

Taxation (Annual Rates, Taxpayer Assessment and Miscellaneous Provisions) Bill

Commentary on the Bill

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RESEARCH AND DEVELOPMENT (R&D)

(Clauses 39, 60 and 178)

Summary of proposed amendments

Taxpayers will be able to deduct for tax purposes the R&D expenditure that is recognised as an expense under Financial Reporting Standard 13, *Accounting for Research and Development Activities* (FRS 13). FRS 13 requires all “research” costs to be expensed. “Development” costs must be expensed until five criteria are all met. These criteria are designed to approximate the point at which the R&D expenditure gives rise to a valuable asset.

Fixed assets (such as vehicles, buildings and patents) that are used in the R&D process will continue to be depreciated under the normal tax rules.

Use of this new rule will be optional. Thus a taxpayer will be able to use the current law to deduct R&D if that is preferred.

Application date

The changes will apply from the beginning of the 2001-2002 income year.

Key features

A new section DJ 9A is being introduced into the Income Tax Act 1994. It provides that spending on R&D that is expensed for accounting purposes under FRS 13 is not expenditure “of a capital nature” for the purposes of section BD 2(2)(e) of the Act. This will confirm that taxpayers are allowed a deduction for such expenditure under the Act’s general deductibility rules (section BD 2(1)(b)(i), (ii)).

Background

Three sets of provisions in the Act permit the deduction of R&D expenditure – the general deductibility provisions in section BD 2, the specific deduction allowed for scientific research expenditure in section DJ 9, and the depreciation rules. Which of these provisions permits a deduction for an item of R&D depends on the nature of the expenditure.

The general deductibility provisions allow a taxpayer a deduction for expenditure if the expenditure is incurred in the income-earning process and is not “of a capital nature”. It can often be very difficult for taxpayers and Inland Revenue to determine whether R&D expenditure is capital or revenue. It is this lack of certainty, and the risks that this gives rise to, that many taxpayers and their advisers have considered to be the greatest problem in this area.

This provision addresses the uncertainty around the capital/revenue boundary by permitting taxpayers to follow accounting treatment to the extent that when R&D expenditure is immediately written off for accounting purposes, it will be immediately deductible for tax purposes.

Under FRS 13, expenditure on “research” is always written off, while “development” expenditure is written off until it is considered that the expenditure has resulted in a valuable asset with sufficiently certain future economic benefits. FRS 13 determines that this point is reached when the product or process being developed meets five asset recognition criteria. From the point at which all these criteria are met, further “development” expenditure is amortised (subject to the application of paragraph 5.4 of FRS 13, discussed below). This point approximates, but is generally clearer than, the current capital/revenue boundary operating in a tax context. The asset recognition criteria are:

- The product or process is clearly defined and the costs attributable to the product or process can be identified separately and measured reliably.
- The technical feasibility of the product or process can be demonstrated.
- The entity intends to produce and market, or use, the product or process.
- The existence of a market for the product or process or its usefulness to the entity, if it is to be used internally, can be demonstrated.
- Adequate resources exist, or their availability can be demonstrated to complete the project and market or use the product or process.

Detailed analysis

To effect the proposed change, new sections DJ 9A and DJ 9B are being inserted, and consequential amendments are being made to sections EG 19 and OB 1 (new definitions of “research” and “development”).

Section DJ 9A(1)

This subsection is the provision that enacts the core R&D change. It provides that expenditure that taxpayers write off as R&D after applying FRS 13 is not to be treated as expenditure “of a capital nature” for the purposes of section BD 2(2)(e). (This is the provision that excludes capital expenditure from the general deductibility rules in section BD 2). The effect of this provision is to confirm that taxpayers can deduct under the general deductibility rules (section BD 2(1)(b)(i), (ii)) R&D expenditure that they expense for accounting under FRS 13.

Aside from the capital exclusion, the general deductibility rules will apply in full. Therefore a deduction will be granted only if there is a sufficient link between the R&D expenditure and the income-earning process, and the deduction is not prohibited by the exclusions in paragraphs (a) to (d) or (f) of section BD 2(2). (These prohibitions relate to private expenditure, expenditure incurred in deriving exempt income or income from employment, and expenditure specifically disallowed as a deduction.)

Many taxpayers qualify for an exemption from certain financial reporting standards under the Framework for Differential Reporting. These taxpayers are not required to apply paragraphs 5.1 and 5.2 of FRS 13 and may write off all R&D for financial reporting purposes. Section DJ 9A(1) only applies to R&D expenditure if the taxpayer has applied paragraphs 5.1 and 5.2. Effectively, therefore, these taxpayers will be able to take advantage of the new rules only if they have applied FRS 13 in full for financial reporting purposes.

