Taxation (Annual Rates, GST, Trans-Tasman Imputation and Miscellaneous Provisions) Bill

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Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

8 October 2003

Prepared by the Policy Advice Division of the Inland Revenue Department and the Treasury

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GST and financial services: zero-rating supplies

OVERVIEW

Clauses 104(2), 109(2), 111, 113(5), 114, 115, 116(1) and 119

The proposed changes to the Goods and Services Act 1985 (the GST Act) will zero-rate business-to-business supplies of financial services. This is intended to alleviate distortions caused by the current exempt treatment of financial services, which has the potential to overtax the supply of financial services to businesses.

The changes integrate the supply of financial services more fully into the GST system by taxing at the rate of zero-percent certain supplies of financial services to businesses and allowing financial service providers to claim input tax credits in respect of those supplies. This is in contrast to the current exempt treatment whereby GST is not charged and financial service providers are unable to claim input tax credits.

The proposed changes zero-rate the supply of financial services from financial service providers to business customers if the customer (or the group to which the customer belongs) is a GST-registered person who has an activity of making taxable supplies that equal or exceed 75 percent of their total supplies in a 12-month period.

This means that a financial services provider will be able to zero-rate supplies of financial services made to most businesses such as those that sell goods at a wholesale or retail level, are involved in manufacturing or primary production or provide professional services.

Financial services will not be zero-rated if:

- the services are supplied to businesses such as other financial institutions which make exempt supplies that exceed 25 percent of their total supplies;[1] or
- the services are supplied to non-registered persons (or final consumers).

Services that can be zero-rated under these proposals are set out in the definition of "financial services" contained in the GST Act. The definition of financial services is not being amended in this bill. This definition was, however, reviewed as part of the proposals to zero-rate business-to-business supplies of financial services. The government proposed in the October 2002 discussion document *GST and financial services* that the activities of third-parties be excluded from the definition, thereby making them taxable at the standard rate of GST of 12.5 percent. However, because of the negative impact it was suggested this reform would have on the savings industry it has not proceeded further.

[1] Supplies of financial services as between financial institutions will, however, qualify for a special input tax credit for the supplier to the extent that the recipient financial institution supplies financial services to taxable businesses.

Eight submissions were made supporting the proposed zero-rating of business-to-business supplies of financial services. Of the eight submissions received, one supported the reforms as part of a package associated with the proposed introduction of the reverse charge mechanism. Five made recommendations about the scope of the zero-rating proposals and various other technical issues.

ZERO-RATING BUSINESS-TO-BUSINESS SUPPLIES OF FINANCIAL SERVICES

Issue: Support proposals

Clauses 104(2), 109(2), 111, 113(5), 114, 115, 116(1) and 119

Submissions
(1W – New Zealand Business Roundtable, 13 – New Zealand Venture Capital Association Inc, 18W – Deloitte Touche Tohmatsu, 19 – Business New Zealand, 32 – New Zealand Bankers' Association, 33 – PricewaterhouseCoopers, 39 – Institute of Chartered Accountants of New Zealand, 45W – Promina)

The submissions note their support for the proposed amendments that zero-rate business-to-business supplies of financial services. The New Zealand Bankers' Association supports the amendments as part of the package associated with the introduction of the proposed reverse charge.

Business New Zealand hopes that the savings created by the proposals will be passed on to business consumers.

Submissions also endorsed the government's intention that Inland Revenue issue public guidelines to assist taxpayers in determining when supplies of financial services may be zero-rated.

Recommendation

That the submissions be noted.

Issue: Maintain an ongoing review of policy principles concerning GST and financial services

Submission
(32 – New Zealand Bankers' Association)

It is possible that academic developments both in New Zealand and internationally will enable further refinement of the GST treatment of financial services.

Comment

Officials are continuing to review international developments on the conceptually correct GST treatment of financial services.

Recommendation

That the submissions be noted.

Issue: Valuing financial services

Submission
(39 – Institute of Chartered Accountants of New Zealand)

The basis for determining the value of an exempt supply should be legislated or Inland Revenue be required to publish a safe harbour basis for determining the value of an exempt supply.

Comment

Financial services can be priced in one of two ways. A financial institution may charge its customers a discrete fee (for example, 25¢ per transaction regardless of the value of the transaction) or it may take a margin on the transaction based on a set percentage, such as an interest rate or commission (for example 10 percent of funds managed or a difference between rates or percentages such as a 2 percent charge, being the difference between a lending rate of 6 percent and a borrowing rate of 4 percent).

In most cases the value of a supply of financial services should be determined on the basis of the net amount received for the service.[2] This means that the value of the supply must take into account the costs or fees incurred in making that supply.

Officials consider that a net output and input approach should be the general rule used for valuing financial services under the proposed new zero-rating rules in relation to business-to-business supplies of financial services. This rule is applied in respect of determining the value of supplies for the purposes of apportioning input tax credits between taxable and exempt supplies. For this rule to apply generally, it is assumed that most financial service providers will adopt a turnover or Commissioner-approved method of apportioning input tax credits.

However, officials understand that some financial service providers may adopt different methods of apportioning input tax, such as directly attributing input tax to taxable and exempt supplies. For certain supplies, such as those for which a specific fee is charged, it may be appropriate for the value to be determined on a gross basis.

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[2] This is consistent with the principles established in the European Court of Justice decision *Commissioners of Customs and Excise v First National Bank of Chicago* (case C-172/96).

This variation in the way that financial services can be valued and the variety of methods that can be used to apportion input tax means that including a rule in the GST Act that provides an acceptable basis of valuing exempt supplies may not be appropriate for all taxpayers. However, it is recommended that Inland Revenue prepare a commentary on the best way to value financial services in the guidelines.

Recommendation

That the submission be declined but note that commentary on the valuation of exempt supplies will be included in the proposed Inland Revenue guidelines on how registered persons should comply with the new zero-rating of business-to-business supplies of financial services.

Issue: Commencement date

Clause 2(15)

Submissions
(30 – Investment, Savings and Insurance Association of New Zealand Inc, 32 – New Zealand Bankers' Association)

The proposed deferred application date of at least 12 months after the date that the bill receives the Royal assent is supported. For ease of compliance the application date should coincide with the start of a quarter (1 April, July, October or January). *(Investment, Savings and Insurance Association of New Zealand)*

A 12-month leeway, as proposed, is required in order to enable banks and other service providers to introduce systems changes required to implement the proposals. *(New Zealand Bankers' Association)*

Comment

As noted in the commentary on the bill, the government has recognised that the proposed reverse charge on imported services and the proposal to zero-rate business-to-business supplies of financial services will require affected registered persons, particularly those in the financial services sector, to change accounting, computer and similar technical systems. For this reason the proposed reverse charge on imported services and zero-rating of business-to-business supplies of financial services will apply no earlier than 12 months after enactment.

Officials agree that the commencement date of the proposals should coincide with the start of a financial quarter. This will further assist in reducing compliance costs associated with the transition to the introduction of the reverse charge and zero-rating of business-to-business supplies of financial services.

Recommendation

That the submissions be accepted.

Issue: Meaning of term “financial services” – financial intermediation

Clause 103

Submissions
(13 – New Zealand Venture Capital Association Inc, 39 – Institute of Chartered Accountants of New Zealand, 42W – KPMG)

- The definition of “financial services” should be amended to include the holding of both debt instruments and equities.

  The GST Act should be amended to make clear that the activity of investment in equity and the continued holding of equity investments in an equity fund are financial services.

  A clear definition is required and a legislative, rather than operational, response will minimise compliance costs and uncertainty. *(Institute of Chartered Accountants of New Zealand, KPMG)*

- The business-to-business proposals should apply to all financial intermediation services, including the activities of equity funds. *(New Zealand Venture Capital Association, Institute of Chartered Accountants of New Zealand)*

Comment

Officials have spoken to the Venture Capital Association and ICANZ regarding the issues raised in their submissions. From these discussions and the written submissions it appears that the issues concern the application of the definition of financial services as contained in the GST Act rather than the new zero-rating rules contained in this bill.

The submissions are in response to various ways that some financial transactions are structured and the decisions financial service providers have made in relation to outsourcing certain activities or retaining them in-house. As such, the reforms suggested by submissions will have a significant impact on the way that GST applies to financial services. The impact of this on the business community and the government in terms of revenue forgone has yet to be determined.

Officials consider that further work is required to resolve the underlying principles supporting the definition of “financial services” and recommend that additional consultation be undertaken with interested parties. Officials recommend including the issue on the government’s tax policy work programme and will report to Ministers once the issues have been properly considered.

Recommendation

That the submissions be declined but note that officials are continuing to work on this issue and recommend including it on the government’s tax policy work programme.

Issue: Meaning of term "financial services" – management services

Clause 103

Submission
(39 – Institute of Chartered Accountants of New Zealand)

The treatment of management services for other investment vehicles such as group investment funds and unit trusts should be the same as the treatment of superannuation schemes and life insurance.

Comment

There are two options for reform in relation to the treatment of management services supplied to group investment funds and unit trusts. These are to either:

- remove the management of superannuation funds from the scope of the definition of financial services; or
- include the management of group investment funds and unit trusts within the scope of the definition (as advanced by submissions).

The outcome of either option ensures the consistent GST treatment of management fees in relation to long-term savings products. Officials consider that the option most consistent with the overall objective of properly integrating financial services into the GST base and removing tax cascades would be to remove the management of superannuation funds from the definition of financial services. This would, however, be strongly opposed by the long-term savings industry, and officials therefore recommend that, without further consultation, no change occur in this area at this time.

Recommendation

That the submission be declined.

Issue: Meaning of term "financial services" – participatory securities

Clause 103

Submission
(43W – Russell McVeagh)

A new definition of "participatory security" in the definition of "financial services" in the GST Act should be inserted. This new definition should refer to the use of the term "participatory security" in the Income Tax Act 1994 rather than the Unit Trust Act 1960.

The effect of this change would be to widen the definition by not limiting it to unit trusts offered to members of the public. The new definition should apply retrospectively.

Comment

The GST treatment of participatory securities and other equity securities is currently under review by officials. Officials have a number of concerns relating to use of participatory securities (and equities generally) being used to recharacterise taxable supplies of goods and services as exempt financial services and with the appropriate GST treatment of equities generally. These issues were raised in the recent case *Gulf Harbour Development Ltd v Commissioner of Inland Revenue*[3] and in submissions received on the discussion document *GST and financial services*,[4] in relation to timeshare arrangements.

Because of the current work in this area, officials consider that the change recommended by the submissioner should not proceed at this time.

Recommendation

That the submission be declined but note that officials are currently reviewing the GST treatment of participatory securities and other equities as part of the government's tax policy work programme.

Issue: New sections 11A(1)(q) and (r) – the 75 percent threshold

Clause 109(2)

Submissions
(39 – Institute of Chartered Accountants of New Zealand, 45W – Promina)

- The proposed 75 percent taxable supplies threshold (to determine whether a customer of a financial institution is entitled to receive zero-rated supplies) should be removed and replaced with the principal purpose test.

  Alternatively, the proposed 75 percent threshold should be lowered to a percentage greater than 50 percent to allow flexibility and reduce compliance costs. *(Institute of Chartered Accountants of New Zealand)*

- The proposed 75 percent threshold should be lowered to 70 percent. Lowering the threshold from 75 percent to 70 percent will provide a greater margin of error for suppliers who, in most cases, will be obliged to rely on estimates of the level of taxable supplies made by their customers. It will also broaden the base of supplies to which the zero-rating provision can be applied. *(Promina)*

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[3] Unreported, High Court, M1930-SD01, 27 June 2003.
[4] *GST and financial services: a government discussion document*, October 2002.

Comment

Officials consider that the 75 percent threshold is an appropriate threshold for determining when a customer is eligible to receive zero-rated financial services.

The proposed zero-rating rules are designed to reduce the extent to which tax cascades of GST may arise in relation to supplies of financial services between financial service providers and business customers. This means that zero-rating should apply only when the business customer has a predominant activity of making taxable supplies since, as a general rule, tax cascades do not arise when supplies are made to businesses that make exempt supplies.

Because the precise setting of the threshold is a matter of judgement, as with most thresholds, opinions will vary as to where it is best set. The threshold of 75 percent was based on the understanding that most business taxpayers would clearly fall on one side or other of a percentage of this size. For example, businesses that sell goods at a wholesale or retail level and manufacturers may have an incidental function of providing credit but it will rarely, if ever, amount to close to 25 percent of turnover. This threshold, supported by appropriate guidelines, should be sufficient to address concerns and provide taxpayers the necessary flexibility when ascertaining whether or not to zero-rate financial services to business customers.

Officials consider that any problems associated with the threshold will, in any event, still exist even if the threshold were set at a lower percentage.

Further, early comments from interested parties on these proposals suggest that at least some large financial service providers, which have a significant proportion of final consumer customers, will, under these proposals, be making taxable supplies of more than 50 percent of their total supplies. This means that a lower percentage threshold could provide those institutions with full input tax credits (albeit with subsequent apportionment to reflect the level of non-taxable supplies), which may be excessive relative to the size of the tax cascade the reforms are attempting to address.

Recommendation

That the submissions be declined.

Issue: New sections 11A(1)(q) and (r) – 12 month period of assessment

Clause 109(2)

Submissions

(18W – Deloitte Touche Tohmatsu, 39 – Institute of Chartered Accountants of New Zealand

New sections 11A(1)(q) and 11A(1)(r) should be redrafted to clarify that the twelve-month period can include months either prior or subsequent to the taxable period in which the financial services are supplied. This flexibility will eliminate the potential for abnormal activities conducted by taxpayers to affect their overall eligibility to receive zero-rated financial services.

Comment

As noted in the discussion document *GST and financial services*, the government intended that the period of assessment could be either retrospective or prospective, depending on the nature and circumstances of the customer.

New sections 11A(1)(q) and (r) have been drafted to refer to "a 12-month period that includes the taxable period". This means that the 12-month test is already drafted in such a way that allows a financial institution to undertake a prospective and/or retrospective analysis of a customer's activity.

Recommendation

That the submissions be declined.

Issue: New section 11A(1)(r) – drafting issue

Clause 109(2)

Submission

(44 – MinterEllisonRuddWatts)

The reference to "person" in the second line of new section 11A(1)(r) should be a reference to a "registered person".

Recommendation

That the submission be accepted.

Issue: New section 11C – election as to whether zero-rating rules apply

Clause 111

Submission
(26 – New Zealand Law Society)

The new zero-rating rules as they affect the supply of financial services could potentially impose significant compliance costs in terms of obtaining information from a recipient of the supplier's financial services as to the actual level of taxable supplies made by those recipients. The new zero-rating rules are mandatory unless the taxpayer elects out.

The opposite situation to that required by new section 11C should be the case. That is, a financial institution who wishes to take advantage of the new zero-rating provisions should elect into those rules. This is consistent with other elective provisions in the GST Act which, if elected to be applicable, involve an element of compliance cost.

Comment

Whether taxpayers should be required to elect into or out of the new zero-rating rules involves balancing two competing considerations:

- The new rules result in the correct policy outcome and produce a reduction in the economic inefficiencies created by the present exempt treatment of financial services. Taxpayers should be required to apply the zero-rating rules because continuing to exempt business-to-business supplies of financial services potentially gives rise to a cost for businesses.
- As the new rules are likely to result in an increase in compliance costs with limited benefits to some financial service providers and their customers, taxpayers should be required to elect into the rules only if they consider that the benefit of the new rules outweigh the costs.

On balance, officials consider that the better policy response is to allow taxpayers to elect into the new rules. This means that financial service providers will have to balance their customers' expectations of zero-rated financial services and the cost that the institutions will need to incur to determine the eligibility of those customers under the rules against the overall benefit of an increased entitlement to input tax credits.

While this means that exemption will remain the default treatment of financial services (thereby retaining inefficiencies in the New Zealand economy), officials acknowledge that the costs associated with the new rules may be high for taxpayers other than the larger financial institutions in New Zealand.

Recommendation

That the submission be accepted. New section 11C should be redrafted to provide that taxpayers must elect into the rules rather than elect out.

Issue: New sections 11C and 11D – placement of election provision

Clause 111

Submissions
(18W – Deloitte Touche Tohmatsu)

The placement of new section 11C, which provides that registered persons may elect out of the new zero-rating of business-to-business supplies of financial services, does not fit within the current scheme and layout of the GST Act. New section 11C should be inserted into section 21 of the GST Act.

Comment

The submission's concern would appear to apply also to the placement of new section 11D regarding the methodology used by taxpayers for zero-rating business-to-business suppliers of financial services.

While officials agree that section 11C and section 11D should be moved, we do not agree that they should be inserted into section 21. Section 21 of the GST Act imposes a liability for GST (output tax) when goods and services are applied for a purpose other than that of making taxable supplies. Sections 11C and 11D do not relate to the imposition of output tax. Officials do note, however, that the current placement of these sections is inconsistent with the scheme of the Act (as raised by the submissioner), and we recommend moving the new sections to follow section 20 of the GST Act.

Recommendation

That the submission be accepted in part by moving sections 11C and 11D to follow section 20 and providing appropriate cross-references to assist users of the GST Act.

Issue: New section 11D – application of new section 11A(1)(q) and (r) – guidelines and safe harbours

Clause 111

Submissions
(42W – KPMG, 44 – MinterEllisonRuddWatts, 45W – Promina)

- The Commissioner should issue guidelines to assist registered persons to determine when a supply of financial services can be zero-rated. If a method is approved for determining an amount based on supplies made by another person, that should be considered a "safe harbour" and the Commissioner should not be able to reassess any GST returns furnished on that basis.

The guidelines should be prepared in consultation with interested parties, be publicly available and cover all relevant industry groups.

If a Commissioner-approved method is not available for taxpayers, interest and shortfall penalties should not apply.

If there are revenue concerns the "safe harbour" should not apply to associated person transactions. *(KPMG)*

- New sections 11A(1)(q) and (r) should affirmatively allow zero-rating when a financial institution correctly identifies a recipient as a person who, according to a method approved by the Commissioner, makes taxable supplies in excess of the 75 percent threshold. In these circumstances, adopting the method approved by the Commissioner should be a "safe harbour" protecting the taxpayer against any requirement to make subsequent adjustments. *(MinterEllisonRuddWatts)*
- The development of administrative guidelines by Inland Revenue is supported as this will assist taxpayers in determining whether customers are appropriately categorised as businesses that are entitled to receive zero-rated financial supplies. As part of any administrative guidelines, specific categories of customers or products should be identified as automatically qualifying for zero-rating. *(Promina)*

Comment

The application of the new zero-rating rules relating to business-to-business supplies of financial services as set out in new section 11D allows taxpayers to adopt one of two practices: identify the particular characteristics of a customer on a transaction by transaction basis or apply a method approved by the Commissioner of Inland Revenue.

The nature of the business undertaken by financial service providers suggests that analysis on a transaction-by-transaction basis will not be practical for the majority of supplies to businesses. For this reason the government has acknowledged that guidelines will be required to assist taxpayers in determining when supplies of financial services should be zero-rated.[5]

Reasonable care by a financial service provider in ascertaining a customer's characteristics should provide a sufficient safe harbour against an assessment being amended by the Commissioner and interest and shortfall penalties, even if it is subsequently shown that the customer provided incorrect information to the financial institution. Compliance with the guidelines will provide a strong indication that taxpayers have taken reasonable care in discharging their tax obligations.

In some instances reasonable care will have been taken, but a change is required to the GST treatment of certain transactions, either as a result of a change in the customer's activity or the financial institution becoming aware that information supplied by the customer was not correct. In such cases, given that the financial service provider will have complied with the guidelines at the relevant time, it is expected that the financial service provider will be required to alter the GST treatment of future transactions only

[5] Refer Commentary on the Bill – Taxation (Annual Rate, GST, Tran-Tasman Imputation and Miscellaneous Provisions) Bill, page 8.

from the date that it was alerted to the change or to the fact that incorrect information was supplied.

The Commissioner may, however, need to amend an assessment when adherence to the guidelines would clearly result in an outcome that is inconsistent with the objective of the zero-rating rules – for example, if the guidelines inadvertently zero-rated supplies to those that do not make predominantly taxable supplies or final consumers.

