trading stock is an amalgam of the current definition and the proposal in the discussion document for the definition to be:

- limited to a business undertaking; and
- linked to a purpose of sale.

Consumable aids are excluded from the definition of trading stock for clarity. They will be added back as gross income under the accrual expenditure rules in section EF 1. Spare parts held for maintaining plant that are treated as inventory under FRS-4 are also excluded from the definition of trading stock for clarity. They should either be depreciated (when appropriate) or added back as gross income under the accrual expenditure rules in section EF 1.

Binding rulings

The binding rulings legislation in the Tax Administration Act will be amended so that the Commissioner cannot rule on a matter which would require him to form an opinion as to “generally accepted accounting principles” or commercially acceptable practices. The Commissioner is not a recognised expert in these areas so it is not an appropriate area for rulings, for the same reasons that questions of fact are excluded from the rulings legislation.

Provisions currently in Subpart EE

The current subsections (4)(5)(6) and (10) of section EE 1 will be retained in Subpart EE, without substantive amendment. The current section EE 2 will also be retained in Subpart EE, without substantive amendment.

Consequential amendments

Consequential amendments will be made to the family support rules in section KD (1) and to the amalgamation rules in sections FE 2 and FE 6.

TAXATION OF PROPERTY OBTAINED WITHOUT COLOUR OF RIGHT

(Clauses 4, 9, 15, 33(6), 47 and 48)

Summary of proposed amendment

The amendments will protect the income tax base by including within the meaning of “gross income” property obtained without colour of right. A colour of right is an honest belief that the holder is entitled to possession or control of the property. The amendments cover property obtained by fraud, embezzlement, theft or misappropriation. In addition, taxpayers may claim a deduction for the amount of reparation or restitution to the legal or beneficial owner of that property.

Application date

The amendments to the Income Tax Act 1994 are applicable to property taken or controlled in the 1995/96 and subsequent income years. The equivalent amendments to the Income Tax Act 1976 are applicable to property taken or controlled between 1 April 1989 and beginning on the 1995/96 income year.

The amendments will not apply to competent objections or challenges made before 6 March 1998.

Key features

The bill introduces four specific amendments to the Income Tax Act 1994:

- A new section CD 6 will provide that property obtained without colour of right will be included within the meaning of gross income subject to income tax.
- A new section DJ 18 will allow taxpayers a deduction for reparation or restitution made to the legal or beneficial owner of the property. This is because there is no enduring benefit to the taxpayer. Interest payments and other penalties will not be deductible.
- A new section EN 5 will provide that income under CD 6 is included as income to the taxpayer in the year in which the property was obtained.
- In section OB 1 the definition of property will be amended to include money and money's worth for the purposes of sections CD 6 and DJ 18.

A new section 80A and an amendment to section 2 of the Income Tax Act 1976 mirror these amendments.

Background

For many years the practice of Inland Revenue has been to tax recipients of misappropriated property on the basis that such property was income. In 1997 the Court of Appeal, in *A Taxpayer v CIR*, CA 196/96, held that stolen money was not income according to ordinary concepts. The Court considered that unless stolen money was made subject to income tax by express provision, it was not taxable. The Government's view is that money obtained without colour of right should be taxable.

CONSOLIDATION RULES AND SECTION LE 3 HOLDING COMPANIES

(Clause 21)

Summary of proposed amendment

An amendment to the consolidation rules will exclude the application of the exemption for intra-group transactions to a dividend or a supplementary dividend derived by a section LE 3 holding company member of a consolidated group. This will ensure that the foreign investor tax credit (FITC) rules work as intended, which requires such dividends to be taxable.

Application date

The amendment will have retrospective application to the 1995/96 income year. However, there is a savings provision for taxpayers who have filed returns claiming the benefit of the exemption for intra-group transactions before the date of introduction of the bill.

Key features

The efficacy of the section LE 3 holding company mechanism is dependent on dividends and supplementary dividends paid to a section LE 3 holding company being taxable to that company. This ensures that if the section LE 3 holding company does not on-pay such dividends, the FITC credit allowed to a lower tier company is effectively clawed back from that section LE 3 holding company. Therefore section LE 3 provides that the wholly-owned group inter-corporate dividend exemption in section CB 10(2) does not apply to dividends (to the extent fully imputed) and supplementary dividends derived by a section LE 3 holding company.