Section DJ 9A(2)

Subsection (2) provides that “development” expenditure is not “of a capital nature” if the taxpayer has not treated the expenditure as an asset for financial reporting purposes by virtue of paragraph 5.4 of FRS 13. Paragraph 5.4 limits the amount of “development” expenditure that can be treated as an asset to an amount equal to the likely future economic benefit that will be gained from the asset. “Development” expenditure in excess of this must be expensed. This provision has the effect of allowing taxpayers a deduction for “development” expenditure incurred after the five asset recognition criteria have been satisfied to the extent that, if the expenditure were treated as an asset, the recognised costs would exceed the probable future economic benefits.

Section DJ 9A(4)

Under paragraph 2.3 of FRS 13, the five asset recognition criteria apply only if their application is of material consequence. This means that if an amount of R&D expenditure incurred by a firm is not material, it may all be expensed for accounting purposes. Subsection (4) requires that if a taxpayer wants to make use of the new R&D provisions, the five asset recognition criteria must be applied to all R&D expenditure whether or not their application is of material consequence.

Section DJ 9A(5)

This provision removes the potential argument that R&D expenditure that is incurred in devising an invention that is later patented is the “cost of revenue account property” that should be carried forward under section EF 2 and deducted when the resulting patent is sold.

Section DJ 9A(6)

This provision removes capital inputs into the R&D process from the ambit of the new rules. Current tax treatment will apply to this property. For example, if the asset qualifies for a depreciation deduction the depreciation rules will apply. The cost of an asset that is not currently deductible (such as costs associated with know-how) will remain non-deductible.

The subsection will not apply to an asset that is itself created from the R&D. This will confirm that R&D expenditure incurred on such assets is eligible for a deduction. Without this proviso, there is an argument that R&D expenditure incurred on, for example, a prototype would not be deductible on the basis that the prototype could qualify for a depreciation deduction.

Section DJ 9A(7)

This provision allows a taxpayer applying FRS 13 in full for financial reporting purposes to opt out of the provision for tax purposes. Some taxpayers may wish to expense some R&D for accounting purposes but capitalise and depreciate the expenditure for tax purposes.

This provision will not apply to taxpayers not required to follow FRS 13 in full for financial reporting purposes, and not wishing to take advantage of the new R&D provisions. These taxpayers will not be required to make an election under this subsection, since the new R&D provisions apply only to those who follow FRS 13 in full.

Section DJ 9A(8)

Subsection (8) provides that “research” and “development” have the meanings set out in paragraphs 4.1 and 4.2 of FRS 13 (as interpreted by the relevant commentary in FRS 13). FRS 13 defines “research” and “development” as follows:

“Research” is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

“Development” is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

Ability to use current rules

Taxpayers may still argue, however, that “development” expenditure incurred after this point is deductible on the basis that it is revenue and deductible under the general deductibility rule, or deductible under section DJ 9 as scientific research expenditure.

Section DJ 9B

This section addresses the Government’s concern about re-categorisation of expenditure as R&D, and avoidance schemes developing around R&D. By providing that certain types of expenditure and activity can be removed from the definition of R&D by regulation, the Government will be able to move quickly to counter tax avoidance.

Interaction with the depreciation rules

A new subsection (2)(A) is being added to section EG 19 (disposition of depreciable property). It ensures that deductions taken for R&D costs incurred in relation to creating software are not clawed back under section EG 19(2) if the software is subsequently sold.

INTEREST DEDUCTIBILITY FOR COMPANIES

(Clauses 5, 21, 62, 63, 65, 92, 93, 95, 107, 112 and 157)

Summary of proposed amendments

The general interest deductibility rules for companies are being clarified and simplified in order to reduce compliance costs.

The key amendment ensures that interest incurred by most companies is deductible, subject only to the existing thin capitalisation and conduit interest allocation rules. The companies affected are all companies other than qualifying companies and companies that derive exempt income other than exempt dividends (for example, charities and local authorities).

Two remedial amendments are also being made to overcome any doubt inadvertently created by amendments to the Income Tax Act's core provisions in 1997. The first amendment is to ensure that the rule that allows companies to deduct interest on borrowings used to capitalise subsidiaries that are at least 66 percent owned is fully effective. The second remedial amendment confirms that interest incurred is generally timed under the accrual rules rather than other timing rules in the Act.

Consequential reference changes are also being made.

Application date

The amendment clarifying the tax treatment of interest incurred by companies will apply from the 2001-02 income year, including to taxpayers that have balance dates before 1 April 2001.

The remedial amendments are to be backdated to the application of the Taxation (Core Provisions) Act 1996, from the 1997-98 income year.