An administrative process for determining reasonable care as a standard and for what constitutes reasonable care is considered preferable to legislation as it provides the flexibility needed for Inland Revenue and taxpayers to reach agreed positions which are in line with the objectives of zero-rating. Inland Revenue officials anticipate that the guidelines will be prepared in consultation with interested parties and that these will be made publicly available once finalised. This process is expected to commence early next year.

Recommendation

That the submissions and officials' comments be noted.

Issue: New section 11D – level of detail that needs to be obtained from customers

Clause 111

Submissions
(39 – Institute of Chartered Accountants of New Zealand, 45W – Promina)

- The information required to estimate the characteristics of a customer should be limited to the following information only:
  - the GST registration status of the recipient or a reasonable assumption;
  - a broad description of the recipient's business;
  - if relevant, a broad description of the business and registration status of the recipient's customers.

  Recipients should not be compelled to divulge any information and suppliers should not be required to update the information more than annually. *(Institute of Chartered Accountants of New Zealand)*
- New section 11D should be amended to provide further clarification as to how the level of taxable supplies made by customers and financial intermediaries should be determined. Further, the level of accuracy required in determining the level of taxable supplies and the ability to place reliance on information provided by customers should be clarified. *(Promina)*

Comment

Officials consider that, within the legislative framework, conditions for when zero-rating may apply are best determined administratively by allowing taxpayers and Inland Revenue to develop methodologies for whether a customer is eligible to receive zero-rated supplies.

Consultation on the proposals with interested parties has shown that, in the interests of reducing compliance costs and other concerns, there is a strong preference that the zero-rating rules work without the financial institution being required to contact the customer. As noted in the discussion document *GST and financial services*,[6] the government considers that as the difference between zero-rating and exemption can generally be described as the respective ability to claim input tax credits, it is expected that the recipient of financial services should not be required to have any direct involvement in terms of the provision of any information in order to determine whether a transaction qualifies for zero-rating.

Officials consider that this approach is consistent with the need to reduce compliance costs, as is our recommendation that taxpayers are given the option to elect into rules rather than having to specifically elect out.

The criteria presented by ICANZ appear to be broadly consistent with what is expected would be required at an administrative level under the proposed guidelines. It is not recommended that there be a legislative set of criteria as this will not provide the flexibility to ensure that the information required is appropriate for individual circumstances.

Recommendation

That the submissions be accepted in part but further clarification of the information sought from taxpayers be made through guidelines, not legislation.

Issue: New section 20C

Clause 114

Submissions

(42W – KPMG)

The submission raises a number of issues concerning the application of new section 20C (which allows an input tax credit in respect of certain supplies between financial service providers):

- Item "a" of new section 20C should be redrafted so that it is based on all available deductions for all supplies made by the registered person rather than as it is currently written, which limits item "a" to deductions in respect of supplying financial services.

[6] *GST and financial services*, page 25.

- New section 11D should clearly apply to deductions available under new section 20C. New section 11D provides that a registered person must determine whether a customer is eligible to receive zero-rated financial services from statistics obtained from the customer or by using a method that is approved by the Commissioner. In respect of new section 20C, components "d" and "e" of the formula are based on another person's taxable and total supplies respectively.
- The Commissioner should be able to approve a method to determine the fraction d/e. It is arguable that new section 11D would not apply to deductions claimed under new section 20C.
- In order to reduce compliance costs it is recommended that the Commissioner approve a method of determining supplies made by another party in respect of deductions made under new section 20C.
- New section 20C should be redrafted to apply to suppliers of financial services that do not use the turnover method to apportion input tax.

Comment

New section 20C is intended to apply in a different manner from the general zero-rating rules in proposed sections 11A(1)(q) and (r).

The proposed section 20C is in response to submissions that the proposals contained in the discussion document *GST and financial services* did not adequately address the tax cascade that could arise in respect of supplies between financial service providers. As noted in the discussion document,[7] broadly applying the basic zero-rating rules for supplies between financial service providers could create a tax advantage in respect of supplies to final consumers. This would arise where financial services supplied to an interposed financial institution and on-supplied to the final consumer were zero-rated. As the case for entirely zero-rating financial intermediation has not been made, officials consider exemption is still the most appropriate policy response in relation to taxing business-to-consumer supplies of financial services.

The government recognised, however, that denying the zero-rating of supplies of financial services between financial service providers, to the extent that the services are on-supplied to eligible business customers, does not achieve the best policy outcome as a proportion of the tax cascade would remain.

For these reasons new section 20C was developed. Provided actual information in relation to business supplies by those financial service providers is obtained, supplies of financial services to recipient financial service providers are able to be recognised in the overall amount of input tax credits claimed by the first financial service provider.

Allowing the Commissioner to approve a general method to determine the fraction d/e, such as an industry average, was considered at the time of consultation but officials noted that for the main trading banks alone there is a differential of up to 25 percent in the level of customers that are potentially eligible to receive zero-rating. This variation is expected to be considerably more pronounced across the wider

[7] *GST and financial services*, page 23.

financial services industry. Officials therefore consider that an industry average method would not be an appropriate option as the level of relief may not correspond to the activities of the parties concerned.

Concerns with accuracy have been integral in developing the proposals to zero-rate business-to-business supplies of financial services. For this reason the deduction under new section 20C must correlate to the activities of the recipient financial institution and their respective ratio of business and non-business customers. New section 11D concerns estimates of supplies that should be zero-rated and is not, therefore, relevant to the application of new section 20C.

In relation to the other points raised by the submission:

- *Whether item "a" of the formula gives the right outcome*: Inland Revenue will, in setting guidelines for zero-rating, review the deduction allowed under 20C to determine at a detailed level if it provides the correct policy outcome. While the numerical example provided in the submission appears compelling, it assumes that the GST cost incurred is evenly spread across all activities. This is not always the case. Further, it does not take into account the fact that a taxpayer may adopt a number of methods of apportionment whereby certain costs may be directly attributed to exempt and taxable activities. Officials note that the issue is relevant only for entities that are not solely engaged in the provision of financial services and who are not therefore currently subject to the same level of tax cascading as those who are.
- *That the formula be re-drafted so that it applies more broadly*: New section 20C does not assume that taxpayers use the turnover method of apportioning input tax. The formula is meant to apply broadly across different apportionment methodologies but requires that information be formatted in a particular manner to allow taxpayers to determine the value that can be claimed as a deduction from output tax. The only complexity in relation to the formula is that it requires the appropriate information to be supplied by the direct supplier. This is seen as necessary to ensure that if accurate information is not provided by the direct supplier the deduction will not be allowed.

Recommendation

That the submission be declined but that in relation to item "a" Inland Revenue should review the practical application of the formula to determine whether it achieves the correct policy outcome.

Issue: Base maintenance (1)

Clause 104, 115 and 116

Submissions
(39 – Institute of Chartered Accountants of New Zealand, 42W – KPMG)

The proposed amendments (which restrict the ability to obtain up-front input tax credits for second-hand goods) could be seen as revenue protective at the expense of consistency with the policy underlying the main zero-rating proposals. *(Institute of Chartered Accountants of New Zealand)*

Section 3A(2)(c) should not be amended to deny a second-hand goods notional input tax credit when goods are acquired for the making of supplies that are zero-rated under the main zero-rating proposals. *(KPMG)*

Comment

The restriction in relation to the one-off deduction is necessary to ensure that when the principal purpose for goods and services changes from an exempt to a taxable purpose as a result of zero-rating there will not be a significant revenue loss from up-front input tax credits. Rather, the additional input tax credits arising from the new zero-rating rules will be required to be claimed periodically over the period during which the goods and services are used.

The restriction in the ability to claim credits for second-hand goods is intended to prevent large one-off input tax credits from the transfer of existing assets (for example, land) from an entity that is exempt to an associated entity that has a principal purpose of making taxable supplies as a result of the new zero-rating rules.

Both are, therefore, anti-avoidance measures aimed at protecting the revenue base and are not inconsistent with other anti-avoidance provisions in the GST Act.

Recommendation

That the submissions be declined.

Issue: Base maintenance (2)

Submission
(Matter raised by officials)

An amendment is necessary to ensure that supplies of financial services between associated parties are required to be valued at market if the financial services provider is entitled to zero-rate the supply under proposed section 11A(1)(q) or (r) or is entitled to a deduction under proposed section 20C.

Comment

The GST Act generally requires that supplies between associated persons are valued at open-market value if there could otherwise be an underpayment of GST. This rule is primarily directed at supplies made to unregistered recipients at less than full value. However, if the supplier and the recipient are both registered for GST this general rule is "switched off" as any increase in GST (output tax) returned by the supplier would be matched by an equivalent increase in input tax credits available to the recipient. The transaction in question would, therefore, be revenue neutral from the government's point of view, and requiring an uplift to market value would impose unnecessary compliance costs for no revenue gain.

In respect of supplies of financial services it has previously not been necessary to prescribe a valuation rule as the supplier is generally not required to charge GST on the supply of financial services and the recipient is unable to recover an input tax credit as GST has not been paid. The new zero-rating rules in proposed section 11A(1)(q) and (r), concerning supplies of financial services to businesses, and the deduction allowed under proposed section 20C, in respect of supplies of financial services between financial services providers, change this position.

Officials consider that it is necessary to require financial services providers to value supplies of financial services to associated entities at market. This is primarily to ensure that there is no overvaluation of the financial services supplied. Unlike the normal situation when ordinarily taxable non-financial goods and services are supplied between two associated registered persons, the GST consequences created by proposed sections 11A(1)(q) and (r) and 20C are not neutral because of the increase in input tax credits that can otherwise be claimed as a result of removing the exemption of financial services supplied to businesses. For example:

- If a financial services provider supplies zero-rated financial services (under proposed section 11A(1)(q) and (r)) to an associated business it will be able to claim input tax credits in respect of supplying those financial services. If the financial services provider apportions input tax credits on the basis of turnover it may inflate the value of services supplied to the associated business with a view to maximising its overall access to input tax credits. The input tax credits claimed in respect of the supply to the associate may, therefore, be greater relative to the size of the tax cascade the reforms are attempting to address.
- In the case of proposed section 20C the supplier (the first financial services provider) is able to obtain a further deduction of input tax relative to the value of financial services supplied to another (recipient) financial services provider if the recipient supplies financial services to businesses. If the first financial services provider inflates the value of the services supplied this could also create a larger deduction under proposed section 20C relative to the size of the tax cascade the reforms are attempting to address.

Because of these risks, officials recommend that financial services between associated persons be valued at market value if the financial services provider is entitled to zero-rate the supply under proposed section 11A(1)(q) or (r) or is entitled to a deduction under proposed section 20C. This will require an amendment to section 10(3A) of the GST Act to ensure that it does not "switch off" the general rule (that supplies of goods and services between associated person to be valued at market) when supplies of

financial services are made between registered associated persons in these circumstances.

Recommendation

That the submission be accepted.

Issue: New section 26B

Clause 119

Submissions
(30 – Investment Savings and Insurance Association of New Zealand Inc, 32 – New Zealand Bankers' Association, 45W – Promina)

- All but Promina submit that new section 26B, which requires wash-up adjustments to the zero-rating calculation, be removed. *(All)*
- New section 26B can easily result in the continual requirement to make adjustments to prior GST periods as and when information comes to light as to the status of the recipient of a supply.

  The entire zero-rating proposal requires certain estimates/proxies to be established and used as a reasonable basis for determining the level of taxable supplies made by customers who purchase financial services from financial services providers. New section 26B would require banks to constantly determine whether estimates made are accurate, and, if not, to make adjustments accordingly absent any explicit clearance not to do so from the Commissioner. It would not be possible to comply with this requirement. *(Investment Savings and Insurance Association of New Zealand, New Zealand Bankers' Association)*
- Proposed section 26B is supported as it protects taxpayers from penalties and interest until such time as the taxpayer has actual knowledge of the error. However, it should be amended so that an adjustment is only required when the error is detected within four years of the end of the taxable period during which the error arose. *(Promina)*

Comment

Proposed section 26B is intended to address situations when differences arise in the level of input tax recovery allowed for a given period based on a taxpayer's estimation of their zero-rated supplies against what should actually have been claimed for that period. The new section requires an adjustment to be made if a taxpayer has made a return based on supplies made by another person and an inaccuracy in the determination of those supplies has affected the accuracy of the return. If this has resulted in an excessive input tax credit recovery, output tax is payable in respect of the excess. If the result is an under-recovery of input tax credits, further input tax credits are allowed.

The Commissioner can relieve the taxpayer from making an adjustment if satisfied that the taxpayer's estimated amount gives an overall result for zero-rated supplies under sections 11A(1)(q) and (r) that is not significantly greater than the result that would arise if actual rather than estimated figures were used.

New section 26B requires the adjustment to be made either in the taxable period in which the inaccuracy becomes apparent or in a later period that is acceptable to the Commissioner.

Officials note the New Zealand Bankers' Association's concern that it would not be possible to comply with new section 26B since it implies that it is possible to establish an exact, correct figure for zero-rating. Officials also note that, even if it were possible to establish a correct figure, it would need to be established in each case to determine whether new section 26B needed to be applied. This could create significant compliance and administrative costs.

Removing proposed section 26B would, in most cases, mean that compliance with the zero-rating provisions had occurred if the taxpayer had applied a method of estimation agreed with the Commissioner under new section 11D.

However, the Commissioner would be able to use his or her general power to amend an assessment of a taxpayer's return in the event that the taxpayer had not applied the method to the Commissioner's satisfaction, or had not agreed an estimation.

Recommendation

That the submissions by Investment Savings and Insurance Association and New Zealand Bankers' Association be accepted. Officials recommend that clause 119, which introduces new section 26B, be removed from the bill.

Issue: Drafting issue – grouping rules

Clause 122

Submission
(44 – MinterEllisonRuddWatts)

Section 55(7)(d) should be amended so that both taxable and exempt supplies to a member of a GST registered group are treated as made to the representative member. If this is not done, when a supply of financial services is made to a member of a GST registered group other than the representative member it will not be clear whether or not zero-rating is available.

Recommendation

That the submission be accepted.

GST on imported services: introducing a reverse charge

OVERVIEW

Clauses 101, 102, 104(1), 105, 106, 107, 108, 109(1), (3) & (4), 110, 113(1)-(4) & (6), 117, 118, 121, 122, 123 and 124

The proposed changes to the Goods and Services Tax Act 1985 (the GST Act) will introduce a "reverse charge" mechanism to tax certain imports of services. The reverse charge is intended to alleviate the current distortion in favour of imported services created by the non-taxation of imported services compared to the taxation of domestically supplied services. It also aligns New Zealand's GST system with that of most other countries with a VAT or GST system and the treatment of services with that of goods.

The reverse charge will require GST registered recipients of supplies of imported services to self-assess GST on the value of the services if:

- the services are not acquired by a person who makes taxable supplies that represent 95 percent or more of total supplies; and
- the supply of those services, if made in New Zealand by a registered person, would be a taxable supply.

This means that if a registered person has an activity which does not consist of making solely taxable supplies and imports services that would be subject to GST if supplied in New Zealand, the recipient will be required to add GST to the price of the services and return the GST to Inland Revenue.

The recipient of a supply of imported services will be treated as the person who made the supply for the purpose of imposing and enforcing the reverse charge and for determining whether the GST registration threshold is exceeded. For all other purposes in the GST Act the recipient of a supply of imported services will remain the recipient, rather than the supplier, of the services.

The proposed changes also apply the reverse charge to related party internal charges. Such charges will exclude amounts relating to salaries and interest.

Twelve submissions were made on the introduction of a reverse charge to tax imports of services. Two submissions did not support the introduction of a reverse charge, three (two written and one oral) supported the introduction of a reverse charge, and one supported the introduction of a reverse charge as part of a package including reforms to the GST treatment of financial services. Nine submissions made recommendations about the scope of the reverse charge and various other technical issues.

POLICY BASIS FOR THE REVERSE CHARGE

Submissions
(19 – Business New Zealand, 39 – Institute of Chartered Accountants of New Zealand)

A reverse charge should not be introduced, as:

- the substitutability issues it is intended to address only exist theoretically, not in fact;
- it will disadvantage GST groups with non-resident members as opposed to solely resident member groups; and
- it will add costs (including compliance costs) to New Zealand businesses, especially those in the financial sector.

Comment

Submissions state that the services that will be subject to the reverse charge are not substitutable, as New Zealand firms do not produce equivalent services, or, because the New Zealand entity is either a branch or subsidiary of an offshore company, it has no choice but to receive the services from offshore.

While officials understand these concerns, in most instances there is nothing in the inherent nature of the services supplied which would preclude their supply by a third party in New Zealand. In the absence of the reverse charge, the distortionary effects of not imposing GST on such supplies would therefore remain.

Submissions' arguments on the lack of New Zealand-sourced substitutes for services provided from overseas are based on a static view of the market for services, instead of recognising that the market is rapidly changing. The arguments also do not recognise the possibility that the GST disadvantage New Zealand suppliers face may well be a factor in any potential lack of New Zealand substitutes for overseas services.

A reverse charge mechanism based on taxing only specific services with New Zealand substitutes would be extremely difficult to operate – the degree of substitutability of services is often a subjective issue and any list of services would rapidly become obsolete. Such a mechanism would also be inconsistent with the broad-based approach to GST in New Zealand, and may raise questions as to why a similar treatment is not applied to imported goods.

Officials consider, in any event, that the exclusions for salary and interest components in intra-group and inter-branch transactions which are, in part, intended to recognise the concerns as to actual substitutability raised by submissions, ensure that mixed offshore-resident groups will not be disadvantaged compared to wholly resident groups.

While officials are mindful of compliance costs, the competitive, production and consumption distortions caused by the current exclusion of imported services from the New Zealand GST base justify imposing GST on imported services. The change is also necessary to protect against any future significant erosion of the GST base caused by increases in the volume of imported services as a result of the growth in electronic commerce.

We note that the New Zealand Business Roundtable (submission 1W) and PricewaterhouseCoopers (submission 33) support the introduction of a reverse charge, and that the New Zealand Bankers' Association (submission 32) supports the introduction of a reverse charge as part of a package including reforms to the GST treatment of financial services.

Recommendation

That the submissions be declined.

DEFINITION OF "NON-RESIDENT"

Clause 101

Submission
(18W – Deloitte Touche Tohmatsu)

The definition of "non-resident" should be amended to make it consistent with the definition of "resident". A person is a resident "…to the **extent** that that person carries on…any [activity], while having any fixed or permanent place in New Zealand relating to that [activity]". Therefore a person should be defined as a non-resident to the **extent** that they are not a resident.

Comment

Officials agree the change suggested by the submission, which will ensure that the definition of "non-resident" is not broader than intended.

Recommendation

That the submission be accepted.

IMPORTED SERVICES AND THE REGISTRATION THRESHOLD

Clause 105

Submissions
(26 – New Zealand Law Society, 43W – Russell McVeagh)

Persons making supplies who are not registered and are below the registration threshold should not be required to register and pay GST on all supplies they make solely because importing services (and being deemed to be the supplier of those services) takes the level of supplies they make over the registration threshold.

Comment

Under the proposed amendments, supplies of imported services that a person receives are treated as supplies made by that person for the purposes of imposing GST and enforcing liability to GST under the reverse charge. Therefore when the total of a person's supplies that would be taxable if they were a registered person and supplies of imported services that would be subject to the reverse charge if they were a registered person exceed $40,000 per annum (the registration threshold), the person will be required to register for GST and charge GST on all of those supplies.

Submissions use the example of an unregistered business making $38,000 of supplies that would be taxable importing $2,001 of services that would be subject to the reverse charge if the business were a registered person. As services that would be subject to the reverse charge are added to the amount of taxable supplies, and the total value of those supplies is in excess of $40,000, the business would be required to register for and charge GST on all of the taxable supplies it makes, not just the supplies subject to the reverse charge.

In comparison, a person making the same level of supplies ($38,000) who purchases $2,001 of services from a supplier in New Zealand is not treated as having made the supply of $2,001 and is, therefore, not required to register for and charge GST. Submissions state that this is inequitable, and that the activity of making taxable supplies should be treated as separate from the importation of services – that is, the person would have two activities, making supplies of goods and services, and importing services.