However, there is a separate exemption in the consolidation rules (section HB 2(1)(a)) for intra-group transactions. Although it is the clear policy intention that dividends (to the extent fully imputed) and supplementary dividends derived by a section LE 3 holding company always be taxable, this exemption has not been expressly excluded from applying to such dividends.

Accordingly, section HB 2(1)(a) is amended to exclude the application of its exemption for intra-group transactions to dividends or supplementary dividends derived by a section LE 3 holding company member of a consolidated group.

Background

The effect of the FITC rules is to ensure that the maximum rate of New Zealand tax (combining company tax and non-resident withholding tax) on non-resident shareholders in New Zealand companies does not exceed 33%, the same rate as for New Zealand shareholders.

The FITC rules allow a company an income tax credit (the FITC credit) when it pays a supplementary dividend of the same amount to its non-resident shareholders.

A special holding company mechanism in section LE 3 allows the FITC rules to be used in circumstances where a New Zealand holding company has an insufficient tax liability to utilise the FITC credit arising from paying a supplementary dividend to its non-resident shareholders. The mechanism allows a lower tier New Zealand company receiving a dividend and a supplementary dividend (a “section LE 3 holding company”) to claim a FITC credit when paying dividends up the chain of companies to the ultimate New Zealand resident holding company with non-resident shareholders.

EXCESS IMPUTATION CREDIT CONVERSION RATE

(Clause 26)

Summary of proposed amendment

The conversion rate for excess imputation credits is being reduced from 21.75% to 21%, consistent with recently enacted reductions in the extra emolument rate, with effect from 1 April 1998.

Application date

The proposed amendment will apply from the 1999/00 income year onwards.

Key features

The conversion rate specified in section LB 2(3)(iv) for the purpose of converting imputation credits is amended from 21.75% to 21%.

Background

Excess imputation credits are imputation credits which taxpayers cannot credit against their income tax because they have insufficient income tax liability. Excess imputation credits are converted to losses to prevent imputation credits being refunded to taxpayers. The conversion rate for individuals holding excess credits is based on the extra emolument rate, which is the middle effective tax rate.

The imputation credit conversion rate for 1998/99 was set at 21.75% with the enactment of the Taxation (Remedial Provisions) Act 1997.

TAXATION OF SPECIFIED SUPERANNUATION CONTRIBUTIONS

(Clauses 31, 32 and 33(7))

Summary of proposed amendments

Employees will be allowed to elect to have employer superannuation contributions included in their salary or wages and taxed at their personal tax rates if they are lower than the statutory rate of 33%.

Application date

Employees will be able to elect to have employer superannuation contributions treated as salary or wages from the date of enactment.

Key features

The new section NE 2A will allow employees to elect to have all or part of their employer superannuation contributions included in their salary or wages and therefore subject to PAYE. This will allow employees to have their employer superannuation contributions taxed at their personal tax rate. Employees will be able to revoke elections at any time.

If the contributions are treated as taxable income of the employee, this income will be taken into account for social assistance targeting such as family support, independent family tax credit, student loans and child support.

Background

Under the current specified superannuation contribution withholding tax rules, employer contributions to superannuation funds are subject to a flat, final tax of 33%. The report to the Government from the Working Party on the Taxation of life Insurance and Superannuation Fund Savings (April 1997) noted that this treatment resulted in employer contributions being over-taxed for employees whose effective marginal tax rate was below 33%.

The working party identified a number of options for taxing employer contributions to employee superannuation funds. In its report, it concluded that for employer contributions that vest immediately, the use of the existing PAYE mechanism already provided a relatively straightforward and effective way of dealing with the issue of over-taxation of employer contributions. In relation to contributions that do not vest immediately, the working party concluded that it could also be appropriate to adopt the same treatment proposed for contributions that vest immediately.

Inland Revenue issued a draft Standard Practice Statement late last year confirming that the current PAYE system could be used to tax employer superannuation contributions as salary or wages if employees agreed to this treatment. In response to submissions on the draft statement, it was decided it would be more appropriate to provide for an election in the legislation.