Key features

The key interest amendment involves overriding the specific rules relating to interest deductions in section DD 1 of the Income Tax Act 1994. Deductions will no longer be confined to interest incurred either in deriving gross income, or in the course of carrying on a business, or in relation to borrowings used to capitalise subsidiaries. A change is also being made to the core provisions (Part B) to ensure that a deductibility prohibition in section BD 2(2) is expressly overridden: this is the prohibition for expenditure incurred to derive exempt income. As noted above, these changes will apply for the majority of companies. The current rules will continue to apply to anyone else seeking to deduct interest.

The first remedial change involves amending section DD 1 to verify that despite the exclusions from allowable deductions in section BD 2, interest can be deducted on borrowings used to capitalise subsidiaries that are at least 66 percent owned -- that is, group companies.

Section EH 26 will also be amended. That provision sets out the relationship between the accrual rules and other parts of the Act. The amendment lists the timing rules that are overridden by the accrual rules so that any interest incurred is timed under the accrual rules rather than those other timing rules. As their name suggests, the accrual rules are a set of tax rules that quantify and time, on an accrual basis, income and expenditure in relation to financial arrangements.

There are several reference changes as a consequence of adding further subsections to section DD 1. The affected sections are FG 8, FG 9, FH 5, HB 2, HG 9 and LF 7.

The purpose of all these changes is to reduce compliance costs for taxpayers by removing both the uncertainty that currently surrounds these tax rules and their need to structure to achieve the same result.

Background

Core interest deductibility rule

In general, the policy intent is that interest on business borrowings should be deductible in a manner similar to that of other business-related expenses. Most interest incurred by companies is deducted under present law. It is deductible when incurred:

- to derive gross (taxable) income; or
- as part of a business of deriving gross income; or
- as part of the cost of acquiring shares in a group company.

Groups of companies frequently use the third test to ensure that interest on all of their borrowings is deductible. However, this can involve some structuring, and having to go through this process can cause companies significant compliance costs.

Moreover, there is a technical doubt that the third test is effective in all the circumstances in which it could be expected to work. (This doubt, which arises as a result of the major changes made to the Act's core provisions in 1997, is discussed later.)

The interpretation of the tax law as it applies to interest deductions is uncertain as the case law is neither comprehensive nor fully convergent.

There are also practical problems with trying to apply restrictions to interest deductions. Since money is fungible, it is substitutable with other money. For example, a company might establish a pool of funds for a variety of purposes. The pool could be sourced from sales revenue, equity finance, loans or overdrafts or the proceeds from the sale of fixed assets or investments. All those restrictions (such as a requirement to trace the use to which the funds are put) do in these circumstances is create compliance costs.

Accordingly, the key change proposed in this bill is to simplify the general interest deductibility rules for most companies. This should reduce compliance costs for those companies that deduct interest and offer certainty as to the law.

Nevertheless, there will still be some restrictions. The rule will continue to be subject to the thin capitalisation and conduit interest allocation rules in subparts FG and FH of the Act. The thin capitalisation rules are designed to ensure that profits of foreign controlled entities are subject to New Zealand income tax and are not removed from the tax base by way of interest expense. Likewise, the conduit interest allocation rules are designed to ensure that interest expenses are not unduly allocated against the New Zealand tax base. They apply when there is some foreign ownership of a New Zealand company and that company in turn has outbound investment. The interest expense is allocated between the New Zealand company and the outbound investment.

The change will not extend to qualifying companies or to companies that derive any exempt income (other than exempt dividends), individuals, trusts or partnerships. This reflects concerns about the effectiveness of apportioning interest expense between private and domestic use and between exempt income and taxable income. This is not a problem for other companies because the private and domestic boundary is in their case effectively buttressed by the dividend rules, with any benefits obtained by shareholders being dividends in their hands. Those not covered by the new rule would be able to continue deducting interest as under current law.

The proposal has already been subject to extensive consultation. It was first raised in a September 1999 discussion document, *Interest Deductions for Companies*, and has been positively received.

Remedial changes

The first remedial change involves clarifying the legislation to verify that interest incurred in acquiring shares in a group company is deductible even when the income derived is exempt income. This change is to rectify the position referred to above, that since the 1997 changes to the core provisions, there has been some doubt as to whether interest incurred is always deductible in these circumstances.

The second remedial change relates to the timing of interest deductions. The timing of interest deductions is usually governed for tax purposes by the accrual rules. Interest under these rules is generally deductible when incurred, as a per period expense. However, the core provision changes have led to queries as to whether the Act's other specific timing rules override the accrual rules. For example, if a land developer borrows to finance a project, does the interest form part of the cost of any unsold land at year-end, in the same way as, say, the bulldozer costs do? The land is no more valuable if it has been debt financed than if it had been equity financed. Thus there is no reason for the interest to form part of the cost. The amendment confirms this.