Officials acknowledge that a person in the situation described above importing services will be in a different position than a person purchasing services domestically. This is an accepted result of the use of the reverse charge mechanism proposed for New Zealand, and applied in the European Union, Canada and, latterly, Australia. The existence of boundaries such as the registration threshold means that there will always be perceptions of inequality, depending on which side of the threshold a person falls.

The registration threshold is based on judgements about compliance costs and the distortions involved in not taxing supplies of goods and services. While $40,000 is the compulsory threshold, it is open to taxpayers to make these judgements themselves as, provided a taxable activity is carried on, they may choose to register for GST below the threshold.

In the situation outlined by submissions the unregistered person purchasing services in New Zealand would be subject to GST on those services – either directly if the supplier was registered, or indirectly through the inability to claim input tax credits (or tax cascades) if the supplier was unregistered. The unregistered person could in fact be in a more disadvantageous tax position as a result of tax cascades than the person who was registered. This is the reason many entities with total supplies under the $40,000 threshold opt to register for GST – in fact around 20 percent of all registered persons with a turnover of under $40,000 are registered.

Officials do not, therefore, agree that the difference between the taxpayers below and above $40,000 is necessarily as significant as the submissions indicate. Furthermore, $40,000 per annum has proved to be a practical threshold at which the carrying on of a taxable activity is considered sufficiently large (after compliance cost considerations) to be brought into the GST base. Whether the size of the activity arises from making taxable supplies, importing services or a mixture of both is not in officials' view a significant consideration.

Submissions' proposal that the recipient of a supply of imported services not aggregate supplies of imported services with other supplies it makes would result in one entity have two separate activities. Officials consider that having two separate activities would add an unjustifiable level of complexity while perpetuating the distortions the reverse charge is intended to remove.

Recommendation

That the submissions be declined.

APPLICATION OF SECTION 78 CONCERNING ALTERATION IN GST LAW TO SUPPLIES UNDER THE REVERSE CHARGE

Clause 105

Submission
(30 – Investment Savings and Insurance Association of New Zealand)

Section 78(2) allows parties to a contract to adjust the price in the contract for a change in the GST law. Section 78 should not apply for the purposes of the introduction of the reverse charge. It could allow a non-resident supplier to increase the price charged for services when they are not the party on which the reverse charge is imposed, and therefore not the party which bears the increase in costs brought about by the introduction of the reverse charge.

Comment

Section 78(2) allows the supplier of the goods and services to adjust the price following a law change. Under the reverse charge, the recipient is treated as the supplier for the purposes of liability for GST and other limited purposes only. Section 78(2) cannot, therefore, be sensibly applied to the reverse charge.

Recommendation

That the submission be accepted.

CLAIMING INPUT TAX CREDITS AND MAKING ADJUSTMENTS

Clause 105

Submission
(26 – New Zealand Law Society)

It should be explicitly stated in the legislation that input tax credits are available to, and adjustments are able to be made by, registered persons who have self-assessed GST under the reverse charge.

Comment

The GST Act allows an input tax credit to a recipient of goods and services acquired for the principal purpose of making taxable supplies. Adjustments by way of output tax are then made in the current or later GST periods to reflect any non-taxable use. Correspondingly, if the goods and services are acquired for a principal purpose other than of making taxable supplies no input tax credit is available other than by way of an adjustment to reflect any taxable use in the current or later periods.

This method for apportioning GST costs between taxable and exempt supplies will apply under the reverse charge as for this purpose the recipient of the relevant supply will remain the recipient and not the supplier. Thus, although the GST cost of the imported services will have been charged by the recipient, an input tax credit will be available to the recipient to the extent that the services are used in making taxable supplies.

The submission argues that the wording of current sections 3A and 21E(2)(a) would preclude a registered person in the situation above from claiming an input tax credit or making an adjustment for a change in use in respect of that supply.

It interprets the words "…tax charged under section 8(1) on the supply of goods and services made to that person…" in section 3A (and substantially similar words in section 21E(2)(a)) as meaning that the tax must have been charged by the natural supplier of the imported services (the non-resident), and not the recipient of the supply who has self-assessed the tax under the reverse charge (the New Zealand resident importer).

Officials do not consider that the plain words of the section support the submission's contention – neither section refers to tax being charged by a person, and tax being charged by a person is not a concept that the GST Act generally recognises. Tax is charged on a supply, and output tax is returned by a person. Officials therefore consider that it is sufficiently clear that input tax credits are available to, and adjustments are able to be made by, registered persons who have self-assessed GST under the reverse charge.

Recommendation

That the submission be declined.

Clause 106

Issue: Remove the recipient's 95 percent of turnover test

Submissions
(26 – New Zealand Law Society, 44 – MinterEllisonRuddWatts, 45W – Promina)

The test based on the recipient's turnover (95 percent or more taxable supplies) should be replaced with a test based on the purpose for which the recipient acquired the services. Options submitted are that the reverse charge apply when a service is not acquired for solely taxable purposes, when it is not acquired wholly for the purposes of a taxable activity, or when it is acquired for the principal purpose of making taxable supplies. If the principal purpose test were adopted, the change in use adjustment provisions could be amended to ensure that GST is charged to the extent that imported services are not used for taxable purposes.

Comment

The reverse charge will require GST registered recipients of supplies of imported services to self-assess GST on the value of the services if:

- the services are not acquired by a person who makes supplies of which 95 percent or more are taxable supplies; and
- the supply of those services, if made in New Zealand by a registered person, would be a taxable supply.

This means that if a registered person has an activity which does not consist of making, in effect, solely taxable supplies and imports services that would be subject to GST if supplied in New Zealand, the person will be required to add GST to the price of the services and return the GST to Inland Revenue.

The discussion document *GST and imported services*[8] proposed that the reverse charge apply if a person imported services other than for the sole purpose of making taxable supplies. That is, if the recipient of the services was acquiring the services other than 100 percent for making taxable supplies the import of those services would be subject to the reverse charge. This would require the recipient to consider the purpose for which they had acquired each imported service in order to determine whether they were required to return GST under the reverse charge. They would then have to further consider to what extent they had acquired the services for either taxable or non-taxable activities to determine whether they were entitled to an input tax credit for the supply, and, if so, over what period.

[8] *GST and imported services: a government discussion document*, June 2001.

During consultation officials were advised that a test based on the nature of the business, that is, whether the person made, in effect, solely taxable supplies or not, would be a simpler test to apply. The nature of the business is judged according to the supplies the person makes over a twelve-month period – if 95 percent or more of the supplies a person makes in a twelve-month period are taxable supplies the reverse charge will not apply to any services they acquire. Officials consider that the test proposed will remove a significant number of taxpayers from the need to apply the reverse charge while reducing any risk to the revenue base and being less or at least no more compliance cost-intensive than the other methods proposed.

The adoption of the 95 percent threshold is based on the de minimis test in section 21(4), which allows a registered person to use goods and services acquired for taxable purposes for a small level of exempt purposes without requiring output tax adjustments to reflect the exempt purposes.

Recommendation

That the submissions be declined.

Issue: Lower the percentage threshold in the recipient's turnover test

Submissions
(26 – New Zealand Law Society, 45W – Promina)

Reduce the threshold of taxable supplies in the recipient's turnover test to either 90 percent or 75 percent.

Comment

Reducing the threshold of taxable supplies in the recipient's turnover test below 95 percent, to either 90 percent or 75 percent, would allow registered persons making material levels of non-taxable supplies to escape the application of the reverse charge. The reverse charge is intended to apply to all persons making other than, in effect, solely taxable supplies. Officials consider that the five percent allowance for non-taxable supplies in the test as currently drafted will exclude the majority of entities making solely taxable supplies from the ambit of the reverse charge. As noted in our previous response, the 95 percent figure is also consistent with the exempt supplies adjustment de minimis in section 21(4).

Officials do not consider it is valid to compare the reverse charge test with the test for zero-rating of financial services. The test for zero-rating of financial services gives more leeway to the registered person zero-rating services as it must make a "calculated guess" at the status of the taxpayer to which it is supplying services. Seventy-five percent is a high enough figure to allow all entities making predominantly taxable supplies of services to receive zero-rated supplies, without including a disproportionate number of entities making significant amounts of non-taxable supplies. The reverse charge does not require the recipient of the services to estimate the status of taxpayers to whom it is making supplies – the registered person

will know the status, be it taxable, exempt or otherwise, of the supplies it is making, so a greater degree of precision is justified.

Recommendation

That the submissions be declined.

Issue: Target only exempt supplies

Submission
(43W – Russell McVeagh)

The registered recipient's turnover test should be altered so that the reverse charge will apply when 5 percent or more of a person's supplies are exempt, rather than when less than 95 percent of their supplies are taxable.

Comment

The submission states that the reverse charge should only be targeted at persons making supplies of exempt services, as only supplies to such persons cause the distortions that the reverse charge is aimed at removing. While many of the persons that will be subject to the reverse charge will be suppliers of exempt services, the group of suppliers of services targeted by the reverse charge is broader, encompassing all persons making other than taxable supplies. This includes exempt supplies, other non-taxable supplies and final consumption. Adopting the submission's test would, therefore, narrow the application of the reverse charge and perpetuate some of the distortions intended to be removed.

Recommendation

That the submission be declined.

Issue: Insert a de minimis

Submission
(30 – Investment Savings and Insurance Association of New Zealand)

A de minimis threshold should be included in the reverse charge so that it does not apply to supplies under $10,000 in value.

Comment

Officials consider that a dollar figure de minimis is inappropriate in the context of a reverse charge mechanism, and note that the five percent allowance for non-taxable supplies fulfils a role similar to a de minimis. A dollar figure de minimis leaves the

reverse charge open to circumvention by splitting a supply into smaller component supplies which fall below the de minimis. This is especially a risk when related party transactions are involved, as are many of the transactions that will be subject to the reverse charge. Officials also question the suggested quantum of the de minimis – a $10,000 transaction is a significant transaction, especially for medium and smaller registered persons.

During discussion of its submission at the Finance and Expenditure Committee meeting considering the submission, the submissioner stated that its proposed de minimis would reduce compliance costs by allowing some leeway for taxpayers to "miss" transactions that might be insignificant in their systems, or not enter their systems, so that the taxpayer would not be subject to penalties. Officials consider that small errors by taxpayers can be dealt with pragmatically under the compliance and penalties rules, instead of adopting the submission's approach, which would undermine the effectiveness of the reverse charge.

Officials are also concerned that there would be an increase in compliance and administration costs with having to identify and itemise transactions under a dollar level de minimis to ensure exclusion from the reverse charge.

Recommendation

That the submission be declined.

Issue: The twelve-month period

Submission
(26 – New Zealand Law Society)

Section 8(4B)(b), which will apply the reverse charge if services are acquired by a person who, in a twelve-month period that includes the date of the supply of services, makes supplies of which less than 95 percent in total value are taxable supplies, should be amended so that a registered person can take a reasonable view as to whether they will meet the test in a twelve-month period.

Comment

Officials agree that the test, as currently worded, will be impractical to apply, as there can be many twelve month periods which include the date of the supply of services, and there is no guidance as to which period should be used. The test will be amended to be consistent with the test for GST registration in section 51 of the Act. This test looks at the end of any month where the total value of supplies in that month and the 11 months immediately preceding that month exceeds the registration threshold. It also allows the use of a test which looks at whether at the beginning of any month where there are reasonable grounds for believing that the total value of the supplies to be made in that month and the 11 months immediately following that month will exceed the registration threshold.

Recommendation

That the submission be accepted.

Issue: Remove "in New Zealand" from section 8(4B)(c)

Submission
(30 – Investment Savings and Insurance Association of New Zealand)

The reference to "…in New Zealand..." should be removed from proposed section 8(4C)(c) as it is potentially confusing.

Comment

The reverse charge will apply to imported services if, among other requirements, the "…supply, if made in New Zealand by a registered person in the course or furtherance of a taxable activity carried on by the person, would be a taxable supply…", as required by section 8(4C)(c).

Officials consider the meaning of section 8(4C)(c), and the use of the phrase "...in New Zealand…" in particular, is clear – it is referring to the hypothetical situation of the services in question being supplied in New Zealand, by a hypothetical registered person in the course or furtherance of its taxable activity. If this hypothetical supply by the hypothetical registered person would be taxable, then the services which are being considered, those supplied to the New Zealand registered person which has in the "real world" imported the services, will be subject to the reverse charge. Officials therefore consider that no change is justified to section 8(4C)(c).

Recommendation

That the submission be declined.

COST ALLOCATIONS

Submissions

(32 – New Zealand Bankers' Association, Matter raised by officials)

- Clause 106 should be amended so that a cost allocation from a non-resident to a resident is subject to GST under the reverse charge. The new provision would treat an allocation of costs from a non-resident to a resident as a taxable supply of services for the purposes of the reverse charge, except to the extent that the cost allocation is consideration for a supply of services to the resident, and therefore already subject to GST under the reverse charge. Note that salaries and interest allocated to a New Zealand subsidiary or branch are excluded in determining the value of the supply under the reverse charge. *(Matter raised by officials)*

- The New Zealand Bankers' Association submission refers to an officials' draft provision in relation to cost allocations for possible inclusion in the bill:

  "(4C) An allocation of costs by a non-resident to a resident is treated as being a supply of services that satisfies **section 8(4B)(c)** except to the extent that the costs allocated do not relate to consideration provided for goods or services received by a non-resident."

  The submission argues that the proposed cost allocation provision should not be introduced, as:

  – is not necessary because the general reverse charge provisions will tax cost allocations;

  – is incomprehensible;

  – will result in GST being charged where there is no consumption in New Zealand; and

  – will tax imports of goods twice.

Comment

In some circumstances individual services supplied to a business will not be charged for or identified separately. This may be the case within a group of companies or single multi-national company, where the parent company or head office may, for example, allocate a proportion of its costs to the various parts of the enterprise. The existence of a supply of services may not be easily ascertainable in this situation. The charging of a global sum, or allocation of global costs, does not, however, change the fact that a supply may have been made to which at least part of the costs relate.

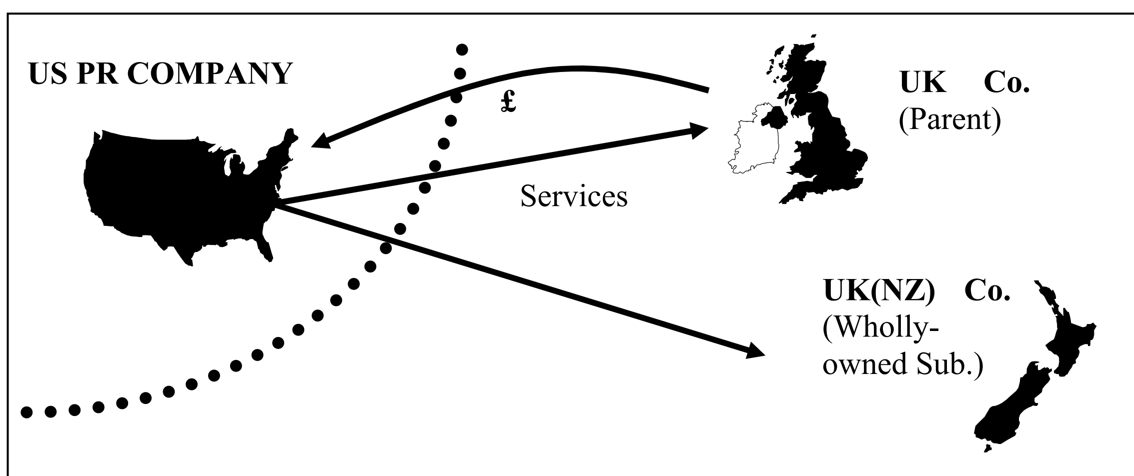
Thus, in principle, the nature of the charge, be it a global sum or a specific charge for specific services, should not affect the GST treatment of any supplies made. Officials had, therefore, suggested in consultation with the submissioner before introduction of the bill that an allocation of costs from a non-resident to a resident should be treated as a taxable supply of services.

The issue was not, however, dealt with in the bill as further consideration was needed as to how it would best be presented. An officials' draft was provided to the submissioner and this forms the basis of their submission to the Committee.

Officials now consider that a provision should be included in the legislation to treat as a supply of services an allocation of costs to a New Zealand resident that is in respect of goods or services provided to a non-resident. This would ensure that a charge by an offshore-related entity is subject to the reverse charge except to the extent that certain excluded amounts are able to be identified.

It is important that it be clear that, subject to certain exclusions, an allocation of costs that relates to services indirectly supplied to a person is a supply under the Act. The Act does not deal very well with composite supplies or with the issue of nexus between a supply and any goods and services and there is, therefore, quite a lot of confusion in this area.

For example, take the situation of a group with a UK-based parent and a wholly owned subsidiary in New Zealand embarking on an international advertising campaign. The UK parent contracts with a US based PR firm to arrange the production and screening of a series of generic advertisements in all of the countries in which the group operates. In this situation there would, in effect, be a supply of advertising services to the New Zealand subsidiary. However, because the contract is with the UK parent only, it is unclear whether the New Zealand subsidiary itself receives a supply of services for the purposes of the reverse charge.



The proposed legislation, as drafted, operates on an assumption that cost allocations are included in the reverse charge as there is an explicit carve-out for interest and salaries. However, following further analysis, officials consider that the intention that cost allocations be subject to the reverse charge except to the extent of any such exclusions needs to be made explicit.

The exclusion under officials' draft section 8(4C) is intended to be limited to cash contributions or other amounts in relation to which there is no underlying supply, and would not, therefore, give rise to the substitutability concerns that the reverse charge is intended to address. Officials agree that its scope is difficult to determine. In addition, cash contributions and the like are generally managed in some other way, such as through the provision of loans, so that the exclusion is arguably unnecessary. Officials therefore propose to remove the exclusion.

The submission states that the cost allocations provision will result in GST being charged when there is not necessarily any consumption in New Zealand. It is difficult to determine definitively where all the benefit of a supply accrues – it is just as difficult, in many circumstances, to determine where a service is consumed. This is why the general place of supply rules in section 8(2) of the GST Act are based on the residence of the supplier, with all supplies by New Zealand suppliers treated as resulting in consumption in New Zealand, and the zero-rating provisions fulfilling the role of carving out those specific, listed supplies that are considered to result in consumption outside New Zealand. The reverse charge is based on the same principles as the general place of supply rules in section 8(2).

Officials consider that the recommended changes in this report to clause 109 in relation to zero-rating, following a number of submissions on the point, will ensure that services which can definitively be said to be consumed outside New Zealand are not taxed under the proposed cost allocation provision. This is because the cost allocation provision, as with the general reverse charge rule, will be subject to the zero-rating provisions of the Act, as modified.

We note that the submission's concern with regard to a double impost of GST on goods will be removed if the exclusion from officials' draft section 8(4C) is removed as recommended.

Recommendation

That officials' submission be accepted.

REGISTRATION OF PRIVATE INDIVIDUALS

Clause 106

Submission
(18W – Deloitte Touche Tohmatsu, 39 – Institute of Chartered Accountants of New Zealand)

The legislation should be amended to ensure that private individuals are not required to register for, and pay, GST when they import more than $40,000 of services per annum, as:

- it will impose compliance costs on individuals;
- it will be difficult to enforce;
- the UK does not require individuals to register for VAT; and
- the discussion document *GST on imported services* stated that such supplies of imported services would not be taxed under the reverse charge.

If this submission is rejected the legislation should be clarified to ensure that private individuals are required to register for, and pay, GST when they import more than $40,000 of services per annum.

Comment

Officials consider that $40,000 is a significant amount of services to import as an individual, and therefore registration for GST, and the compliance costs that this entails, is justified to protect the GST base. An individual importing such a level of services is acting in a manner akin to a registered business, and should be treated as such for GST purposes. We note that this threshold is generous compared to the treatment of imported goods.

Officials do not anticipate that there will be many individuals who import in excess of $40,000 of services per annum. As time goes on and technology improves, the requirement to register will be easier to enforce, and the associated compliance costs should also decrease – while at the same time the level of imports of services by individuals could also increase because of improved technology.