DEPRECIATION

(Clauses 14, 33(1) and 34)

Summary of proposed amendments

Several minor technical amendments are being made to the Income Tax Act which arise out of amendments to the depreciation legislation in September 1997. These are:

- An amendment to ensure that in all circumstances taxpayers can only depreciate property when it is used or available for use in a business. Arguably, property that is owned but not yet in the possession of a taxpayer may currently be depreciated, but will not be depreciable after these amendments are enacted.
- Amendments to the definition of “adjusted tax value” to ensure that taxpayers can amortise the whole of the cost of depreciable property used or available for use for business purposes.
- An amendment to provide that taxpayers can depreciate property while it is under repair or inspection.
- The reinsertion of words removed in error from the definition of “associated person” in section OD 8(3).

Application dates

The amendment to ensure that in all circumstances property must be used or available for use in business in order to be depreciable will apply from the 1998/99 income year.

The amendments relating to the repair of depreciable assets and to the definition of “adjusted tax value” are generally taxpayer friendly and are retrospective to 23 September 1997, the date on which the Taxation (Remedial Provisions) Act 1997 came into effect.

The correction of the drafting error in section OD 8(3) applies retrospectively from 1 July 1997, the date on which the amendment to section OD 8(3) came into force.

Key features

- Section EG 2(1)(a) and (e) are amended to ensure that in all circumstances property must be used or available for use in business in order to be depreciable. Item c of the formula in paragraph (a) is now in the same terms as item g of the formula in paragraph (e).
- A new subsection EG 2(2A) is added to provide that property continues to be available for use in deriving income or in carrying on a business if it is under temporary repair or inspection.

- Amendments are made to both components of the definition of “adjusted tax value” in section OB 1. The definition of “base value” is amended to ensure that if property is first used or available for use in business, it enters the tax base at cost – that is, paragraph (i) of item bv (base value) applies.
- The term “aggregate deductions” is also amended to provide, in effect, that the tax book value of an asset decreases only during the period that the asset is either used or available for use in a business, or used for private purposes.
- The two references to “paragraph (iv) of the item bv in the definition of ‘adjusted tax value’ ” are reinserted in section OD 8(3).

Background

In September 1997 the depreciation provisions of the Income Tax Act were amended to provide that a deduction for depreciation would be permitted only when property was used or available for use in deriving gross income or in carrying on a business. This amendment has given rise to three problems.

First, the amendment may not be effective in situations where depreciable property is owned by a taxpayer but not yet in the possession of the taxpayer. It can be argued, for example, that property that has been purchased but not delivered to the taxpayer may still be depreciated. The bill remedies this so that such property is not depreciable until it is used or available for use in deriving income.

Second, property that has been used or available for use by a business should continue to be depreciable while it is under repair or inspection. Property under repair is arguably not available for use by a business. If this is correct, it would currently not be depreciable. The bill enables such property to be depreciated during the period of repair.

Finally, the definition of “adjusted tax value” in section OB 1 requires consequential amendment. That definition calculates the tax book value of an asset at any particular time. The tax book value comprises the “base value” of the asset (generally cost) and “aggregate deductions” (broadly the amount of depreciation deductions to which the taxpayer has been entitled). An amendment is required to each of these definitions in order not to disadvantage taxpayers. The proposed amendments are explained below.

Base value of asset

The base value of an asset is generally its cost. However, if an asset is not immediately depreciable to a taxpayer (because, for example, it is first used for private purposes), the base value of the asset is its market value at the time that it becomes depreciable.

Following the recent depreciation amendments, property is not depreciable unless it is owned and used or available for use in business. If it is owned but not yet available for use, it is not immediately depreciable to the taxpayer and in certain circumstances the base value of the property is its market value when it becomes available for use.

For example, plant that is purchased by a business but that is in transit to New Zealand is owned by the business but is not available for use. It is not depreciable until it is available for business use. Currently, in certain circumstances, such plant will be required to be depreciated from its market value at the time it becomes available for use, rather than from its cost. This is not appropriate and, when the market value is less than cost, will penalise taxpayers.

The definition of base value is amended to provide that the base value is cost in these circumstances.

Aggregate deductions

At any time, the maximum remaining depreciation that may be claimed for an asset is its tax book value. Currently, the tax book value of an asset decreases from the time that the asset is owned, even where it is not yet available for use. As taxpayers can now deduct depreciation for an asset only when it is available for business use, this decrease in the tax book value is penal and means that taxpayers cannot deduct all of the cost of an asset that is only ever available for business use.