UNIT TRUSTS: TRANSFER OF DEDUCTIBLE EXPENSES

(Clauses 10(1) & (3), 31 and 178(25) & (36))

Summary of proposed amendments

The amendments will allow a qualifying unit trust to elect to transfer deductible expenses it has incurred to another qualifying unit trust if it invests in whole or in part in that second unit trust. The second unit trust will be able to deduct the expenditure so transferred. If the second unit trust cannot claim a deduction for all of the expenses transferred, the unclaimed amounts reverts back to the first unit trust and the first unit trust can elect to transfer that expenditure in a subsequent year.

Payment in the form of cash or additional dividends by the second unit trust for the amount of the expenditure transferred and claimed by that unit trust will not be treated as gross income or a dividend of the first unit trust.

The ability of such unit trusts to transfer excess deductible expenditure will enable them to use all their imputation credits without entering into otherwise inconvenient arrangements to do so. The amendments will avoid the need for qualifying unit trusts to enter into such arrangements, thus reducing compliance costs.

Application date

The amendments will apply for the income year beginning 1 April 2001.

Key features

- A new section DI 3B is being introduced into the Income Tax Act 1994. It will allow a qualifying unit trust to elect to transfer deductible expenditure to another qualifying unit trust in which it has invested in whole or in part in that second qualifying unit trust.
- The transferable expenditure is restricted to costs incurred with respect to developing, marketing, selling, promoting or advertising of units, or relating to the management of the fund.
- A new definition of “qualifying unit trust” is being added to section OB 1.
- A new section DI 3C allows the second qualifying unit trust a deduction for the expenditure transferred by the first qualifying trust. If all of the transferred expenditure cannot be claimed as a deduction by the second qualifying unit in the year of transfer, the unclaimed amount reverts back to the first unit trust, and the first unit trust can elect to transfer that expenditure in a subsequent year.
- Section CF 3 is being amended to ensure that any payment by the second qualifying unit trust for the transfer of the expenditure claimed as a deduction is not treated as dividend or gross income of the qualifying unit trust that transferred the excess expenditure.

Background

It is common for unit trusts to invest in other unit trusts as it is an efficient and effective way of conducting business.

This way of operating does, however, create a problem for unit trusts that fully or partially invest their funds in other unit trusts. In such situations, the retail unit trust incurs deductible expenditure on administration and receives its only income in the form of dividends from the other unit trusts. Such dividends are usually fully imputed. The effect of this is that the unit trust will have excess imputation credits to set off against its tax liability. These excess imputation credits can be converted into losses and carried forward. If the retail unit trust continues to receive fully imputed dividend income it will not be able to utilise its accumulating losses, unless it receives income from another source such as interest, so that the excess imputation credits or losses can be absorbed. This is inconvenient and adds to compliance costs.

The amendment is similar to the expenditure transfer rules available to superannuation funds.

UNIT TRUSTS: IMPUTATION CREDIT STREAMING

(Clauses 105 and 235)

Summary of proposed amendments

The amendments will remove an exposure to an imputation tax credit streaming anti-avoidance rule for unit trusts that did not attach imputation tax credits on unit repurchases by unit trust managers that gave rise to tax-exempt dividends during the period 1 April 1988 to 31 March 1996. They remove the potential for an unexpected tax impost for such unit trusts that would affect current unit holders.

Application date

The amendments will apply retrospectively for the period 1 April 1988 to 31 March 1996.

Key features

- A new section GZ 2 is being added to the Income Tax Act 1994 to ensure that the practice of not imputing dividends paid to unit trust managers upon redemption of the unit does not constitute imputation credit streaming for the period 1 April 1995 to 31 March 1996.
- A new section 394ZGA is being added to the Income Tax Act 1976 for the period 1 April 1988 to 31 March 1995.

Background

Unit trusts are taxed as if they were companies and are generally subject to the same tax obligations as companies. They differ from companies, however, in the way in which their investors enter and exit the unit trust. The usual way this happens is by investors acquiring and disposing of units through the unit trust manager, who operates as a type of clearing house. The redemption of those units by the unit trust manager gives rise to a dividend to that unit trust manager.

For the period 1 April 1988 to 31 March 1996 these dividends were exempt from income tax under section 63(2H) of the Income Tax Act 1976 and section CZ 4 of the Income Tax Act 1994.