While the European Union's VAT framework, of which the United Kingdom is a part, does not generally require private individuals to register for VAT, it recognises the magnitude of the distortions caused by the non-taxation of business-to-consumer transactions and instead requires non-resident suppliers to register for, and charge, VAT on supplies to EU resident consumers. Officials do not consider it is feasible for New Zealand to enforce its GST rules on non-resident suppliers generally, but we do consider that it is possible to require New Zealand resident individuals to register for GST in appropriate circumstances. Officials also note that Canada's GST Act requires individuals to register for GST in certain circumstances when they import services.

Officials note that the discussion document *GST and imported services* stated only that there would not be a general requirement for private individuals to register for GST, and that it was specifically stated that private individuals who imported over $40,000 of services per annum would be required to register for GST.

Recommendation

That the submission be declined, and the legislation be clarified to ensure that private individuals who import more than $40,000 of services are subject to the reverse charge.

TIME OF SUPPLY RULES

Clause 107

Submission
(45W – Promina)

The new time of supply rule for the reverse charge in section 9(2)(a)(iv) should also apply to supplies within New Zealand.

Comment

Section 9(2)(a)(iv) will, in conjunction with the existing subparagraphs (i) to (iii), fix the time of supply for a supply of services between associated parties which is subject to the reverse charge at the earliest of:

- when an invoice is issued;
- when payment is made in respect of the supply; or
- the end of the taxable period that includes the date which is two months after the recipient's balance date for the year the service was performed.

This rule modifies the existing time of supply rules by allowing an extra period, until the end of the taxable period that includes the date which is two months after the recipient's balance date for the year the service was performed, for determining the time of supply of services that are subject to the reverse charge. This rule applies when neither payment has been made nor an invoice received.

This extra concessionary period was included after consultation indicated that there would be problems applying the normal associated party time of supply rules to cross-border supplies because of difficulties in obtaining information from offshore associates. Officials consider that these difficulties do not exist to such an extent within an entity in New Zealand as to justify extending this treatment to purely domestic supplies. The time of supply rules are fundamental to fixing an entity's GST liability, and any changes to the general rules in the Act create the potential for tax planning opportunities and the ability to inappropriately defer GST, as has occurred in the past with certain deferred settlement transactions.

Recommendation

That the submission be declined.

VALUE OF SUPPLY RULES

Clause 108

Issue: The associated party valuation rules

Submission
(30 – Investment Savings and Insurance Association of New Zealand)

The associated party valuation rules should not apply to supplies under the reverse charge in any circumstances, or the exclusion from the rules in new section 10(3B) should be broadened to include supplies that contribute to a depreciable cost.

Comment

The associated party valuation rules in section 10(3) of the GST Act require supplies between associated parties generally to be valued at the market value of the supply. The use of the open market value rule for supplies between associated persons in the context of the reverse charge, however, could lead to an increase in compliance costs and potentially to a revenue loss if tax deductions resulting from the deemed value of supply were taken into account. The valuation of services for which there is no charge could, in particular, involve substantial compliance costs.

To minimise any compliance costs and revenue loss, under proposed section 10(3B) the cost basis for supplies between associated parties will be required to be used if the consideration for the supply would be an allowable deduction to the New Zealand recipient under the Income Tax Act. This also applies where the consideration for the supply is nil, but the consideration would have been deductible if it were not nil.

This concession is limited to situations where there is no net revenue gained from requiring market valuations, and is limited to cross-border supplies. There is still a general need to ensure that supplies of services between associated parties are not made for consideration that is below market value (which would result in an inadequate amount of GST being collected) in the same way as with transactions within New Zealand.

The submission notes that the transfer pricing rules in section GD 13 of the Income Tax Act 1994 provide a discipline to ensure that the correct value is placed on a supply of services. However, the transfer pricing rules are only aimed at ensuring New Zealand firms are not charged an excessive amount for supplies they receive or charge an inadequate amount for supplies they make – they will not apply if a supply is received by the New Zealand firm for inadequate consideration.

Therefore officials consider it is important that the associated party valuation rules continue to apply to the extent that there is net revenue gained from requiring market valuations.

Officials do not consider that it is appropriate to extend the concession to "supplies contributing to a depreciable cost." Officials consider that such an extension would be inappropriate as the concession is intended to apply to services, and it is unclear in what circumstances services relating to depreciable costs would not be deductible. Officials therefore consider that the current concession is sufficiently broad, especially when compared to transactions wholly within New Zealand when the associated party valuation rules would apply fully.

Recommendation

That the submission be declined.

Issue: Inter-branch supplies

Submission
(44 – MinterEllisonRuddWatts)

Section 10(3B) should be amended so that supplies to branches are given the same treatment as supplies to members of groups.

Comment

For the purposes of the reverse charge, a branch in New Zealand will be treated as a separate entity, independent of its non-resident parent. Under general law, and under the Income Tax Act 1994, a head office and its branch are generally treated as a single entity, and any transfers of goods or services between the head office and its branch are not generally recognised as supplies. This means that there might not be an income tax deduction for supplies that are recognised for GST purposes, and the valuation rule in section 10(3B) would not be able to apply for inter-branch supplies.

Officials agree that inter-branch supplies should be treated in the same way as intra-group supplies for the purposes of section 10(3B).

Recommendation

That the submission be accepted.

THE SCOPE OF THE RELATED PARTY SUPPLY EXCLUSIONS FROM THE REVERSE CHARGE

Clause 108

Issue: Exclude internal value-added

Submission
(30 – Investment Savings and Insurance Association of New Zealand)

Section 10(15C) (which excludes salaries and interest from intra-group and inter-branch transactions) should be extended to exclude all internal value added in intra-group and inter-branch transactions from the reverse charge.

Comment

In many instances, charges for services from an associated overseas business will be incorporated into a larger sum. This may be the case, for example, within a group of companies or single multi-national company, where the parent company or head office may allocate a proportion of its costs to the various parts of the enterprise or charge a management fee (referred to as "internal charges").

Section 10(15C) provides that the value of related party services that are to be subject to the reverse charge is reduced by the value of any salary or interest charges from any member of a non-resident company's group under section IG 1 of the Income Tax Act 1994 that form a part of an internal charge.

Interest is excluded because, to the extent that it retains its nature as interest, it represents a non-taxable supply which should be excluded from the scope of the reverse charge.

Salaries are excluded for two reasons:

- ***Salaries are not generally subject to GST in New Zealand***: employees do not charge their employers GST on the services they provide (as opposed to independent contractors) so the salary component of "internal" services within a single entity, or within a group of companies, in New Zealand, will not bear GST. It is acknowledged that the salary component of services provided by third parties (including independent contractors) is subject to GST, and that as a part of the reverse charge reforms, New Zealand branches and subsidiaries are to be treated as separate from their offshore head offices and parents (meaning they are treated as third parties). However, consolidating the entities for this purpose is considered appropriate.
- ***Acknowledging, to an extent, that there may be limited substitutability with related party transactions***: although there is nothing inherent in the nature of the services that are provided from a head office or a parent company that would preclude their supply by a third party in New Zealand (such as accounting services and processing services), in many instances the New Zealand branch or

subsidiary has no choice but to receive services from its offshore head office or parent, as the offshore entity controls the New Zealand entity. To ensure there is no risk of offshore supplies creating distortions relative to domestic supplies from outside a group, the reverse charge should apply to intra-group and inter-branch supplies. However, to acknowledge that in some instances substitutability is limited, a concessionary carve-out of the salary component of related party charges is allowed.

Officials consider that the exclusion of interest and salaries from related party charges is a reasonable concession, and strikes a pragmatic balance between:

- the objective of imposing the tax on services that, if not taxed, would give rise to distortions;
- the need to ensure that the revenue base is maintained – if internal charges were not taxed imported services could be routed through the offshore-related entity and the reverse charge avoided;
- acknowledging that, in some instances involving related party transactions, substitutability is limited; and
- the objective of minimising compliance and administration costs, limiting the extent to which the various components of the charge must be identified.

Officials consider that other charges, such as internal value added, can too readily include third party elements because they are made up of any number of components. While officials accept that salaries are also open to substitution, they are likely to carry less of an avoidance risk because they involve a single charge.

The use of offshore associated entities through which New Zealand entities are able to access supplies from offshore third party entities could very easily undermine the effectiveness of the reverse charge, so it is vital that the scope of the exclusions from the reverse charge is precise and limited.

Recommendation

That the submission be declined.

Issue: Definition of a group of companies

Submission
(30 – Investment Savings and Insurance Association of New Zealand)

Section 10(15C) should apply to intra-group transactions between companies in a group under section IG 1 of the Income Tax Act 1994.

Comment

As currently drafted, section 10(15C) applies to intra-group transactions if the non-resident member of the group supplying the services is part of a GST group for the purposes of section 55. However, for the purposes of the interest and salaries exclusions, the section applies to services supplied to the non-resident member (and then on-supplied to the New Zealand resident group member) by other non-resident members of a group of companies under section IG 1 of the Income Tax Act 1994. The section should consistently refer to members of a group of companies under section IG 1 of the Income Tax Act 1994.

Recommendation

That the submission be accepted.

Issue: Extend exclusions to domestic related party supplies

Submission
(45W – Promina)

Section 10(15C) should be extended to apply to domestic intra-group and inter-branch transactions.

Comment

Section 10(15C) was intended to replicate the treatment of intra-group supplies under section 55 of the GST Act for supplies between non-resident and resident members of groups of companies under section IG 1 of the Income Tax Act 1994, while taking into account the aim of taxing most imports of services. That is, the interest and salary exclusions allow internal charges to be disregarded to a degree.

Officials consider that the GST grouping rules in section 55, which are aimed at consolidating related companies and thus allow them to disregard internal supplies for GST purposes, are sufficient to cater for domestic intra-group supplies and that there is no need to apply section 10(15C) to domestic intra-group supplies. Section 55 allows certain supplies to be disregarded for GST purposes, while section 10(15C) excludes parts of the consideration for a supply from GST – officials consider that these two approaches are not entirely consistent and it would be confusing and potentially contradictory to have two sets of rules covering the same sort of supplies domestically.

Officials also note that the grouping rules in section 55 were intended to reduce compliance costs on groups of companies by not requiring certain supplies of services between members of a group to be accounted for. The change proposed by the submission would, if operated together with section 55, increase compliance costs.

However, as signalled in the discussion document *GST and financial services*, officials will be carrying out a broader review of grouping for GST purposes and will consider this issue during that review.

Recommendation

That the submission be declined.

ZERO-RATING UNDER THE REVERSE CHARGE

Clause 109

Submissions

(18W – Deloitte Touche Tohmatsu, 26 – New Zealand Law Society, 30 – Investment Savings and Insurance Association of New Zealand, 32 – New Zealand Bankers' Association, 39 – Institute of Chartered Accountants of New Zealand, 44 – MinterEllisonRuddWatts)

The scope of the reverse charge should be narrowed to ensure that supplies of services that would be zero-rated if made in New Zealand will be zero-rated under the reverse charge.

Comment

Officials have examined the provisions of section 11A (which zero-rates services) to determine which services should remain zero-rated under the operation of the reverse charge. We consider that all zero-rating provisions, except for section 11A(1)(j), should apply fully to zero-rate services subject to the reverse charge.

Section 11A(1)(j) zero-rates services "…that are physically performed outside New Zealand or are the arranging of services that are physically performed outside New Zealand…" These services, when supplied to a person in New Zealand, are exactly the services targeted by the reverse charge (for example, computer processing services provided from offshore). Zero-rating all such services would render the reverse charge ineffective.

However, not all services within the scope of section 11A(1)(j) should be excluded from zero-rating under the reverse charge. Where the services are provided to a New Zealand resident who is outside New Zealand, and the services are consumed/received wholly outside New Zealand, zero-rating should apply. For example, if a registered sole trader took a holiday offshore, unconnected to their taxable activity, accommodation in a hotel outside New Zealand should be zero-rated. Offshore hotel accommodation provided to a company executive for business purposes should similarly be zero-rated. The application of section 11A(1)(j) should therefore, for the purposes of the reverse charge, be narrowed to allow such services to be zero-rated.

Services which are intangible in nature, such as the provision of a legal opinion or feasibility study offshore, for which a New Zealand entity provides consideration in whole or part will, therefore, not be allowed to be zero-rated under the modified application of section 11A(1)(j). They will thus be subject to GST, on the basis that such services cannot be regarded as being wholly consumed offshore.

Recommendation

That the submissions be accepted in part, and section 11A(1)(a) to (i) and (k) to (r) apply to zero-rate supplies of services subject to the reverse charge. That section 11A(1)(j) apply to zero-rate supplies of services subject to the reverse charge where those services are provided to a New Zealand resident who is outside New Zealand, and the services are consumed/received wholly outside New Zealand.

CLAIMING INPUT TAX CREDITS – RECORD KEEPING REQUIREMENTS

Clauses 113 and 117

Submissions

(18W – Deloitte Touche Tohmatsu, 30 – Investment Savings and Insurance Association of New Zealand, 32 – New Zealand Bankers' Association, 39 – Institute of Chartered Accountants of New Zealand)

Taxpayers should not be required to hold the information required by section 24B to justify claiming an input tax credit for a supply subject to the reverse charge, as they have paid output tax on that supply and the input tax credit will be based on the output tax they have paid.

Comment

Proposed section 24B will require recipients of services subject to the reverse charge to hold sufficient information to ascertain:

- the name and address of the supplier:
- the date on which, or the period during which, the supply was received:
- a description of the services supplied:
- the consideration for the supply:
- the time by which payment of the consideration for the supply is required:
- the amount of the consideration for an intra-group or inter-branch supply which has been excluded from the reverse charge as salary or interest.

This information is important as it allows Inland Revenue to verify whether the recipient of a supply of imported services has correctly self-assessed GST on that supply of services. If the recipient has self-assessed and returned output tax on the supply officials consider that any input tax credit they may be able to claim in relation to that supply should be able to be based on that output tax paid.

Recommendation

That the submissions be accepted.

RECIPIENT AS A BAD DEBTOR

Submissions
(18W – Deloitte Touche Tohmatsu, 39 – Institute of Chartered Accountants of New Zealand)

The recipient of a supply of imported services should not be required to return GST for a supply if they refuse to pay for that supply (meaning they become a bad debtor of the offshore supplier).

Comment

Submissions contend that GST should be charged on a supply only where consideration has been received for that supply, and that where the recipient of a supply subject to the reverse charge refuses to pay for those services they should not be required to pay GST. Officials do not agree that this is necessarily so, especially with respect to imported services under the reverse charge. When a person receives a supply of imported services they will have consumed the services (unless they "return" those services) and should therefore be taxed on that consumption. Their choice not to pay for those services does not change the fact that they have consumed those services.

Proposed section 25AA allows an alteration to output tax paid or input tax deducted in respect of supplies of services subject to GST under the reverse charge when there has been:

- an agreed alteration to the consideration for a supply;
- a fundamental alteration in the services supplied; or
- the services or part of the services have been "returned" to the non-resident supplier (as may be the case with digitised products).

Officials consider that section 25AA addresses all of the situations where it is appropriate that the recipient of a supply of imported services be able to alter the amount of GST in relation to such a supply. These are situations in which the value of the consumption that has occurred has been legitimately altered, and therefore the amount of GST that should be paid has altered.

Officials also have concerns that GST could be avoided on the import of services merely by refusing to pay for those services and structuring transactions so that payment is received in another form. As a non-resident supplier is involved, identifying and tracing such transactions could be extremely difficult for Inland Revenue.

Recommendation

That the submissions be declined.

OUTSIDE NEW ZEALAND

Clause 123

Submission
(42W – KPMG)

"Outside New Zealand", which is used in section 56B in relation to branches of a company, should be defined using the definition in section 11A(3).

Recommendation

That the submission be accepted.

OTHER ISSUES

Issue: Transitional provisions

Submission
(30 – Investment Savings and Insurance Association of New Zealand)

Transitional provisions are needed to determine and apportion the time of supply for supplies which are provided on an ongoing basis which span the introduction of the reverse charge.

Comment

Officials agree that transitional provisions similar to those enacted when GST was first introduced should be used for the introduction of the reverse charge.

Recommendation

That the submission be accepted.

Issue: Guidelines

Submission
(30 – Investment Savings and Insurance Association of New Zealand)

The Commissioner should issue guidelines on the documentation required to support the valuation of imported services.

Comment

Officials note that Inland Revenue is drafting detailed guidelines on the application of the reverse charge, which will cover documentation requirements for the valuation of services.

Recommendation

That the submission be accepted.

Issue: Management fees for investment vehicles

Submission
(30 – Investment Savings and Insurance Association of New Zealand)

The treatment of funds management services under the reverse charge should be clarified.

Comment

Under an agreement between Inland Revenue and ISI, the proportion of funds management services that are taxable has been estimated at ten percent of the total charge for the funds management services provided. Officials can confirm that this treatment will also apply to identical services provided by offshore funds managers.

Recommendation

That it be noted that the treatment of funds management fees under the reverse charge will be the same as that given to domestically provided funds management services.

Issue: Terminology used in calculation of tax payable

Clause 1B

Submission
(Matter raised by officials)

The terminology used in calculating tax payable under section 20 of the GST Act should be clarified in relation to the definition of "input tax".

Recommendation

That the submission be accepted.

Trans-Tasman imputation

OVERVIEW

Australia and New Zealand are reforming their imputation laws to reduce a long-standing problem of the double taxation of certain trans-Tasman investments, known as “triangular tax”. Australian and New Zealand shareholders of trans-Tasman companies that choose to take up these reforms will be allocated imputation credits representing New Zealand tax paid and franking credits representing Australian tax paid, in proportion to their ownership of the company. However, each country’s credits can be claimed only by its residents.

New Zealand is also introducing a new form of grouping for imputation purposes only which Australian companies may also join. This is an attempt to mitigate the problem that imputation credits cannot pass through companies resident in neither Australia nor New Zealand.

Submissions have welcomed the reform but hold the general view that this should be only the beginning of further such developments between Australia and New Zealand.

Most submissions were of an implementational or technical nature, most of which are supported by officials.

Issue: Elections before the law is enacted

Submissions
(33 – PricewaterhouseCoopers, 43W – Russell McVeagh, 39 – Institute of Chartered Accountants of New Zealand)

Inland Revenue should state how Australian companies can take advantage of the new rules before the law has been passed. Alternatively, retrospective attachment of imputation credits should be allowed.

Comment

Officials do not support the retrospective attachment of imputation credits as information on how Inland Revenue plans to treat elections received before the legislation is passed is on the Inland Revenue website in the trans-Tasman imputation section. Inland Revenue has also agreed to publish those details in an upcoming *Tax Information Bulletin*.

Recommendation

That the submissions be declined with respect to the retrospective attachment of imputation credits.

Issue: Foreign investor tax credit rules

Submission
(42W – KPMG)

Dividends paid to Australian residents should be exempt from non-resident withholding tax, as is the case in Australia, rather than be subject to the foreign investor tax credit rules.

Comment

Wherever possible the intention of the trans-Tasman imputation reform was to leave existing New Zealand rules unchanged except to allow Australian companies to join the imputation rules.

It was not necessary to amend the foreign investor tax credit rules in any form to allow Australian companies to pay dividends with New Zealand imputation credits attached. Officials therefore do not support the submission as it goes beyond what is necessary to enact the reform.

Recommendation

That the submission be declined.

Issue: Third country companies

Submissions
(14W – Australia New Zealand Business Council, 33 – PricewaterhouseCoopers, 43W – Russell McVeagh, 39 – Institute of Chartered Accountants of New Zealand)

Dividends should be able to flow through third country companies without the loss of imputation credits or the deduction of non-resident withholding tax. Alternatively, imputation grouping should be extended to include companies from countries other than Australia and New Zealand.

Comment

Officials do not support this submission as it would give imputation groups which contain Australian companies an advantage that consolidated groups that can contain only New Zealand companies do not.

Recommendation

That the submissions be declined.

Issue: Notice period for elections

Clause 39

Submission
(44 – MinterEllisonRuddWatts)

The requirement for 30 days' notice should apply only where an election has previously been revoked by the Commissioner.

Comment

The requirement for 30 days' notice is to give the Commissioner time to process the application, and send information about the New Zealand imputation system to the Australian company to ensure it understands our rules before paying a dividend.