The definition is amended to provide, in effect, that the tax book value of an asset decreases only during the period that the asset is used or available for use in a business, or is used for private purposes. It does not decrease over the period when an asset is unavailable for any use.

The amendment therefore ensures that all expenditure by a business on an asset, except that attributable to private use, is deductible over the life of the asset. Such an amendment would mean, in relation to the plant in transit in the example above, that the tax book value of the plant would not decrease until the plant was available for business use.

Drafting error in section OD 8(3)

A minor technical amendment is required to correct a drafting error previously made in amending section OD 8(3). That section provides a definition of associated person for the purposes of several provisions, including depreciation.

In that section, the two references to “paragraph (iv) of the item by (base value) in the definition of ‘adjusted tax value’” were omitted, in the expectation that they would no longer be required because of the insertion of a reference to Part EG. This is incorrect and the two references are reinserted.

CONFIRMATION OF ANNUAL INCOME TAX RATES FOR 1998/99

(Clause 51)

Summary of proposed amendment

Amendments to Schedule 1 confirm the income tax rates for the 1998/99 income year as follows:

Policyholder income	33 cents for every \$1 of schedular taxable income
Maori authorities	25 cents for every \$1 of taxable income
Undistributed rents, royalties and interest of the Maori Trustee	25 cents for every \$1 of taxable income
Companies, public authorities and local authorities	33 cents for every \$1 of taxable income
Trustee income (including that of trustees of superannuation funds)	33 cents for every \$1 of taxable income
Trustees of group investment funds	33 cents for every \$1 of schedular taxable income in respect of Category A income
Taxable distributions from non-qualifying trusts	45 cents for every \$1 of taxable distribution
Other taxpayers (including individuals)	Income not exceeding \$34,200: 20 cents for every \$1 of taxable income Income exceeding \$34,200 but not exceeding \$38,000: 22.875 cents for every \$1 of taxable income Income exceeding \$38,000: 33 cents for every \$1 of taxable income
Specified superannuation contribution withholding tax	33 cents for every \$1 of the contribution

Application date

The amendment will apply for the 1998/99 income year.

NOTICE OF PROPOSED ADJUSTMENT

(Clause 42)

Summary of proposed amendment

The amendment requires that a notice of proposed adjustment (NOPA) be accompanied by a cover sheet when it is filed. This will allow Inland Revenue to identify NOPAs more readily and deal with them quickly.

Application date

The amendment applies from the date of enactment.

Key features

Sections 3 and 89F of the Tax Administration Act are being amended to require NOPAs to be accompanied by a cover sheet.

Background

A NOPA is a notification proposing that an adjustment to an assessment is required. It formally initiates the disputes resolution process. The Act currently prescribes what must be included in a NOPA. There is no requirement for a particular form to be completed. A form (IR 210) is available from Inland Revenue for this purpose, but because the information required can vary considerably, depending upon the nature of the adjustment required, taxpayers and their agents often prefer to file the NOPA in the form of a letter. The amendment will require NOPAs to be accompanied by a cover sheet when filed. This will ensure they are more easily identified and responded to within the time specified by law.

PRIVACY PROVISIONS IN THE STUDENT LOAN SCHEME ACT 1992

(Clause 50)

Summary of proposed amendment

Inland Revenue will be able to supply the Ministry of Education with taxpayer information that relates to a case that the Ministry is investigating when it suspects that a student loan has been fraudulently obtained, or that an attempt to obtain a loan fraudulently is being made. This will assist the Ministry of Education to investigate and prosecute fraud.

Application date

The amendment will apply from the date of enactment.

Key features

Section 62, the privacy provision of the Student Loan Scheme Act 1992, is amended to allow the Ministry of Education to request Inland Revenue to supply information about a taxpayer and his or her loan account. The information will include:

- whether repayments have been made;
- the individual's current loan balance;
- the current whereabouts of a borrower;
- whether someone is an existing taxpayer;
- the number of borrowers living at a particular address; and
- any other information that is relevant to the investigation.

Background

Over the last five years the Ministry of Education has investigated nearly 800 cases in which it suspects that a loan has been fraudulently obtained or that an attempt is being made to obtain a loan fraudulently. Although Inland Revenue and the Ministry of Education have separate roles in administering the student loan scheme, these roles are to a large degree interdependent.

At present, Inland Revenue can release to the Ministry of Education only such information as is required to correctly identify a borrower.