Because the dividends received upon redemption were exempt from tax, it was the standard practice of some unit trusts not to impute these dividends, since the unit trust managers could not use the imputation credits. Inland Revenue has recently formed the view that this practice technically constitutes imputation streaming and would result in the unit trusts having to attach imputation credits to those dividends. This would result in an unexpected additional tax impost for such unit trusts. The implications of this potential unexpected tax impost is that it would have a negative impact on the unit values for the current unit holders in these trusts.

UNIT TRUSTS: UNIT HOLDER CONTINUITY RULE

(Clauses 97, 100, 178(25) & (36) and 179)

Summary of proposed amendments

The amendments will allow the unit holders (shareholders) of a qualifying unit trust to be treated as a “notional single person” for the purposes of the shareholder continuity rules. Provided a unit trust continues to satisfy the new definition of a qualifying unit trust, it will be able to carry forward losses and imputation tax credits without the need to incur the compliance costs associated with tracking unit-holding changes to ensure continuity has not been breached.

Application date

This amendment will apply from the income year starting 1 April 2001.

Key features

- A new definition of “qualifying unit trust” is being added to section OB 1 of the Income Tax Act 1994. As a result, there will be two types of qualifying unit trusts:
 - retail unit trusts, whose units are offered to the public and which have a hundred or more unit holders;
 - wholesale unit trusts, whose units are held by widely held investment vehicles such as other unit trusts or superannuation funds.
- Section OD 5 is amended by inserting a new subsection (4A) to treat the shares held by each unit holder of a qualifying unit trust as if those shares were held by a “notional single person”.
- Specific anti-avoidance provisions will apply to a qualifying unit trust. A new section GC 4A will prevent the net loss of a qualifying unit trust being offset against another taxpayer’s income. This is to prevent loss trading. A new section GC 22A is being introduced to prevent imputation streaming.

Background

Unit trusts are treated as companies for tax purposes and are, therefore, subject to the same continuity rules applied to companies when carrying forward imputation tax credits and losses.

Companies cannot carry forward imputation tax credits or losses unless the shareholding continuity rules are satisfied. The continuity threshold for carrying imputation tax credits and losses forward is 66 percent and 49 percent respectively. This means that a group of persons must hold, in aggregate, interests in the unit trust of at least that threshold for the imputation tax credits or losses to be carried forward from the year in which the tax was paid or the loss incurred to the year in which that tax paid is imputed to dividends or the loss is offset. The intention is to ensure that only those unit holders who paid the tax or incurred the losses are entitled to benefit from that tax paid or those losses in future years.

Unit trusts differ from companies in the way their investors enter and exit. Investors entering a unit trust are issued units that increase the capital of the unit trust. These units are redeemed when the investor exits, causing the capital of the unit trust to decrease. In the case of a company, the capital base is generally more stable, with shares being traded between shareholders. These changes in the capital base of a unit trust means that the continuity percentages change much more than they do for a company. This imposes significant compliance costs on unit trusts in monitoring unit holder changes to ensure that no breach occurs.

CHARITABLE DONEE STATUS

(Clause 140(2) & (3))

Summary of proposed amendment

The Cry for the World Foundation New Zealand Humanitarian Aid Fund is to be given charitable donee status.

Application date

The amendment will apply from the 2002-03 income year.

Key features

The Cry for the World Foundation New Zealand Humanitarian Aid Fund is being added to section KC 5 of the Income Tax Act 1994, which lists the organisations that qualify for charitable donee status.

Background

The Foundation, whose moneys can be used outside New Zealand, 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 per annum. Donations by non-closely held companies qualify for a deduction from net income. The amount allowable as a deduction depends on the company's net income.

REMEDIAL AMENDMENTS TO INCOME “ATTRIBUTION RULE”

(Clauses 98 and 162)

Two remedial amendments are being made to the income "attribution rule" enacted last year. The rule is aimed at employees who circumvent the 39 percent tax rate by interposing a company, trust or partnership between themselves and their employer so that their income will be taxed at a lower rate.

The first change increases the extra imputation credit allowed to companies that have been subject to the attribution rule. The imputation credit is a mechanism to avoid double taxation of the attributed income on its distribution by the company. Currently, the credit is calculated at 33 percent of the amount attributed, but this is insufficient because a credit of 49.25 percent is needed to allow the dividend to be fully imputed. The amendment increases the credit to this amount.

The second change involves narrowing the scope of the attribution rule to exclude natural person intermediaries not acting in partnership. When a sole trader employs relatives to carry out personal services of a type to which the attribution rule applies, the rule causes the income from the services to be directed to those relatives, leaving the sole trader with no income from those services. This result was not intended. There is no need for the rule to apply to natural persons not in partnership. Accordingly, the attribution rule will be changed so that it does not apply to sole traders.