The 30-day notice period is, therefore, important with reference to the payment of a dividend. Officials agree, however, that it is of little value with respect to the imputation credit account and therefore agree that it should be lifted in this instance.

Recommendation

That the submission be declined except with regard to the maintenance of imputation credit accounts when the election should apply from the beginning of the imputation year in which the election is received.

Issue: Date of formation of group

Clause 15

Submissions
(45W – Promina, 39 – Institute of Chartered Accountants of New Zealand, 43W – Russell McVeagh)

Companies should have the option of forming or joining an existing imputation group from the later of: a) The beginning of the imputation year that is 30 days after the notice of election; b) the date the company becomes first eligible to join the imputation group; or c) the date of the election. *(Promina)*

The date of formation of an imputation group should be the later of the beginning of the imputation year in which a notice is received or the date the imputation group was eligible to be formed or at the option of the company, the date of election. *(Institute of Chartered Accountants of New Zealand)*

Clarify from when an imputation group is formed. *(Russell McVeagh)*

Recommendation

Officials agree that the proposed legislation is not clear about when an imputation group is formed. However, we recommend that the application date for forming or joining an imputation group is the beginning of the imputation year in which the election is made. This is consistent with the other provisions with this reform.

Issue: More than one consolidated group to be allowed to group for imputation purposes

Clause 45

Submissions
(45W – Promina, 39 – Institute of Chartered Accountants of New Zealand)

Imputation grouping provisions should allow for members of more than one consolidated group to group for imputation, and the balances of the existing consolidated imputation credit accounts should be combined into one opening balance for the new imputation group.

Comment

Officials accept that the proposed legislation envisages only that one consolidated group would wish to be the basis of an imputation group and agree in principle that it should be possible for members of more than one consolidated group to form an imputation group.

Officials also agree that combining the balances of the consolidated imputation credit accounts would be the simplest option of making this work.

However, it is possible for consolidated groups while currently 100 percent commonly owned to have imputation credits individually with different continuity profiles.

For example, assume consolidated group A and B now are both fully owned by C. However, consolidated group A had previously been owned 90 percent by C and 10 percent by D and subsequently C bought out D's 10 percent share. Consolidated group B has always been owned by C.

Consolidated group A has a different continuity profile for the credits that arose before the ownership change in a way that consolidated group B does not. Thus it would not be appropriate to allow those credits to be combined in one account.

However, if A had no residual credits from the previous ownership structure, and all the current credits in its account arose after C bought out D, there would be no problems with A's credits being combined with B's in an imputation group.

Officials therefore agree that members of more than one consolidated group may form or join an imputation group when the credits of all the consolidated groups have the same continuity profile.

Consolidated groups with different continuity profiles, as in A and B above, should not be entitled to group for imputation until the residual credits with a different profile have been passed to shareholders.

Recommendation

That the submissions be accepted subject to the credits of the consolidated groups having the same shareholder continuity profile.

Issue: Interface with dividend withholding payment rules

Clauses 47, 48, 49 and 50

Submissions
(43W – Russell McVeagh, 45W – Promina)

- The consolidated group rules for dividend withholding payment accounts should be amended to apply to consolidated imputation groups that do not include an Australian company, and a combined DWP account should be able to be used.

  Any company that maintains an existing DWP account and is a member of an imputation group should have the option of ceasing to be a DWP account company from the later of the start of the imputation year, 30 days after the notice of election and the date the company joins the imputation group.

  If any company ceases to be DWP account company on the date of election, all the DWP credits should be transferred to the company (or consolidated group's ICA). *(Promina)*
- Members of an imputation group should be able to transfer imputation credits to their DWP account to the extent that the imputation credits arise from tax on net foreign attributed income. *(Russell McVeagh)*

Comment

The creation of imputation groups in the proposed legislation is an attempt to mitigate the 'third country issue'. As Australian companies cannot maintain a dividend withholding payment account, there is no need to extend the concept to dividend withholding payment accounts or make changes to the dividend withholding payment rules generally. Officials do, however, agree that amendments are necessary to cater for:

- crediting and debiting of dividend withholding payments and credits when the individual members of an imputation group or resident imputation subgroup do not have a dividend withholding payment account; and
- transfers from individual members' or the consolidated group's dividend withholding payment accounts to an imputation group's imputation credit account.

Recommendation

That the submissions be declined with the exception of consequential amendments to the consolidated imputation group rules.

Issue: Interface with policy holder credit account rules

Clauses 47, 48, 49 and 50

Submissions
(33 – PricewaterhouseCoopers, 39 – Institute of Chartered Accountants of New Zealand, 42W – KPMG, 45W – Promina)

Grouping of policy holder credit accounts only should be allowed. *(Promina)*

The consolidated group rules for policy holder credit accounts in subpart ME should be amended to apply to consolidated imputation groups. *(Promina, PricewaterhouseCoopers, Institute of Chartered Accountants of New Zealand, KPMG)*

If the submission above is accepted then where one or more consolidated groups maintain a PCA they should be able to use a combined PCA based on the individual PCAs formerly used by the consolidated groups. *(Promina)*

Comment

The creation of imputation groups in the proposed legislation is an attempt to mitigate the "third country issue". This is not an issue for policy holder credit accounts as the credits cannot be passed up a chain of companies, so there is no need to make changes to the policy holder credit account rules generally. Officials do, however, agree that amendments are necessary to cater for the fact that transfers need to be able to be made, consistent with the existing rules, to and from individual members' policy holder credit accounts and an imputation group's imputation credit account.

Recommendation

That the submission to allow grouping for policy holder credit account purposes be declined but that consequential amendments be made to the consolidated imputation group rules.

Issue: Details of elections

Submission
(42W – KPMG)

The legislation should set out the details of any election notices required under the new Trans-Tasman imputation rules.

Comment

The legislation prescribes that the election has to be made "in a form acceptable to the Commissioner", and the current details of what that entails is set out on the Inland Revenue website. As the requirements relate to companies that themselves may have no presence in New Zealand, officials consider it appropriate that the legislation allows the Commissioner to determine what information is needed from an Australian electing to maintain an imputation credit account.

Recommendation

That the submission be declined.

Issue: Extending the deemed loss from further income tax payments by Australian companies without an income tax liability

Clause 43

Submission
(42W – KPMG)

The deemed loss that arises when an Australian imputation credit account company cannot use a payment of income tax should also be able to be carried back for that company if it chooses, or grouped with other group companies.

Comment

The current provisions already provide a benefit to Australian imputation credit account companies that may not generally pay income tax in New Zealand and so may not be able to use the payment of further income tax against a future New Zealand income tax liability. New Zealand companies in a similar position are not given this option, so officials do not support extending this benefit further from wholly owned companies to group companies, as submitted.

Additionally, payments of further income tax can be used only against future income tax liabilities, not past liabilities, so officials do not support carrying the payment back to past liabilities for Australian companies.

Recommendation

That the submission be declined

Issue: Post-implementation review

Submission

(30 – Investment Savings and Insurance Association of New Zealand)

A post-implementation review should be committed to and undertaken.

Comment

For most major tax policy reforms, a post-implementation review is the final stage in the generic tax policy process. The precise timing of such a review is dependent on a number of factors which could include difficulties with complying with the legislation.

As it not clear at this stage that there are difficulties with the legislation or any other such factors that would indicate a post-implementation review was a priority, officials do not support the submission.

Recommendation

That the submission be declined.

Issue: Dual resident companies

Clause 39

Submission
(44 – MinterEllisonRuddWatts)

The exclusion for Australian resident companies treated as resident of another country under a double tax agreement should be narrowed to include only cases where the treaty excludes the right to tax Australian income. This is because that is the effect of the current exclusion for New Zealand dual resident companies.

Comment

Officials accept that the proposed wording may theoretically exclude companies over which Australia retains full taxing rights on worldwide income even though they are treated as non-resident of Australia under a double tax agreement. Such situations must, however, be rare as the advantage of being treated as non-resident of Australia under a double tax agreement is that Australia no longer has full taxing rights over a company's worldwide income.

On balance, officials' view is that the value of simpler wording in the proposed legislation for almost all cases outweighs the situation that a company treated as non-resident of Australia over which Australia maintains full taxing rights cannot maintain an imputation credit account.

Recommendation

That the submission be declined.

Issue: Other technical matters

Clauses 2, 15, 45 and 82

Submissions
(14W – Australia New Zealand Business Council, 33 – PricewaterhouseCoopers, 39 – Institute of Chartered Accountants of New Zealand, 42W – KPMG, 43W – Russell McVeagh, 45W – Promina)

- Make the legislation clear that a resident subgroup may only have one member. *(Australia New Zealand Business Council, PricewaterhouseCoopers, Institute of Chartered Accountants of New Zealand)*

- The legislation should include provision to join an imputation group – legislation currently provides only for forming. *(Australia New Zealand Business Council, PricewaterhouseCoopers, Russell McVeagh, Promina)*
- Clarify that special rules allowing consolidated groups to transfer balances when forming an imputation group override the current provisions that start a consolidated groups ICA at zero. *(Promina)*
- The 1 October 2003 start date for payment of dividends should not apply to resident companies in an imputation group.

  The exchange rate provisions for Australian imputation credit account companies should interface with the exchange rate provisions for RWT. *(KPMG)*
- The requirement that an imputation account must be filed whether a return of income is or not should be restricted to Australian imputation credit account companies. *(Institute of Chartered Accountants of New Zealand)*

Comment

Officials agree that the legislation in the bill is deficient in the area identified in submissions.

Recommendation

That the submissions be accepted.

Issue: Other drafting issues

Clauses 9, 45, 47 and 48

Submissions
(33 – PricewaterhouseCoopers, 14W – Australian New Zealand Business Council, 39 – Institute of Chartered Accountants of New Zealand, 44 – MinterEllisonRuddWatts, 43W – Russell McVeagh)

- Clarify that debits and credits go to the imputation credit accounts of both trans-Tasman imputation group and resident imputation subgroup. *(PricewaterhouseCoopers, Australian New Zealand Business Council, Institute of Chartered Accountants of New Zealand)*
- The rules for determining the amount of an Australian dollar dividend should be put in Part M rather than CF as present.

  Clarify that the imputation credit account should be maintained in New Zealand dollars by Australian companies. *(MinterEllisonRuddWatts)*
- New sections ME 10(1B) and (1D) should be rephrased to ensure the two subsections apply to situations they are intended to apply to. *(Russell McVeagh)*

Comment

Officials agree with all the submissions except the request for clarification that the imputation credit account should be maintained in New Zealand dollars by Australian companies. This is because New Zealand imputation credits implicitly represent New Zealand tax paid in New Zealand dollars.

Recommendation

That the submissions be accepted except for the request for clarification that an imputation credit account be maintained in New Zealand dollars which should be declined.

Deferred deduction rule

OVERVIEW

Clause 14

The bill inserts a new Subpart ES which contains the deferred deduction rule, into the Income Tax Act 1994.

The general purpose of the deferred deduction rule is to combat aggressive tax arrangements which provide taxpayers with excessive tax advantages. The tax savings occur regardless of the success of the arrangement.

While the central problem with the arrangements in question is of asset valuation, targeting valuation is difficult in practice, given that the forecasts of income that underpin such valuations are inherently difficult to verify or challenge and are very subjective. The asset valuation question arises particularly where the purchaser is only contingently obliged to pay for the assets in question. Hence, the deferred deduction rule focuses on loans that the taxpayer is only contingently at risk of having to repay.

Eight submissions on the proposed rule were received. They generally expressed concern about the scope of the rule and any potential for it to apply to genuine commercial activities. This concern has been expressed throughout the policy design phase of the deferred deduction rule, and the rule has been repeatedly modified in light of these concerns. Further modifications are proposed by officials to ensure that the deferred deduction rule does not apply to genuine commercial activities.

Officials do not believe these proposals will necessarily stop all future schemes. Given the level of ingenuity and modus operandi of some tax advisers, it is possible that variations of today's schemes that circumvent these rules will emerge in due course. This leads to two conclusions, that:

- these rules will need to be monitored to ensure they apply to, and only to, appropriate transactions; and
- that the general anti-avoidance rule should continue to apply whether these rules apply or not.

USE EXISTING POWERS

Clause 14

Submission

(7 – Screen Production and Development Association, 30 – Investment, Savings and Insurance Association, 33 – PricewaterhouseCoopers, 39 – Institute of Chartered Accountants of New Zealand)

The deferred deduction rule is not necessary and existing legislation provides sufficient powers to attack offensive schemes.

Comment

The reference to existing legislation is presumably to the anti-avoidance provisions. The deferred deduction rule will overcome a number of difficulties being experienced with invoking the anti-avoidance provision.

There is general uncertainty about the scope of the anti-avoidance provision. To date, Inland Revenue has been successful in combating a number of aggressive tax arrangements. However, it must be noted that a number of arrangements still need to be tested in court. One large case (the second largest alleged avoidance case) is currently before the High Court.

Officials consider that there is some doubt about whether some of the targeted arrangements will constitute tax avoidance. The deferred deduction rule will be more certain in its application to aggressive tax schemes than the existing anti-avoidance provision is. In particular, one targeted arrangement (the largest alleged avoidance case) yields deductions of $70 million per year over 40 or so years. The fiscal risk if this is found not to be tax avoidance is very high. The substantive issues are due to be heard in the High Court early next year.

Inland Revenue generally finds out about aggressive tax arrangements only after investors' tax returns are filed. Under the current voluntary compliance tax system, a tax audit may not be carried out until a few years after a return is filed. There are often, therefore, significant delays before the tax can be recovered if the arrangement is considered to amount to tax avoidance. Under the deferred deduction rule, the investor will not be able to claim deductions if the arrangement meets the criteria for the rule. This should limit investors' exposure to the anti-avoidance rule.

From a practical perspective, a number of investors are surprised when Inland Revenue not only suggests that deductions under certain arrangements should be disallowed, under either technical or anti-avoidance grounds, but that penalties and interest might also apply. The compliance costs and stress faced by investors when an arrangement is audited should not be underestimated.

The rule will also allow a major saving of Inland Revenue's resources. To date, all of these arrangements have been found to constitute tax avoidance, but current resources used in identifying the cases and testing for tax avoidance can be deployed elsewhere.

The deferred deduction rule aims to:

- protect the revenue base;
- allow more efficient use of Inland Revenue's resources; and
- remove, in terms of the individual investors in these arrangements, unexpected exposure to interest and penalties on any resulting unpaid tax.

It would therefore ensure that the tax system operates more efficiently and effectively.

Recommendation

That the submission be declined.

SCOPE OF THE DEFERRED DEDUCTION RULE

Issue: Abusive tax arrangements

Clause 14

Submission
(2W – Brookfields Lawyers, 7 – Screen Production and Development Association)

The deferred deduction rule should be restricted to abusive tax arrangements.

Comment

The deferred deduction rule has been crafted to be objective. A subjective rule, which would suffer from most of the difficulties of the existing anti-avoidance legislation, would not enable the previously listed objectives to be met.

Recommendation

That the submission be declined.

Issue: Commercial reality

Clause 14

Submission
(39 – Institute of Chartered Accountants of New Zealand)

An additional test focusing on the commercial reality of an arrangement should be added to the gateway.

Comment

The deferred deduction rule has been carefully designed to provide objective tests for determining when the rule should apply and when it should not. Various submissions (in relation to the issues paper that was published previously, as well as to the bill) have identified various arrangements that could be caught, and each has been carefully considered in relation to whether the rule should apply to it or not. Changes have been made to the rule since the issues paper was published, and further changes are recommended in this report, to ensure that the rule does not apply inappropriately to commercial activities.

Inserting a gateway that focused on "commercial reality" is not appropriate because it would require a subjective decision to be made, which leads us back to some of the problems of applying the present anti-avoidance legislation.

Recommendation

That the submission be declined.

SPECIFIC EXCLUSIONS

Issue: Films

Clause 14

Submissions
(7 – Screen Production and Development Association)

The deferred deduction rule should not apply to the film and television industries.

Timing of the introduction is wrong for the film industry, given the present government consideration of the film industry.

The deferred deduction rule will make raising finance for films and television difficult.

Comment

The film industry is already subject to a variant of this rule, which will be repealed as part of the deferred deduction proposals. The deferred deduction rule is a more refined version of this old rule and applies generically to all structures that use funding that is economically limited recourse.

The timing of this tax bill in relation to the other government film initiatives is coincidental. Officials have been working on the issue for some years.

Some participants in the film industry have utilised structures that are explicitly targeted. An example of this that is in the public arena is the film "Kids World". Inland Revenue is aware of several other examples. The rule might make the raising of funds more difficult, but this will only be where the arrangement seeks to leverage off the tax base.

Officials consider the rule should apply consistently to all taxpayers and see no reason to exclude film and television industries from the rule or to otherwise differentiate them, from other industries.

Recommendation

That the submissions be declined.

Issue: Acquisition of shares

Clause 14

Submission
(2W – Brookfields Lawyers, 39 – Institute of Chartered Accountants of New Zealand)

Share purchases should be excluded from the scope of the definition.

Comment

Officials are aware of investment products in relation to the acquisition of portfolio investments (less than 10 percent interests) in listed companies where the funding arrangements would be included in the bill's definition of "money that is not at risk". These products are not the type of arrangement that the deferred deduction rule is targeted at.

Officials therefore recommend that an arrangement for the acquisition of a portfolio investment in a listed company should be added to the list of excluded assets.

Recommendation

That the submission be accepted in respect of portfolio investments in listed companies.

Issue: Share purchase schemes

Clause 14

Submissions
(2W – Brookfield Lawyers, 39 – Institute of Chartered Accountants of New Zealand)

Employee share purchase schemes should be removed from the scope of the deferred deduction rule.

Comment

Again, employee share purchase schemes are not a type of arrangement that is targeted by the deferred deduction rule. Officials agree with the submission that they should be removed from the scope of the deferred deduction rule.

The exclusion would apply to sales of shares where a benefit to the purchaser is to be taxed under section CH 2 of the Income Tax Act 1994. Section CH 2 provides for the tax treatment of benefits conferred on a taxpayer in respect of the taxpayer's employment or service, under an agreement to sell or issue shares in a company.

Recommendation

That the submissions be accepted.

Issue: Interest paid on money that is not at risk

Clause 14

Submission
(44A – MinterEllisonRuddWatts)

The deferred deduction rule should not apply where interest is paid on money that is not at risk and that creates a loss.

Comment

The mere payment of interest will not bring a transaction into the scope of the rule. Other features would have to be present as well, including the "money not at risk".

Further, there are difficulties with tracing interest and suggesting that it is not subject to the rule. The corporate interest deduction rules that were enacted in 2001 were partially predicated on the view that it was not always possible to trace interest payments through a group of companies because of the fungibility of money. There is no reason to believe that these difficulties do not exist still. Therefore, officials do not support this submission.

Recommendation

That the submission be declined.

Issue: 50 percent threshold

Clause 14

Submission
(7 – Screen Production and Development Association)

One criterion for the deferred deduction rule is that the money that is not at risk in the arrangement is 50 percent or more of the total cost of arrangement property. The 50 percent ratio is too low and should be increased to 75 percent (or at least 61 percent).

Comment

As the submission points out, a ratio of 75 percent would allow investors to make tax savings in excess of the money they invested, regardless of the success of the project. Accordingly, officials do not support this submission. The 61 percent alternative is carefully calculated to ensure that the tax base protects investors from any risk by ensuring they get their investment back as a tax refund.

Officials consider both options to be inappropriate.

Recommendation

That the submission be declined.

Issue: Consolidation approach to measuring property

Clause 14

Submissions
(44A – MinterEllisonRuddWatts)

Where borrowing is at one level and is used to acquire equity in another company, the provisions should allow for that other company's assets to be considered in measuring the 70 percent test. This is of concern in terms of the potential for the section to have unintended consequences.

Officials are asked to confirm what they are trying to achieve by section ES 1(3)(c) (consolidation accounting) and whether they have received quality financial accounting advice to the effect that the language used achieves the desired result.

Comment

Section ES 1(3)(c) ensures that the total cost of the property held by the investor and any affected associated persons is calculated on a consolidated basis. The purpose of this is to allow all relevant assets to be counted, while preventing double counting of intra-group assets, liabilities and equity. This will address explicitly the issue identified in submission 1, indirect ownership of property, as long as the "other company's assets" constitute property that is subject to the arrangement.

The example from the commentary on the bill that illustrates this is reproduced below.

Example 5: Determining whether the rule applies

Tom puts $10,000 of his own money into a scheme-specific loss attributing qualifying company which in turn invests into a partnership of such companies. The partnership uses $7,000 of this to plant trees and obtains a deduction for it in year one. The balance is used as part payment for the land on which the trees are grown.

The arrangement provides that the promoter will sell to the partnership land on which to grow trees. This land will cost $12,000 per partner.

Because the partnership cannot afford to pay for the land in full, the promoter arranges a loan of $9,000 per partner. This results in the investors actually not being at risk of having to repay this finance from their non-scheme assets. In economic terms, the loan is limited recourse against the scheme's assets and income.

The cash flows and tax deductions, ignoring interest, are summarised below.

Excess allowable deductions – section ES 1(1)(b)

Section ES 1(1)(b) requires the allowable deductions of the investor and affected associated persons to be to be considered together. In the example, the loss attributing qualifying company, and the partnership of such companies are affected associated persons. The partnership of loss attributing qualifying companies does not have allowable deductions because section HD 1(1)(b) provides that there is no joint assessment for partnerships. Each partner takes into account their share of the allowable deductions incurred by the partnership. Allowable deductions claimed by Tom and the company are:

Tom:	$7,000
Loss attributing qualifying company:	$7,000
Total:	$14,000

However, section ES 1(2) provides that a loss arising under section HG 16(1) is ignored to the extent necessary to prevent double counting. The deduction claimed by Tom is attributed to him by the company, and is ignored to prevent double counting. Therefore, in the first year that Tom acquired an interest in the arrangement, the arrangement's allowable deduction is $7,000. Gross income from the arrangement is nil, so the arrangement satisfies section ES 1(1)(b).

Tangible property test – section ES 1(1)(c)

The rule applies only if less than 70 percent of the property that is subject to the arrangement is tangible property that is land, buildings or major plant and machinery. "Land" means the surface of the ground, and anything attached to it.

For the purposes of determining whether the property of the arrangement is tangible property:

- the property is measured at cost (refer to section ES 1(3)(a));
- the investor and any affected associated persons are considered together as a group (refer to section ES 1(3)(b)); and
- the cost of the property is calculated on a consolidated basis for elimination of intra-group balances, equivalent to that used for companies under generally accepted accounting practice in New Zealand (refer to section ES 1(3)(c)).

The investor and affected associated persons who are considered as a group are:

- Tom;
- the loss attributing qualifying company; and
- the partnership of loss attributing qualifying companies.

Tom owns the shares in the loss attributing qualifying company which is a partner in the partnership of like companies. The partnership owns land (including trees).

Under consolidation principles, the $10,000 capital Tom holds in the loss attributing qualifying company needs to be eliminated. Likewise any capital or advances from the company to the partnership need to be eliminated.

After consolidation, all of the property of the arrangement consists of land (including trees), so the deferred deduction rule does not apply.

Officials recognise that such consolidation, in particular between individuals and their companies, is not a familiar concept.

Officials consider that the following clarifications should be made:

- It should be made clear that it is only the investor's percentage interest in the assets and liabilities of the arrangement that is consolidated. Put another way, assets and liabilities should be consolidated on a proportionate basis as espoused in Statement of Standard Accounting Practice 25 or any replacement thereof.
- Affected associated persons should include all shareholders and their loss attributing qualifying companies. This is appropriate because losses of those companies are attributed to all shareholders, not only those that own more than 25 percent of the shares (the section OD 7(1)(b) associated persons rule).
- The date on which the assets and liabilities and the money that is not at risk are consolidated should be the latest balance date adopted by the investor or an affected associated person.

Recommendation

That the submissions be noted and the officials' proposals be accepted.

PROMOTER

Issue: Scope of the definition

Clause 14

Submissions
(2W – Brookfields Lawyers, 7 – Screen Production and Development Association, 33 – PricewaterhouseCoopers, 39 – Institute of Chartered Accountants of New Zealand, 44A – MinterEllisonRuddWatts)

The definition of "promoter" is too wide and should be narrowed. In particular, ICANZ suggests that the definition be restricted by a requirement that there should be a specific minimum number of investors in an arrangement. *(All)*

The definition of "promoter" should be confined to situations where there are one or more passive investors. *(Screen Production and Development Association)*

Comment

Officials agree that the scope of the definition of "promoter" is wide. Consideration has been given to limiting the scope of the definition by placing a requirement for a particular number of investors in each arrangement, but this suggestion is not appropriate for the deferred deduction rule.

From a compliance perspective, such a requirement would lead to uncertainty because one investor may not necessarily be aware of others in an arrangement.

There is also the issue of what would constitute "the same arrangement" as minor changes to the terms of an arrangement could be made in order to avoid the numerical requirement. Further, there is already some evidence that promoters are amending their schemes to ensure that the recently enacted promoter penalty rules, which require a minimum number of investors, cannot apply because they simply have one fewer investor than the minimum number required. Thus officials conclude that a numerical requirement should be effective against the widely held schemes, but will encourage, as an alternative, more tailored arrangements that will simply avoid the rule by having one fewer than the number of investors specified.

In a number of cases it will be difficult to identify a "passive" investor. At the least, the investment entities are required to be in business. Limiting the definition of "promoter" to circumstances where there was one or more passive investors would not necessarily catch all targeted arrangements.

In order to allay some of the concerns expressed in the submissions, officials recommend that the definition be limited so that it applies only to a person who sells, issues or promotes an arrangement. This will also have the effect of simplifying the definition. It will not be necessary to include the exclusions from the definition that are currently in the bill as they will be unnecessary given this change.

Recommendation

That the submissions be noted, and that officials' recommendation that the definition be limited to persons who sell, issue or promote an arrangement should be accepted.

Issue: Advisors to financiers

Clause 14

Submission
(2W – Brookfields Lawyers)

Professional advisors to a financier who is not a promoter should be excluded from the definition of "promoter".

Comment

Under the bill it would be possible for an advisor to a financier to satisfy the definition of "promoter" if the advisor was significantly involved in formulating the arrangement. However, if officials' recommendation in the previous submission is accepted, it will not be possible for such an advisor to be a promoter unless he or she is involved in selling, issuing or promoting the arrangement. Therefore, if that recommendation is accepted, no further action will be necessary.

Recommendation

That the submission be noted, but if officials' recommendation in relation to the previous submission is accepted, no further action is necessary.

"MONEY THAT IS NOT AT RISK"

Issue: Commerciality

Clause 14

Submissions
(2W – Brookfields Lawyers, 39 – Institute of Chartered Accountants of New Zealand)

Certain financing arrangements included within the definition of "money that is not at risk" can be explained commercially and should not be included in the scope of the definition.

Comment

Officials accept that a number of financing arrangements that result in money not being at risk can be explained commercially. However, the money not at risk criterion is only one of the qualifying criteria for the deferred deduction rule.

The rule will operate only where all the criteria set out in the proposed section ES 1 are present:

- the arrangement has a promoter,
- the arrangement produces losses in its early years,
- the money that is not at risk constitutes 50 percent or more of the net arrangement assets of the investor and associated persons, and
- the arrangement is other than an investment of 70 percent or more in tangible property that consists of land, building, or major plant or machinery.

In particular, the fourth bullet point is key to targeting. Officials propose, as a result of submissions, to extend the categories of assets to which the rule will not apply.

Thus the scope of the deferred deduction rule must be considered as a whole, not simply on the basis of the definition of "money that is not at risk".

It is crucial to the effectiveness of the deferred deduction rule that all funding that is, in effect, limited recourse is potentially subject to the rule. While other criteria have the effect of limiting the scope of the rule, it is not appropriate to narrow the definition of "money that is not at risk".

Recommendation

That the submissions be declined.

Issue: Consultation

Clause 14

Submission
(44A – MinterEllisonRuddWatts)

Special consultation with banks and other financial institutions is desirable if it has not already occurred.

Comment

There have been a number of discussions with lawyers who are familiar with issues faced by financial institutions. The deferred deduction rule has been modified as a result of comments made.

Recommendation

That the submission be noted.

Issue: "Substantially similar economic effect"

Clause 14

Submission
(2W – Brookfields Lawyers)

The extension of the definition of "money that is not at risk", to a loan that has a substantially similar economic effect as the other elements of the definition, reduces the clarity of the provision and should be removed/replaced.

Comment

It is not possible to define precisely "money that is not at risk" because of the variety of funding arrangements that could be used to ensure that an investor may not be required to repay amounts owing. The definition therefore focuses on:

- loans that are explicitly or economically limited recourse; and
- loans where interest or repayments of principal are not required for ten years.

To prevent the deferred deduction rule being circumvented, it is also necessary to include any other loans that have a similar effect. The tenor required in drafting the "catch-all" provision is loans that have a substantially similar economic effect. Officials consider that no amendment is appropriate or required.

Recommendation

That the submission be declined.

Issue: Materiality

Clause 14

Submission
(39 – Institute of Chartered Accountants of New Zealand)

Section ES 2(4) should be removed.

Comment

Subsection ES 2(4) relates to loans where interest or repayments of principal are not required for 10 years (long-term loans). Subsection ES 2(4) provides that, for the purpose of determining whether a long term loan is "money that is not at risk", a payment is not treated as being material to the extent it is made for a purpose of defeating the intention and application of this subpart.

The submission argues that section ES 2(4) is illogical, tautologous and unnecessary. It points out that the element relating to long-term loans contains a materiality test, so if a payment is not material it is disregarded. If a payment is material then, by definition, it says there is no mischief and the loan is ordinary financing.

Officials disagree. Subsection ES 2(4) will apply when what appears to be a material payment is made, but in such a way that the intent and the application of the deferred deduction rule is defeated. An example could be where it appears that a material payment has been made, but in fact the investor is not actually bearing the cost of the payment because the amount of the "payment" is being added to the money that is not at risk.

Recommendation

That the submission be declined.

Issue: Grants and government loans

Clause 14

Submission
(7 – Screen Production and Development Association)

Grant-related suspensory loans, and loans from the Film Commission, the Film Fund Trust, New Zealand on Air and other government agencies should be specifically excluded from the definition of "money that is not at risk".

Comment

At issue is the nature of these "loans". These are generally, in effect, limited recourse loans, being repayable only if the project is successful. However, there are arguments that at least some of them are more in the nature of a grant than a loan. For example, the Film Commission accounts for its "loans" as if they were grants.

Deductions for expenditure incurred are generally reduced when the expenditure is funded from grant-related suspensory loans or government grants to business.

It may be appropriate for the "loans" to be excluded from the definition of "money that is not at risk". However, this will be the case only if the "loan" is treated as a grant. Officials therefore are considering an amendment to clarify the tax treatment of these "loans". The definition of "money that is not at risk" should not, at this stage, be amended to exclude government grants to business, grant-related suspensory loans, and loans from the Film Commission, the Film Fund Trust and New Zealand on Air.

Further consultation is to take place on this issue. This is planned over the next six months, with any resultant amendments being introduced in a later tax bill.

Recommendation

That the submission be declined at this stage.

Issue: Non-resident financiers

Clause 14

Submissions
(7 – Screen Production and Development Association, 26 – New Zealand Law Society, 44A – MinterEllisonRuddWatts)

Exclusions from "money that is not at risk" should not be limited to lenders who are tax resident in New Zealand but should be expanded to cover loans made on arm's length from all lenders (including offshore lenders). *(New Zealand Law Society)*

Overseas banks should qualify if they met certain specified criteria. For example, the exclusion from "money that is not at risk" could apply to banks that are listed on a recognised overseas stock exchange, are subsidiaries of companies that are listed on a recognised stock exchange, or are resident in countries with which New Zealand has a double tax agreement. *(Screen Production and Development Association)*

The exclusion from "money that is not at risk" should be extended to banks and insurance companies registered and tax resident in grey list companies. *(MinterEllisonRuddWatts)*

Comment

Loans are excluded from the definition where the terms are on an arm's length basis, and the lender regularly lends money on arm's length terms and carries on business in New Zealand. This is on the basis that, where appropriate, enquiry can be made of the lender. In contrast, loans from some overseas lenders may be difficult to verify.

Further, some overseas entities that call themselves banks may not, in fact, be banks. For example, the state of Delaware in the United States allows any company incorporated there to call itself a bank. Such an entity was used in the mass-marketed scheme "Kids World".

Accordingly, officials do not agree that the definition should be amended, at least at this stage.

Recommendation

That the submissions be declined, but the issue be kept under review.

ORDERING OF DEDUCTIONS

Clause 14

Submissions

(26 – New Zealand Law Society, 39 – Institute of Chartered Accountants of New Zealand, 42W – KPMG)

Allow deductions for expenditure funded from investors' contributions before applying the deferred deduction rule.

Comment

Officials consider that the fungible nature of money could make this approach too uncertain and complex to be of practical value to investors. Allowing the "at risk" money to be deducted first may also enable promoters to design arrangements that avoid the rules.

Recommendation

That the submissions be declined.

APPLICATION

Issue: Existing schemes

Clause 14

Submissions
(7 – Screen Production and Development Association, 26 – New Zealand Law Society, 33 – PricewaterhouseCoopers, 39 – Institute of Chartered Accountants of New Zealand, 42W – KPMG, 44A – MinterEllisonRuddWatts)

The deferred deduction rule should not apply to existing schemes.

Comment

The bill provides for the deferred deduction rule to apply to future deductions claimed by existing arrangements, but in more limited circumstances than for new arrangements. Not only must all the criteria for the deferred deduction rule be present before the rule would apply to an existing arrangement, but the rule would apply only where a significant portion of the deductions (70 percent) claimed arise in respect of fixed life intangible property or computer software; or where there is a reasonable understanding by investors that there are ten or more investors. This further restriction should ensure there is no impact of the rule on existing arrangements that do not breach these criteria.

Officials consider that the deferred deduction rule should apply to future deductions relating to existing arrangements that breach these criteria, because of the nature of those arrangements and the revenue cost involved. One series of arrangements, which may or may not constitute tax avoidance, has a fiscal cost of $70 million per year, and will continue to do so, if it is found to comply with tax law, for the next 40 or so years. These arrangements will go before the High Court early next year.

Recommendation

That the submissions be declined.

Issue: Criteria for existing schemes

Clause 14

Submissions
(44A – MinterEllisonRuddWatts)

There is no principled basis for a distinction between arrangements with ten or more persons and arrangements with fewer than ten persons. That criterion should be omitted from the application provision.

The criteria for the rule applying to future deductions from existing arrangements should be that a significant portion of the deductions (70 percent) claimed arise in respect of fixed life intangible property or computer software, and there is a reasonable understanding by investors that there are ten or more investors. In the bill these criteria are alternatives.

Comment

The only policy reason for these limitations is to mitigate the effect of the rule on existing arrangements. Officials agree that the limitations are arbitrary. They serve to narrow the transitional impact of the proposed rule. In principle, all future deductions from existing arrangements should be subject to the rule according to the main criteria.

Officials agree that the number "ten" is arbitrary, but a criterion such as this is needed.

Recommendation

That the submissions be declined.

REPEAL OF SECTION DK 1

Clause 13

Submission
(7 – Screen Production and Development Association)

Section DK 1 should be retained and loans that are subject to section DK 1 should be excluded from the definition of "money that is not at risk".

Comment

Section DK 1 partially reflects current policy in relation to film expenditure – that no deduction should be allowed to the extent that it is financed by way of limited recourse loans. However, the scope of the section DK 1 limited recourse rule is too narrow for this policy to be effective.

The deferred deduction rule is more generous than section DK 1, even though its definition of "money that is not at risk" is wider in scope. Therefore the bill provides that section DK 1 will be repealed when the deferred deduction rule is enacted.

As previously discussed, officials consider the film industry should be treated no differently to any other industry.

Recommendation

That the submission be declined.

DRAFTING ISSUES

Issue: Clarification

Clause 14

Submissions
(2W – Brookfields Lawyers, 39 – Institute of Chartered Accountants of New Zealand, 44A – MinterEllisonRuddWatts)

The "70 percent tangible property test" (see section ES 1(1)(c)) needs to be redrafted because it could exclude from the deferred deduction rule any undertaking where the expenditure does not produce property. *(Brookfields Lawyers)*

Section ES 1(3)(a) should make it clear that the point at which the property is valued is the point when it is acquired by the arrangement. *(Institute of Chartered Accountants of New Zealand)*

Section ES 3(5) provides that a repayment of "money that is not at risk" should not be counted if it is repaid as the result of a transaction involving the use of put or call options. However, that provision may not work properly because the repayment could, on a literal interpretation of section ES 1(1)(d), cause the deferred deduction rule not to apply. *(Brookfields Lawyers, MinterEllisonRuddWatts)*

Comment

The first submission raises the point that expenditure that is immediately deductible may not constitute "property". For the purposes of this part of the rule it should be regarded as property.

With regard to the second submission, the proposed use of "cost" for valuation makes this submission redundant.

The third submission raises a valid drafting point.

Recommendation

That the first and third submissions be accepted and the second submission be declined.

Issue: Simplification

Clause 14

Submissions
(2W – Brookfields Lawyers, 26 – New Zealand Law Society, 44A – MinterEllisonRuddWatts)

Section ES 1(1)(c)) is not clear. *(MinterEllisonRuddWatts)*

The use of the word "assumed" in subsections ES 1(2)(a) and (c), and the word "ignored" in subsections ES 1(2)(b) creates uncertainty. The wording of section ES 1(2) should be reconsidered, specifically the use of "assumed" and "ignored". *(New Zealand Law Society)*

The definition of "money that is not at risk" is difficult to interpret. *(MinterEllisonRuddWatts)*

There are many provisions in the Act that target timing of deductions, notably the provisions contained in subparts EF and EH. It would be desirable to prescribe in what way subpart ES relates to those provisions. *(Brookfields Lawyers)*

Comment

Some of the concepts underlying the deferred deduction rule are complex. They are necessary to ensure that the rules target appropriate arrangements.

However, consideration will be given to simplifying these concepts and the relevant drafting, if that is possible.

Recommendation

That the submissions be noted.

GST and local authorities

OVERVIEW

The proposed changes to the Goods and Services Tax Act 1985 for local authorities were referred to the Finance and Expenditure Committee by the Minister of Finance and Revenue on 18 July for inclusion in this bill. Interested parties were then invited to make submissions on the proposals.

Policy objectives

Resource Management Act 1991 and Local Government Act 2002

The Resource Management Act 1991 gives local authorities a framework and rules for administering the use of resources in local communities. As part of managing these resources it is necessary to consider what impacts on the wider community may occur on existing infrastructure assets and public goods. When considering a resource consent application a local authority may, provided it is in accordance with the council's district or regional plan, seek a contribution from the applicant. The contribution may be used either directly in connection with the work allowed under the resource consent (such as a public park or "green area" as part of new property development) or help supplement additional costs that may arise from pressure on existing infrastructure (such as additional demands on sewerage and drainage systems or roads).

The Local Government Act 2002 applies similar principles in relation to local authorities seeking development contributions from parties undertaking property development within a territorial authority's area of administration.

Goods and services tax

GST is meant to tax the consumption of goods and services in New Zealand by final consumers. This is achieved by applying GST to the widest possible range of goods and services supplied in New Zealand so that consumer patterns are not affected. To ensure that only final consumers face the full burden of GST, businesses receive a credit to offset the tax paid on purchases that are used to make supplies on which GST is imposed.

Under the GST Act and relevant case law, GST is imposed according to whether there is a sufficient connection between a payment and any supply of goods and services made in return for the payment. This creates a boundary making it difficult at times to determine whether certain payments should be classified as payment for taxable goods and services (consumption subject to GST) or payments that do not attract GST.

As outlined in the White Paper on GST,[9] it was noted that local authorities provide goods and services paid for by consumers by way of rates, fees, and other charges. In order that local authorities are treated in a manner consistent with other suppliers of goods and services, the policy intent is that fees and charges by local authorities would be subject to GST.