Application date

Both remedial changes are to be backdated to the beginning of the 2001 income year to coincide with the application of the attribution rule.

Key features

The increase in the imputation credit requires an amendment to section ME 4 of the Income Tax Act 1994, while the narrowing of the scope of the attribution rule involves amending section GC 14B.

Background

The attribution rule was enacted last year to coincide with the increase, as from the 2001 income year, in the top marginal tax rate to 39 percent for individuals with incomes above \$60,000. Its intent is to avoid alienation of income from personal services carried out by individuals in specified situations. Accordingly, the attribution rule applies when a provider of personal services has interposed an intermediary, such as a company, trust or partnership, between themselves and the person to whom the services are provided in a bid to avoid the higher marginal rate. It works by allocating income to the provider of the personal services, rather than to the intermediary.

The rule applies for tax purposes only, so that the accounting income stays with the intermediary. Hence, where the intermediary is a company, the accounting income is likely to be paid out by way of dividend. Thus tax on the one amount of income is payable in the first instance by the provider of the personal services, and secondly, by the shareholder(s) if and when the income is paid out as a dividend. This will result in double taxation of this one amount of income. Hence, an imputation credit is attached to acknowledge that tax has been paid at the intermediary level.

The attribution rule did not anticipate that the intermediary could be a natural person, such as a sole trader, rather than a company, partnership or trust. But if the intermediary is a natural person who employs relatives to carry out the personal services, the rule can apply. In such circumstances, all of the income from personal services is attributed to the relatives, and the intermediary employer has no taxable income from personal services. There is no need for the attribution rule to apply to natural persons not in partnership, since any relatives employed will be paid a salary and the employer is taxable on the profits made.

INCOME TAX RATES

(Clause 3)

Summary of proposed amendment

The bill confirms the annual income tax rates that will apply for the 2001-2002 income year.

The annual rates to be confirmed are the same rates that applied for the 2000-2001 income year.

Application date

The amendment will apply for the 2001-2002 income year.

Key features

The rates listed in Schedule 1 of the Income Tax Act 1994 will be confirmed for the 2001-2002 income year.

Background

The Income Tax Act 1994 provides for the rates of income tax specified in the First Schedule of the Act to be confirmed each year.

TAXPAYER SELF-ASSESSMENT

(Clauses 6-30, 32-38, 40-61, 64, 66-91, 94, 96, 99, 101-104, 106, 108-111, 115-156, 158-161, 163-178, 181-183, 185-226, 233, 238, 240-244 and 246-248)

Summary of proposed amendments

The administration of the tax system is in practice based on taxpayers assessing their own tax liabilities by furnishing returns to Inland Revenue. However, the tax legislation is written as if the Commissioner of Inland Revenue still performed all the functions of assessment, as occurred in the years before the tax administration's processes were automated. Today the system relies on taxpayers making the initial assessment of their tax liability. The proposed amendments are to align the tax legislation with the practice of self-assessment.

As well as aligning the law with practice, self-assessment will facilitate the continuing development of policy and legislation in other areas of administrative reform such as the review of compliance and penalties legislation, the review of the tax disputes procedures and the rewrite of the Income Tax Act 1994. Although not involving significant policy change, the introduction of self-assessment will add to and enhance other improvements being made to simplify tax administration.

Application date

Self-assessment will apply from the 2002-03 income year.

Key features

The Commissioner's general power of assessment in section 92 of the Tax Administration Act 1994 (TAA) will be replaced with a specific requirement that taxpayers assess their tax liability each year. Taxpayers will also, under section 33 of the TAA, be required to furnish a notice of self-assessment with their return.

The Commissioner will retain specific powers of assessment to amend a taxpayer's assessment or make an assessment if a taxpayer fails to self-assess.

Consequential changes made to remove legislative impediments to taxpayers making assessments include:

- modifying language that presupposes that assessments are made only by the Commissioner; and
- replacing various discretions of the Commissioner with objective rules in areas affecting the calculation of a taxpayer's tax liability for an income year.

Under an equivalent process to that currently available, taxpayers will be able to propose adjustments to their assessments (other than those agreed with the Commissioner) by notifying the Commissioner by way of a notice of proposed adjustment within two months of furnishing their return.

The Commissioner's administrative function (including the amendment of assessments) will not generally be affected by the changes because the discharge of that function presupposes that taxpayers are already responsible for correctly determining their tax liability. In the same way, the Commissioner's discretions will be retained where they relate to the post-assessment period or are not limited to the assessment process for a particular income year but apply more broadly.