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[9] *White Paper on Goods and Services Tax*, March 1985 pg 14 and 34.

Commissioner of Inland Revenue v New Zealand Refining* and *Chatham Islands Enterprise Trust v Commissioner of Inland Revenue

These cases (which have been raised by submissions) concerned whether GST should be imposed on certain payments by the Crown to the New Zealand Refining Company and the Chatham Islands Enterprise Trust.

The *New Zealand Refining*[10] decision concerned whether an amount paid by the Crown to New Zealand Refining Company was consideration for a supply of goods and services to the Crown. The court considered that for GST to apply in respect of the payment made by the Crown it was necessary for there to be a link between the payment and the supply of goods and services from the New Zealand Refining Company Ltd. The court noted that GST is a tax on transactions, not receipts. From the facts in the case, the taxpayer was not contractually induced to keep operating in response to the payments from the Crown. As the taxpayer could arguably have shut down operations at any time, the payment from the Crown did not have the required nexus with any specific supplies made by the taxpayer for GST to apply.

The *Chatham Islands*[11] decision concerned whether GST should be returned on an amount paid by the Crown to set up a trust to administer former Crown activities in the Chatham Islands. The court considered that the GST consequences arising from the payment depended on the legal form of the transaction – not its substance. As the payment from the Crown was not made pursuant to a covenant or other reciprocal obligation, the taxpayer did not make a supply to the Crown. Further, as the payment settled a trust it was not in response to or for the inducement of a supply of any goods and services.

Inland Revenue draft ruling

Inland Revenue released for public comment a draft ruling[12] which considered the application of GST to contributions made to local authorities under the Resource Management Act. The draft ruling considered the transactions in light of the facts surrounding the contributions and the background of the *New Zealand Refining* and *Chatham Islands* decisions. The draft ruling concluded that GST would not apply to financial contributions sought by a local authority in respect of an application for a resource consent. The basis for this was:

- The emphasis in the case law on the need for reciprocal obligations between parties before a liability for GST will arise.
- There is no direct and identifiable supply made by the local authority that is reciprocal to the payment of a financial contribution.

The effect of the draft ruling was limited to the imposition of GST and did not consider the wider implications that could arise in respect of whether a resource consent applicant would be able to claim input tax credits in relation to GST paid on costs incurred.

[10] (1997) 18 NZTC 13,187
[11] (1999) 19 NZTC 15,075
[12] PU0095a & d.

This draft ruling departs from Inland Revenue's current interpretation,[13] which is that the supply of a resource consent, in return for the payment of a contribution by property developer, is subject to GST. If the consideration given by a registered property developer is non-monetary, Inland Revenue considers that the transaction is a barter transaction and that there are, therefore, two supplies that are subject to GST (and potentially corresponding input tax credits).

Proposed legislation

The proposed legislation confirms that financial contributions are consideration for the supply of goods and services by the local authority and thus treated in the same manner as rates. This is on the basis that the contributions can be regarded as consideration for the supply of goods and services undertaken by the local authority in response to certain activities allowed under the Resource Management Act. The amendment as proposed in the bill will require local authorities to return GST on cash and certain non-cash contributions.

To prevent the risk of backdated claims for refunds the legislation applies retrospectively to 1 October 1991 in relation to contributions under the Resource Management Act 1991 (the application date of that Act). In respect of development contributions sought under the Local Government Act 2002, the amendment applies from 1 July 2003 (the application date of that Act).

A savings provision has been inserted to ensure that taxpayers that have not charged GST on financial contributions in the past are not required to do so until the date that the proposed legislation is enacted.

OVERVIEW OF SUBMISSIONS

Opposition to proposed amendment

Three submissions oppose the proposed amendment and are generally concerned with the technical basis of the change. Most submissions disagree with the amendment in light of the *New Zealand Refining* and *Chatham Islands* decisions. Submissions also comment on the practical difficulties that the proposed amendment will impose on local authorities, including the cash flow cost and that it may restrict local authorities' ability to seek contributions.

Alternative proposal

The Society of Local Government Managers and Local Government New Zealand has proposed an alternative amendment that it believes addresses its members' concerns and those of the government.

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[13] Binding ruling BR97/12

Remedial GST amendments

Three submissions were also received on the remedial amendments referred to the Finance and Expenditure Committee concerning the GST treatment of late payment penalties imposed on local authority rates. Two of the submissions questioned the scope of the proposed amendment.

One submission raised an issue concerning the GST treatment of postponed rates.

GST AND CONTRIBUTIONS MADE UNDER THE RESOURCE MANAGEMENT ACT 1991

Issue: Oppose proposed amendment

Submissions
(12W – PricewaterhouseCoopers on behalf of the Auckland City Council, 31 – Society of Local Government Managers and Local Government New Zealand, 33 – PricewaterhouseCoopers)

Submissions oppose the proposed change and submit that it should not proceed. Specifically, they question the technical basis of the proposed amendment for the following reasons:

- The proposed amendment extends the application of GST beyond its statutory scheme. GST is a tax on transactions, not on receipts. Further, there must be reciprocity between the supplier and recipient for a GST liability to arise. As such, a liability for GST should arise based on the contractual form of the transaction rather than its economic substance. These principles are supported by the Court of Appeal cases *Commissioner of Inland Revenue v New Zealand Refining Company Limited* and *Chatham Islands Enterprise Trust v Commissioner of Inland Revenue*.

  These principles mean that when an applicant makes a financial contribution there is no supply made by the local authority that is reciprocal to the payment of the contribution.

  Inland Revenue has in an exposure draft supported theses principles and signalled that the correct view of the law is that GST does not apply to financial contributions. *(All)*

- The coercive power exercised by local authorities in their administration of the Resource Management Act 1991 should be viewed as a form of taxation. This emphasises that there is no element of reciprocity when a contribution is paid to a local authority. The contribution is therefore no more a consideration for the supply of goods and services that any other tax. *(Society of Local Government Managers and Local Government New Zealand, PricewaterhouseCoopers)*

- No policy reasons have been advanced to explain why the ambit of the GST Act should be extended. Adjunct amendments such as the one proposed here undermine the purpose and statutory scheme of the legislation and create difficulties in interpreting the legislation. *(PricewaterhouseCoopers)*

- The proposal is inconsistent with development contribution schemes operating in Australia and in the United Kingdom. *(PricewaterhouseCoopers)*

For these reasons financial contributions should remain outside the scope of the GST Act. The proposed amendment is therefore not a "clarification" of the current law but the imposition of a new tax.

Comment

Officials' comments are as follows:

- As noted by Local Government New Zealand and Society of Local Government Managers, the GST treatment of financial contributions is not clear.
- The proposed new section 5(7B) confirms the policy principle, as expressed in the *White Paper on Goods and Services Tax* that local authorities provide goods and services paid for by way of rates, fees and other charges. To ensure that no distortions arise between the treatment of goods and services supplied by local authorities and private sector providers of those same goods and services, GST should apply to local authority charges.
- The *New Zealand Refining Company Limited* and *Chatham Islands* cases concerned the treatment of payments by the Crown to taxpayers and naturally reflected the current law, rather than necessarily the appropriate policy outcome.
- Even if submissions are correct in viewing financial contributions as a form of tax, the application of GST is not unique when the tax relates to the provision of goods and services. For example, GST applies on goods and services which have been subject to duties, excises, levies (such as ACC), and statutory licence fees. The only tax in relation to which GST does not apply to is income tax. As noted by the Advisory Panel on Goods and Services Tax in its 1985 report, GST could apply to income tax but doing so would not have any practical meaning as the additional revenue would, in principle, be used to reduce the amount of income tax payable.
- Inland Revenue's current view is that GST applies; the view noted by submissions was expressed in a subsequent draft public ruling. This draft statement does not reflect Inland Revenue's view of how the GST Act should be applied in practice. Officials note it is not proposed to finalise the ruling because it would be superseded by the amendment in the bill. However, the ruling would have introduced further complications for local authorities and property developers as outlined in the Society of Local Government Managers and Local Government New Zealand submissions.
- While the proposed amendment may be inconsistent with practices adopted in the United Kingdom and Australia, officials note that New Zealand's GST is not directly comparable. Unlike the VAT/GST systems operated in the United Kingdom and Australia, New Zealand does not exclude local authority activities from the GST base, as is the case in the United Kingdom, or exclude state and local body taxes, as is the case in Australia.

Recommendation

That the submissions be declined.

Issue: Retroactive application and revenue risk

Submission
(31 – Society of Local Government Managers and Local Government New Zealand)

It is not necessary to make the proposed amendment retroactive. As far as the submissioner is aware, no local authority has sought a refund of GST previously returned on a financial contribution.

In any event, if the local authority did receive a refund it is very unlikely that it would receive any financial benefit as it would have to pay the overpaid GST to the property developer.

If fiscal risk is a concern, the government should legislate to confirm the status quo for events that occurred prior to the current bill only, as it is not necessary for financial contributions to be subject to GST on a go-forward basis.

Comment

Officials note that the GST Act does not require registered persons, as the submission suggests, to pass back GST refunds when GST has been incorrectly paid. Under these circumstances officials consider that there is a fiscal risk. This arises from the fact that currently taxpayers may seek refunds of overpaid GST for periods of up to eight years.

While it is expected that most payments of GST on financial contributions have been made by property developers that are registered for GST, local authorities are not required to pass on to the property developer (or other registered person that made a financial contribution) any GST refunds that could be sought. Inland Revenue could seek a corresponding GST adjustment from the developer or other registered person. However, a potential revenue risk would still arise because Inland Revenue may not in some cases be able to enforce an increase to an assessment – for example, if the property developer was facing financial difficulties or had ceased operating. In addition, Inland Revenue is able to reassess back year returns for four years only rather than the eight years allowed to taxpayers.

Recommendation

That the submission be declined.

Issue: Application date

Submission

(12W – PricewaterhouseCoopers on behalf of the Auckland City Council, 33 – PricewaterhouseCoopers)

There is an inconsistency between the application dates of proposed section 5(7B) in respect of contributions made under the Research Management Act because the amendment will apply to financial contributions made from the date of Royal assent of the bill, when GST has not been accounted for by the local authority but retrospectively from the date of application of the Research Management Act, when a local authority has accounted for GST on contributions.

By contrast, section 5(7B) will apply to development contributions made under the Local Government Act from 1 July 2003. This is contrary to Inland Revenue's view of the application of GST to such contributions and will impose a GST liability when there is no statutory requirement to do so between 1 July 2003 and the date of Royal assent.

Comment

The intention of setting the application date in relation to the development contributions received under the Local Government Act on and from 1 July 2003 is to align the GST treatment of such contributions from the commencement of the Local Government Act. Officials recognise that redressing the tax treatment of development contributions received between 1 July 2003 and the date that this proposed amendment is enacted could give rise to compliance and administrative costs for minimal potential gain. Officials therefore consider that it is appropriate that the commencement date of the proposed amendment in relation to development contributions received under the Local Government Act be change to the date of Royal assent.

Recommendation

That the submissions be accepted and the application date of new section 5(7B) in relation to development contributions made under the Local Government Act be changed from 1 July 2003 to the date of Royal assent.

Issue: Definition of "contribution" – inconsistent treatment and impact on unregistered developers and local authorities

Submission
(12W – PricewaterhouseCoopers on behalf of the Auckland City Council, 33 – PricewaterhouseCoopers)

The proposed amendment provides that a "contribution" required as a condition of resource consent or development contribution is treated as a supply. However, there is a lack of clarification as to what a "contribution" is in the context of the Research Management Act and Local Government Act. It is not a defined term in either Act. While the scope of a contribution is limited by the definition of "development contribution", the range of conditions that can be imposed under the Research Management Act are extensive.

This will create problems for local authorities in terms of how non-monetary contributions in the form of covenants, undertakings, and information disclosures should be valued. It is likely that GST will not be collected from contributions of this nature and this will mean that local authorities will incur a liability to account for GST without the practical ability to collect that amount.

Comment

The proposed amendment is directed at financial and development contributions that are made in the form of money, land or both. The proposed amendment is not intended to be directed at other conditions that can be imposed under the Research Management Act, such as disclosure of information or provision of works because of the valuation difficulties raised by submissioners. While these conditions could be treated as zero-rated to the extent that they constitute a supply, as is proposed for contributions in the form of land, it is questionable whether they will have any market value. Officials therefore recommend that new section 5(7B) be redrafted so that its application is clearly directed to contributions made in the form of money, land or both.

Recommendation

That the submissions be accepted.

Issue: Inconsistent treatment and impact on unregistered developers and local authorities

Submission

(12W – PricewaterhouseCoopers on behalf of the Auckland City Council, 33 – PricewaterhouseCoopers)

The proposed amendment creates fundamental problems in relation to developers that are not registered for GST. While many developers will be registered for GST, there are a significant number that do not need to, and choose not to, register for GST. Auckland City Council has a reasonable proportion of contributions resulting from developments where the developer is not registered for GST.

In addition, in the case of a contribution comprising of works that vest in the council the unregistered developer could effectively bear a GST impost of 26.56 percent on the contribution – this is the aggregate of GST paid in undertaking the required works plus GST imposed by the local authority under the proposed amendment.

This could have the effect of:

- fettering local council discretion when seeking contributions;
- forcing developers to register for GST;
- imposing a significant financial burden on unregistered developers; and
- increasing the cost of sub-dividing properties.

A further consequence of this is that the GST could become embedded in the sale price when works that vest in a council are subsequently sold by the council to a third party (such as a utilities company).

These adverse effects could not have been intended by officials.

Comment

Officials acknowledge that if GST were to apply in addition to works provided by an unregistered person it is possible that the GST would compound. As noted in the response to the previous submission, the proposed amendment should not include works and other conditions that are imposed for the purposes of a resource consent. A liability for GST would arise, however, if works were required to be performed on land owned by the unregistered property developer that later vests in the local authority.

In this situation, officials note that if the consent required a contribution in the form of land, the local authority would generally be able to claim a second-hand goods input tax credit equal to one-ninth of the value of the land. The second-hand goods input tax credit would, in principle, offset the GST cost incurred by the unregistered property developer, including the GST cost of providing certain works required under the consent.

As officials have recommended that the proposed amendment not apply to works, this, combined with the ability to claim a second-hand goods input tax credit, should address submissioners' concerns.

Recommendation

That the submission be noted as being addressed in part by the previous officials' recommendation.

Issue: Remission

Submission
(33 – PricewaterhouseCoopers)

Section 209 of the Local Government Act requires local authorities to refund development contributions when the development does not proceed. This view is based on a recent Inland Revenue view that the remission of rates does not reverse the original GST liability attaching to rates when assessed. If the current proposal is to proceed there will need to be a mechanism that reverses a local authority's GST liability under new section 5(7B) when a development contribution is refunded.

Comment

The submission refers to a matter concerning Inland Revenue's initial view in respect of the GST treatment of rates remission. This matter has since been resolved at an operational level in favour of the local authorities.

Recommendation

That the submission be declined on the basis that the issue has been resolved with Inland Revenue.

Issue: Alternative proposal – zero-rating

Submission
(31 – Society of Local Government Managers and Local Government New Zealand)

The proposed amendment will introduce problems concerning:

- determining the appropriate market value for non-cash contributions;
- the time of supply of non-cash contributions; and
- the availability of input tax credits for property developers.

The submission argues that, to the extent that a local authority treats a financial or development contribution under the Research Management Act and Local Government Act as a barter transaction or as two supplies (where the contribution is in the form of land and the local authority supplies goods and services), the two supplies should be zero-rated. This would simplify compliance for both local authorities and property developers.

Comment

Officials consider that the submission has identified a valid problem with proposed section 5(7B) in respect of ascertaining the value of goods and services supplied by the local authority when they are made in relation to a non-monetary contribution. It is suggested that zero-rating will address this problem and resolve difficulties that might otherwise arise if local authorities and property developers were required to follow the draft Inland Revenue ruling.

The submission notes that there are problems with applying the open market value provisions when a non-monetary contribution is made to a local authority. The open market value rule in the GST Act requires a determination of what another person in the position of the property developer (or other registered person) would be prepared to pay for the supply of goods and services deemed to be made by the local authority under the proposed section 5(7B). This can be difficult as illustrated in the example below:

Example – contribution in the form of land

As part of a development, a local authority requires a property developer to provide a section that can be used as a playground. The value of the contribution could be based on one of the following:

- the price that the property developer could have sold the section for, if it had remained as a residential lot; or
- the value of the land once it has been zoned as a park. Once land is zoned as a park it has a very low value as it requires a Ministerial consent for that land to be rezoned for another purpose.

Under proposed section 5(7B), treating the two supplies (the supply of goods and services by the local authority and the supply of the non-monetary contribution by the property developer) as a barter transaction will be revenue neutral because any GST charged by the local authority and property developer will be met with a corresponding input tax credit to each party.

Achieving this outcome, however, imposes compliance costs and, as the submission notes, creates tensions between local authorities and property developers in respect of which value should be applied. While the valuation applied to the example could be based on the value placed on the land by the local authority, this may not be acceptable to the property developer. If the deemed supplies were instead treated as zero-rated the problem is removed as it is not necessary for the local authority and developer to have an agreed value for GST purposes and revenue neutrality is preserved.

The submission also raises a concern as to the consequences if new section 5(7B) does not proceed and local authorities and property developers are required to follow the draft Inland Revenue ruling. The concern relates to the ability of GST-registered property developers to claim input tax credits in respect of work performed on land that later vests in the local authority.

Under the draft ruling, it is arguable that the property developer will be unable to claim input tax credits in respect of GST incurred in purchasing land which is transferred to a local authority as a development contribution. This is because, under the draft ruling, the contributions would be non-taxable, so the property developer would not be in a position to establish that these costs were incurred for the principal purpose of making taxable supplies.

If the supply created under new section 5(7B) were zero-rated this problem would be resolved as the costs incurred by the property developer would be for the principal purpose of making taxable supplies (being those received under the new section 5(7B)).

Officials further note that zero-rating would address other problems raised by submissions concerning the cash flow impact of the proposed amendment and determining the time of supply.

For example, if GST at the standard rate of 12.5 percent were applied to non-cash contributions the local authority would suffer cash flow problems as it would be obliged to return GST equal to one-ninth, or the tax fraction, of the agreed value of the contribution. The local authority would not, however, have the available cash to meet the liability as the non-cash contribution is not-liquid and may vest to the local authority at a later date. If the rate of GST were zero this cash flow problem would not arise.

Officials agree that the submission's proposal is an effective means of addressing the various compliance cost problems raised in the submission while at the same time preserving revenue neutrality. Officials note, however, that the same issue does not arise when contributions are made in the form of cash. This is because there is only one supply from the local authority to the property developer – being the supply of goods and services deemed to be made under new section 5(7B). The property developer does not make a supply in return as money is excluded from the definition of goods and services. Officials therefore consider that the submission's proposal should be accepted only in part.

Officials therefore recommend that goods and services supplied by a local authority under proposed section 5(7B) be zero-rated only to the extent that they are supplied for a contribution in the form of land. The supply of the land should be correspondingly zero-rated.

Recommendation

That the submission be accepted in part. Officials recommend that contributions in the form of land and the corresponding supply of goods and services by local authorities be treated as consideration for zero-rated supplies from date of Royal assent.

Issue: GST – postponed rates

Submission
(Matter raised by officials, 31 – Society of Local Government Managers and Local Government New Zealand)

An amendment to the Goods and Services Tax Act 1985 (the GST Act) is required to ensure that finance costs recovered by local authorities on postponed rates by way of postponement fees are not subject to GST.

Comment

Section 88 of the Local Government (Rating) Act 2002 allows local authorities to charge a fee when rates are postponed. This fee is meant to recover any administrative and financial costs associated with postponing rates. The current wording of section 88(3) of the Local Government (Rating) Act provides that for all purposes postponement fees, including finance costs, relating to the postponement of rates must be treated as part of the rates on the affected rating unit. This wording, in conjunction with section 5(7) of the GST Act, which treats local authority rates as consideration for the supply of public goods and services to the community, means that GST applies to postponement fees.

While it is appropriate that GST continues to apply to postponement fees generally, officials consider that any finance costs should be treated as "financial services" as postponement arrangements created by local authorities are similar to the creation of a debt security as defined in section 3 of the GST Act.