Background

Tax administration practices currently recognise that taxpayers have the best information about their own activities. As such, taxpayers are better placed than the Commissioner to assess their tax liabilities by making the appropriate calculations and furnishing their returns each year. Inland Revenue automatically processes these returns, producing notices of assessment generally reflecting the information on each return. This approach is supported by the audit process, which may result in assessments being amended by the Commissioner.

Despite current practice, self-assessment is not reflected in the tax legislation. Instead, our tax legislation is written as if it were the Commissioner who actually performed all assessment activities. At the same time, however, a number of key obligations that support self-assessment practices have already been legislated: for example, under section 15B of the TAA, a taxpayer is required to "correctly determine the amount of tax payable by the taxpayer under the tax laws".

Legislating for self-assessment will provide a more consistent framework by aligning the legislation with practice, thus allowing taxpayers' obligations to be provided for more clearly and directly in our tax laws.

Legislating for self-assessment will support reforms in tax administration implemented in the 1990s that were designed on the basis that self-assessment would be enacted. These areas of reform include:

- binding rulings, introduced in 1995;
- the compliance and penalty legislation and dispute procedures introduced in 1996;
- the rewrite of the Income Tax Act; and
- more recently, tax simplification measures removing the requirement for most wage and salary earners to file returns from the 1999-2000 year.

The need to align the legislation with practice was first signalled in August 1994 in the discussion document *Taxpayer compliance, standards and penalties*. Subsequent reforms to tax administration have been designed on the basis of the proposed move to explicit self-assessment. The discussion document *Legislating for self-assessment of tax liability* was released in August 1998.

Detailed analysis

New section 92 and definition of “assessment”

In section 92 of the TAA, the requirement for the Commissioner to make all income tax assessments will be replaced with a requirement for taxpayers to assess their taxable income and income tax liability. The self-assessment will also include an assessment of any net loss and terminal tax or refund due. The Commissioner will retain the power to make default assessments under section 106 and to amend assessments under section 113 of the TAA.

Definition of “assessment”

The definition of “assessment” will be amended to reflect that either the taxpayer or the Commissioner may be performing the assessment function, depending on the context. The definition will also include all amendments to assessments. The definition will apply in both the TAA and the Income Tax Act 1994.

Notice of self-assessment

Under section 33 of the TAA, taxpayers will be required to include a notice of their self-assessment in their return of income.

No separate determination process for losses

Replacing the Commissioner’s general power of assessment in section 92 of the TAA with a specific requirement for taxpayers to assess themselves no longer requires losses to be determined by the Commissioner.

Losses will be self-assessed as part of the process of making an assessment each year. Amendments will remove the specific references to loss determinations made by the Commissioner, with the result that the treatment of losses will be more clearly integrated with the assessment processes. In particular, the determination of loss processes set out in section 92(2)-(4) will be removed. As such, taxpayers’ losses will be available subject to meeting the objective requirements in the loss rules in the Income Tax Act.

Other determination processes removed

In the same way as the determination process is no longer required in relation to losses, neither are the determination processes required in relation to foreign tax credits or carrying forward controlled foreign company tax credits.

Thus section 115 of the TAA and section LC 4(8) of the Income Tax Act are being removed, with the necessary consequential changes made through the tax legislation.

Ensuring finality for non-filing taxpayers

Taxpayers not required to file a return because they have only wage, salary, interest or dividend income satisfy their tax liability by having tax withheld and paid by employers and banks. Taxpayers must ascertain whether in any given year they meet the requirements to be non-filers. Non-filing taxpayers will be considered to have assessed their tax liabilities for an income year to ensure their respective tax positions for a year become certain and final in the same way as for filing taxpayers.

Removing Commissioner discretions and references to the “Commissioner”

Consequential amendments are made to remove legislative impediments to taxpayers making assessments. These include:

- replacing various discretions of the Commissioner with objective rules in areas affecting the calculation of a taxpayer’s tax liability for an income year; and
- modifying language that presupposes that assessments are made only by the Commissioner.

Example 1

Provisions currently written in a form such as:

... such area as, in the opinion of the Commissioner, is required for the reasonable occupation of those premises ...

will be re-expressed as:

... such area as is required for the reasonable occupation of those premises ...

Example 2

Provisions currently written in a form such as:

*No deduction is allowed ... except to the extent that **the Commissioner is satisfied that the interest has been paid during the income year.***

will be re-expressed as:

No deduction is allowed ... except to the extent that the interest has been paid during the income year.

Example 3

Provisions currently written in a form such as:

The Commissioner may allow a deduction ...

will be re-expressed as:

A deduction is allowed ...

Market value

The Commissioner's discretion is often provided for in relation to valuations. In practice, however, this generally means the Commissioner will audit the values used by the taxpayer, checking that they correspond to market values. Thus, for example, valuation rules, including provisions for the Commissioner to determine a value, will be re-expressed, replacing the reference to the Commissioner with a reference to market value.

Example 4

Provisions currently written in a form such as:

An amount equal to such amount as the Commissioner determines, in such manner as the Commissioner thinks fit, was the value of that asset ...

will be re-expressed as:

The amount of the market value of that asset ...

Adjustments for incorrect accounting practices

Section EC 1, concerning adjustments for incorrect accounting practices, applies in situations already covered by the Commissioner's general power to amend assessments. Consequently, this section will be repealed and replaced with a more targeted provision that requires an adjustment to be made when changing accounting bases, from a cash to accruals basis and vice versa.

Thus, for example, in a year a taxpayer changes from a cash to accrual accounting method, amounts owing to the taxpayer must be recognised as gross income and amounts owed by the taxpayer must be recognised as a deduction. The amendments will clarify how the amounts in question should be recognised, so they are recognised once, rather than leaving open the possibility that the income or expenditure may not ever be taxed or deducted properly.

REMEDIAL AMENDMENT TO THE ESTATE AND GIFT DUTIES ACT 1968

(Clauses 230, 231 and 232)

Summary of proposed amendment

The proposed amendment removes the exemption from gift duty when the gift of a financial arrangement is treated as having occurred at market price under the accrual rules. In effect, the amendment restores the law as it applied to gift duty on gifts of financial arrangements before the enactment of an earlier amendment on 10 October 2000.

Application date

The repeal of these sections will be retrospective to their application date, although financial arrangements transferred between 10 October 2000 and the date of the introduction of the amending legislation into Parliament will continue to be exempt from gift duty.

Key feature

Sections 75BA, 75BB and 75BC of the Estate and Gift Duties Act 1968 are to be repealed so that a gift of a financial arrangement will not be exempt from gift duty.

Background

The Taxation (GST and Miscellaneous Provisions) Act 2000 amended the accrual rules so that taxpayers who gift a financial arrangement do not receive an unintended deduction for the value of the financial arrangement. This was achieved by providing that when a financial arrangement is gifted it will be treated as if it had been transferred for its market price.

At the time, officials considered that it was necessary to amend the Estate and Gift Duties Act in order to avoid double taxation. The consequential amendment provided that when the gift of a financial arrangement was treated as having occurred at market price under the accrual rules, the transfer would be exempt from gift duty. The exemption applied retrospectively from the implementation date of the accrual rules.

It is now clear that double taxation does not arise in this situation. In the absence of double taxation, a gift of a valuable asset (whether it be cash or financial arrangement) should be subject to gift duty. Consequently, there should be no exemption from gift duty for gifts of financial arrangements.

However, taxpayers who transferred financial arrangements following the enactment of the exemption on 10 October 2000, but before the introduction of the proposed amendment into Parliament, will continue to be exempt from gift duty.

GST ON SUPPLIES TO VISITING FOREIGN-BASED PLEASURE CRAFT

(Clause 228)

Summary of proposed amendment

The amendment will allow the zero-rating of the final provisioning of consumable stores supplied to a foreign-based pleasure craft that departs New Zealand. This is because the goods in question are likely to be consumed outside New Zealand and therefore should not be subject to GST.

Application date

This amendment will apply from the date of enactment.

Key features

Section 11 of the Goods and Services Tax Act (GST Act) is being amended to allow the final provisioning of consumable stores to foreign based pleasure craft departing New Zealand to be zero-rated (free of any GST impost). Foreign-based pleasure craft will be defined as those pleasure craft in New Zealand as temporary imports under Customs legislation. “Consumable stores” will be defined as goods supplied for consumption by the passengers and crew and will include fuel and lubricants, but exclude spare parts and equipment.

Background

The supply of goods to a destination outside New Zealand is generally zero-rated, provided that the goods are entered for export under the Customs and Excise Act 1996. Zero-rating of goods provides relief on the basis that the goods are not intended to be consumed in New Zealand and therefore should not be subject to GST.

Section 11 allows stores for consumption supplied on a departing aircraft, fishing vessel or foreign-going ship, other than pleasure craft, to be zero-rated. The extension to include foreign-based pleasure craft is consistent with the overall framework of GST in that the goods in question are likely to be consumed outside New Zealand. The amendment will not apply to New Zealand based yachts departing New Zealand as there is a greater risk that the goods supplied will be consumed in New Zealand, such as when the yachts return. Spare parts and equipment will be excluded, as there is a risk that the goods will be on-sold to residents and/or consumed in New Zealand.