The proposed treatment would apply as follows:

- any administrative charge that forms part of the rates deferment payment would be subject to GST; and
- any financing costs would be treated as exempt from GST.

Local Government New Zealand and the Society of Local Government Managers have indicated their support for the proposed amendment.

Recommendation

That the submission be accepted.

Issue: Penalties on overdue rates

Submissions

(3W – Deloitte Touche Tohmatsu, 31 – Society of Local Government Managers and Local Government New Zealand, 33 – PricewaterhouseCoopers)

Submissions support the proposed amendment.

Comment

The amendment confirms that from 1 July 2003 late payment charges on overdue rates imposed by a local authority should be exempt from GST.

The Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002 amended the GST Act to allow penalty interest imposed under statute to be treated as an exempt supply. The amendment was made retrospective to 10 October 2000 to align the treatment of penalty interest imposed under statute with interest penalties imposed under contract. As a result of consultation during the passage of the Act, local authorities were excluded from the retrospective amendment owing to their concerns about compliance costs. It was expected that local authorities would be able to treat penalties imposed on overdue rates as consideration for an exempt supply from 1 July 2003.

Inland Revenue subsequently interpreted the amendment as not applying to penalties on overdue rates as the penalty was not regarded as in the nature of interest. Section 5(7) of the GST Act specifically treats the payment of rates as consideration for the supply of goods and services provided by a local authority to the wider community. This section, in conjunction with the definition of the term "rates" in the Local Government (Rating) Act 2002, means that local authorities are required to return GST on penalties imposed on overdue rates.

This interpretation is contrary to the policy intent of the 2002 amendment. An amendment is therefore required to section 14(3) of the GST Act to ensure that penalties on overdue rates are treated as consideration for exempt supplies.

As local authorities expected that penalties on overdue rates would be treated as an exempt supply from 1 July 2003, the proposed amendment has retrospective effect from that date.

Recommendation

That the submissions be noted.

Issue: Scope of proposed amendment

Submissions

(3W – Deloitte Touche Tohmatsu, 33 – PricewaterhouseCoopers)

The proposed amendment should go further and clarify the GST principle at issue – that late payment penalties imposed by entities other than local authorities should be exempt from GST. If a strict interpretation of the terms "interest" and "a charge in the nature of interest" is adopted the amendment will not achieve its purpose. The amendment should therefore be changed so that any penalty for late payment authorised and imposed under statute should be treated as an exempt supply. Alternatively, penalties under the Fire Services Act 1975 should be specifically clarified as being exempt. *(Deloitte Touche Tohmatsu)*

There is uncertainty concerning the current GST treatment of late payment charges imposed by organisations other than local authorities. This is particularly so when "flat" late payment fees are imposed rather than "interest" charges. Consideration should be given as to whether flat late payment charges should be subject to GST as they are not meant to be consideration for the supply of goods and services. *(PricewaterhouseCoopers)*

Comment

Officials' comments are:

- The situation that makes the current amendment to section 14(3) necessary is unique to local authorities as entities other than local authorities are not specifically treated as making supplies of goods and services (as is the case with rates penalties that are deemed to be part of the rates) when imposing penalties for late payment.
- Officials are not aware of any circumstances where Inland Revenue has required GST to be returned on interest (or charges in the nature of interest) imposed on overdue accounts by a public authority.
- In most cases, as outlined in the government discussion document *GST: A Review* (March 1999) and as enacted in the Taxation (GST and Miscellaneous Provisions) Act 2000, penalty interest is equivalent to the payment of interest on the outstanding balance of the purchase price. The charge therefore compensates for the time value of money, and is comparable to supplies included in the section 3 definition of "financial services". Officials consider that the same argument does not necessarily apply in respect of all "flat fee" charges for late payment. Rather, each case needs to be considered on its facts.
- To include "flat fee" late payments within the scope of the amendment would therefore widen the scope of the amendment beyond the original policy intent – for example, to situations where the fee is a means of recovering accounting and collection costs associated with truculent debtors or for charging debtors for the ongoing use of the goods and services supplied until payment is received. Including flat fee charges within the ambit of section 14(3) would not necessarily be welcomed by taxpayers as it would mean that such taxpayers

would be treated as making exempt supplies and would be required to apportion input tax when previously they were not required to do so.

- In the case of "flat fee" late payment charges imposed under contract, officials consider that ordinary principles should determine whether GST applies. This means that there needs to be a nexus between the "flat fee" and a taxable supply of goods and services for GST to apply.

Recommendation

That the submissions be declined. Officials will, however, continue to review the application of the GST Act to late payment penalties and discuss any issues with interested parties.

Other policy matters

Issue: Unwinding of charitable trusts and companies

Clauses 5, 17 and 66(5)

Submissions

(10 – Combined Community Trusts, 15 – Bay of Plenty Community Trust, 16 – The Community Trust of Wellington, 8 – The Community Trust of Otago, 41 – The Community Trust of Southland, 28 – Trust Waikato, 36 – Whanganui Community Foundation, 37 – The Community Trust (of Canterbury), 40 – West Coast Community trust Inc, 5 – Eastern and Central Community Trust)

The twelve community trusts strongly support the enactment of the proposed income tax exemption for community trusts because it will remove unnecessary compliance costs at the level of the community trusts. The community trusts support the proposal that is contained in clauses 5, 17 and 66(5).

The community trusts seek an additional provision relating to the unwinding of the charitable trusts and companies that they established in recent years. Under this provision, the charitable trusts and companies would be able to transfer their funds back to the community trusts without tax consequences. *(Combined Community Trusts)*

Comment

We appreciate that in a number of cases community trusts have established charitable subsidiary companies or sub-trusts. This has specifically added to the compliance costs for these community trusts. Under current law the practice has been that any income that a community trust is unable to distribute as trustee income can be distributed as beneficiary income to its subsidiary charitable entity. In future years, distributions can be made to charitable beneficiaries out of the community trust's charitable entity. This ensures the beneficiary income paid to tax-exempt charitable entities is not subject to tax. Under the proposed tax exemption it will no longer be necessary to distribute to a charitable subsidiary in order to ensure distributions are not taxable to charitable beneficiaries. Therefore we agree with the submissions. Community trusts should be given an opportunity for a transitional period to wind up their subsidiaries without tax consequences. This will assist in reducing their compliance costs in the future.

Recommendation

That the submissions be accepted.

Issue: Income received and distributed by a community trust should be tax-free to all recipients

Clause 17

Submission
(10 – Combined Community Trusts)

The inherently charitable nature of the income received and distributed by a community trust means that it ought to be able to be distributed on a tax-free basis to all recipients. The treatment of small, non-profit bodies is deserving of attention by government.

Comment

We agree that there is a need to review the tax treatment of non-profit organisations, and the government has indicated that it will consider this as part of the prioritisation exercise for the 2004/05 tax policy work programme. However, we do not agree that distributions to all tax paying not-for-profit organisations should be tax free. This would, in effect, extend the tax exemption for charitable status.

Recommendation

That the submission be declined.

Issue: Community trusts should be deemed to be charities

Clause 17

Submissions
(17 – AMP Henderson Global Investments (New Zealand) Limited (AMP), 42 – KPMG)

Clause 5 should be replaced with a provision that deems a community trust to be a charity for the purposes of the income it derives. Fund managers will then be able to pool the funds of community trusts with those of other charities. Community trusts have no pooling mechanism to manage their funds. *(AMP)*

Community trusts should be deemed to be charities for the purposes of the income they derive. This will give the community trusts the benefits of the efficiencies of investing in pooled investment vehicles. *(KPMG)*

Comment

We do not consider this treatment to be appropriate as the purposes of community trusts are wider than those of charities. This would allow an exemption from tax to organisations that are not charitable.

Recommendation

That the submission be declined.

Issue: Tax-exempt status should be elective

Clause 17

Submission
(42 – KPMG)

Tax-exempt status may reduce the income of some community trusts, and shall depend on an irrevocable election.

Comment

This proposal would add to or at least not reduce the compliance costs of community trusts under a proposal that is being introduced to reduce these costs. Community trusts have been closely consulted and support the proposals. They have not sought that their future exempt status should depend on an election.

Recommendation

That the submission be declined.

Issue: Compliance costs for community trusts and beneficiary organisations

Clause 17

Submissions
(17 – AMP Henderson Global Investments (New Zealand) Limited, 30 – Investment Savings and Insurance Association of New Zealand Inc, 20 – New Zealand Federation of Voluntary Welfare Organisations Inc, 9 – Russell Investment Group)

The proposal may constrain the investment options available to community trusts, creating inefficiencies and distortions in investment decisions. *(AMP)*

This "closely targeted exemption" is an "ad hoc" law change. *(Investment Savings and Insurance Association of New Zealand)*

Compliance costs will be transferred to beneficiary organisations. Added administrative costs will reduce the funds available for community work and services. This problem may be partially solved by increasing the amount of the deduction available to not-for-profit organisations from the existing $1000 to at least $10,000. *(New Zealand Federation of Voluntary Welfare Organisations Inc)*

The bill will not simplify the financial management of the Trusts as far as intended. There is a case for removing the distinction between pre-1 April 2004 and post-1 April 2004 earnings retained by the Trusts as capital. *(Russell Investment Group)*

Comment

In response to the submissions that the tax exemption may constrain the investment options available to community trusts and that the changes are "ad hoc", the proposal was developed in consultation with community trusts to meet concerns over compliance costs. The community trusts support the proposals.

In response to the submission that the proposals will transfer compliance costs to beneficiary organisations, we accept that, in some cases, the tax liability will shift to recipients of community trust donations. This is the intention of the proposal so that there is no alteration to the current tax treatment of beneficiary organisations. As noted above, the government has agreed to consider the treatment of not for profit organisations as part of the prioritisation exercise of for the 2004/2005 tax policy work programme.

The amount of the deduction available to not-for-profit organisations could be increased to cover costs and will be considered as part of this review.

We disagree with the submission that the distinction between pre-1 April 2004 and post-1 April 2004 earnings retained by the Trusts should be removed. This is a transitional measure that ensures that trustee income that has had tax paid on it is not taxed again on the distribution to a taxable beneficiary.

Removing this distinction would effectively exempt from tax distributions to entities that do not qualify for an income tax exemption. We acknowledge that this may leave a compliance cost with the community trust in determining the tax status of the beneficiary to decide whether capital or income is to be distributed to the beneficiary.

Recommendation

That the submissions be declined.

Issue: Withholding tax

Clause 17

Submissions

(20 – New Zealand Federation of Voluntary Welfare Organisations Inc, 39 – Institute of Chartered Accountants of New Zealand)

Grants from community trusts are generally treated as "restricted income", which by definition is available only for the specified purpose. If tax must be paid on the gross amount of the grant, there might be insufficient money left to complete the relevant project. It is recommended community trusts are required to deduct withholding tax from any grants made to a tax-paying entity. *(New Zealand Federation of Voluntary Welfare Organisations Inc)*

Beneficiaries of grants from community trusts should be able to elect to have their grants subject to RWT deducted by the Trust. *(Institute of Chartered Accountants of New Zealand)*

Comment

We understand that community trusts will be able to pay grossed-up grants to tax-paying beneficiaries, so that the grants cover their main purpose and the associated tax charge.

Requiring community trusts to withhold tax would be contrary to the purpose of the proposal. The proposal is the result of community trusts seeking an income tax exemption to reduce compliance costs currently incurred by them in order to make tax-free distributions to mostly tax exempt entities.

Additionally, community trust representatives have indicated that distributions of capital could be made to taxable beneficiaries in order to remove the potential tax liability for the taxable beneficiary. Distributions of capital could be made out of the corpus of the trust – that is, the capital sums that are settled on the trust.

Recommendation

That the submission be declined.

Issue: Imputation credits should be available to community trusts

Clauses 5 and 17

Submission

(20 – New Zealand Federation of Voluntary Welfare Organisations Inc, 39 – Institute of Chartered Accountants of New Zealand)

Cash credits should be made available to the community trusts. This will ensure that the return from investments in companies is maximised and the total amount available for grants is enhanced.

Comment

Cash credits would, in effect, enable community trusts to pass the financial benefit of imputation credits to charitable beneficiaries and to taxable beneficiaries.

The government has said it will review the imputation credit treatment of charities in the future. Such a review will need to consider the position of charities that receive imposed income via community trusts.

Community trusts were consulted on the issue of allowing imputation credits to pass through to taxable beneficiaries. The community trusts did not see this as a significant issue and felt that it was better not to complicate the reforms.

Recommendation

That the submission be declined.

REPEAL OF INCOME TAX EXEMPTION FOR SICK, ACCIDENT OR DEATH BENEFIT FUNDS

Issue: Deferring repeal until wider review of non-profit sector undertaken

Clauses 6, 10, 11 and 62(2)

Submission
(39 – Institute of Chartered Accountants of New Zealand)

The removal of the tax exemption for sick, accident or death benefit (SAD) funds should be delayed pending completion of Inland Revenue's wider review of the tax regime for the non-profit sector. Abuse of this exemption should be able to be dealt with under existing law.

Comment

The current income tax exemption for SAD funds raises tax base maintenance concerns. In particular, schemes with aggressive features which exploit the income tax exemption have been marketed to high-income individuals to reduce the tax they pay.

The tax base maintenance concerns with the current SAD fund income tax exemption need to be addressed now and cannot wait until any wider tax review of the non-profit sector.

The submission argues that any aggressive tax schemes should be able to be targeted under the avoidance rules in the current tax legislation, and the repeal of the SAD fund income tax exemption is not necessary simply to serve this purpose.

Officials do not consider that it is sufficient to rely on existing tax rules to counter aggressive tax schemes exploiting the SAD fund income tax exemption. Because of the open-ended nature of the current exemption, there are few effective barriers preventing high-income individuals exploiting the exemption. The definition of a SAD fund simply refers to any fund established for the benefit of the employees of any employer, or the members of an incorporated society, and the surviving spouses and dependants of any such employees and members. There is no explicit requirement that a SAD fund be established only for protection against sickness, accident or death.

Although Inland Revenue can seek to apply the general anti-avoidance rules in the income tax legislation against aggressive tax schemes, the outcome is not certain. The best way of closing such schemes down with certainty is to address the real cause of the problem, which is the SAD fund income tax exemption itself.

The exemption is also being removed because it is anomalous in terms of current tax policy. The exemption is inconsistent with the current policy for the taxation of savings because it can be used effectively to allow earnings on personal savings to be exempt from income tax. The exemption therefore provides concessionary treatment that is not available to other forms of savings. The current income tax exemption for SAD funds is also inconsistent with the treatment of insurance policies entered into for protection against sickness, accident or death. The earnings on contributions or premiums paid on such policies are generally taxable.

Recommendation

That the submission be declined.

Issue: Inserting anti-avoidance rules in current exemption

Clauses 6, 10, 11 and 62(2)

Submission
(42W – KPMG)

With some appropriate safeguards incorporated in the provisions defining a SAD fund, such funds as are used for their intended purpose should be allowed to continue. Examples of the types of safeguards that could be used to overcome the current problems are:

- Eliminating transactions with the employer entity and associated persons. For example, if a SAD fund owns the employer's premises and rent is paid, the rent will be taxable. Thus only income derived from genuine arm's length investments will be tax free.
- That no benefit, other than a benefit paid under the terms of the scheme, may be paid to any shareholder or director or associated person.
- That the scheme submits annual returns that disclose details of the benefits paid and to whom.
- That the scheme be required to have a trustee oversee its investments and that it requires an auditor's certificate verifying that all of the requirements have been met.

Comment

The current SAD fund income tax exemption raises tax base maintenance concerns. In particular, schemes with aggressive features which exploit this exemption have been marketed to high-income individuals to reduce the tax they pay.

The tax base maintenance concerns with the current SAD fund income tax exemption arise because of the open-ended nature of the exemption. A SAD fund is defined very widely in the Income Tax Act 1994 as a fund established for the benefit of the employees of any employer, or the members of an incorporated society, and the surviving spouses and dependants of any such employees and members. There is no explicit requirement that a SAD fund be established only for protection against sickness, accident or death.

The specific anti-avoidance rules suggested by the submissioner do not address the main cause of the base maintenance problem of the SAD fund income tax exemption which is its open-ended nature. Officials consider it unlikely that specific anti-avoidance rules could be devised to counter the aggressive tax planning schemes which cannot themselves be circumvented. The best way of closing such schemes down with certainty is to address the real cause of the problem, which is the open-ended SAD fund income tax exemption itself.

Recommendation

That the submission be declined.

Issue: Deferring application date

Clause 6(2)

Submission
(42W – KPMG)

If the repeal of the income tax exemption for SAD funds proceeds, a period of time should be allowed of at least one full income year to give SAD funds time to wind up their affairs and distribute their assets or to incorporate in another form. It is appropriate that time be given to allow SAD funds, and employers with SAD funds, to reconsider their future.

Comment

The bill currently provides that the repeal of the SAD fund income tax exemption will apply to income derived after the date of enactment.

The repeal of the income tax exemption for SAD funds has been signalled for some time. The Committee of Experts on Tax Compliance in 1998 considered that the income tax exemption for SAD funds was anomalous in terms of current tax policy and that there was no public policy justification for its continuance. Accordingly, the Committee recommended the repeal of the tax exemption.

It is common for tax measures to apply from the date of enactment. The current bill was introduced on 23 June 2003 and is not expected to be enacted until late November this year. Officials consider that this gives SAD funds sufficient time to consider their situations and either wind up their affairs or reorganise themselves.

Further time is also not necessary when the nature of SAD funds is taken into account. The current income tax exemption for SAD funds applies only to passive income such as interest and dividends, and not to business income. SAD funds therefore do not carry on businesses which would require a longer time to reorganise than passive investments.

If the application date was deferred as suggested by the submission, the exemption would continue in force for another year following the enactment of the legislation. Given the tax base maintenance concerns with the current exemption such an extension of this exemption does not seem to be justified. The current exemption is also anomalous in terms of current tax policy as it is inconsistent with the current policy for both the taxation of savings and insurance policies. Prolonging such an anomaly again does not seem to be justified. The repeal of the exemption should, therefore, not be deferred.

Recommendation

That the submission be declined.

Issue: Closely targeted exemption for SAD funds resembling friendly societies

Clauses 6, 10, 11 and 62(2)

Submission
(22 – Police Welfare Fund Limited, 23 – Health Service Welfare Society Limited, 24 – Educational Benevolent Society Inc, 25 – Union Medical Benefits Society Limited, 19 – Business New Zealand, 21 – New Zealand Council of Trade Unions)

A new, tightly-targeted provision should be inserted into the bill to give certain SAD funds which are similar to friendly societies the same tax exemption as that which is currently available to friendly societies. Such an amendment would maintain the status quo for such bodies.

There is a strong element of mutuality and collective self-help in such entities. Accordingly, they are more akin to friendly societies in nature but, for a number of reasons, are structured differently from friendly societies.

Such entities are not used as savings vehicles and are not comparable with commercial insurance providers. No dividends are payable by these entities.

Because of the way they are currently organised these entities would incur significant compliance costs if they were forced to restructure formally as friendly societies. One of the requirements of the Friendly Societies and Credit Unions Act 1982 is that membership and subscription must be concomitant. Because of the way they are organised this is not the case with these bodies.

Business New Zealand supports the submission from the Police Welfare Fund Limited, Health Services Welfare Society Limited, Union Medical Benefits Society Limited and Educational Benevolent Society Inc that these organisations be provided with the same tax exemption as available to friendly societies.

The New Zealand Council of Trade Unions is concerned that the repeal of the SAD income tax exemption will have a damaging effect on some genuine schemes which employees have been contributing to solely, or almost completely, to ensure there is a payment to them in the event of sickness or accident preventing ongoing employment, or death.

Comment

Officials agree with the submissions that there are a number of SAD insurers that share the mutuality characteristics of friendly societies, which are exempt from income tax under section CB 4(1)(a) of the Income Tax Act 1994. The friendly society income tax exemption covers the majority of the health insurance market.

Although certain SAD funds have the requisite mutuality characteristics, they would incur significant compliance costs if they had to restructure formally as friendly societies. These costs would mostly arise because the Friendly Societies and Credit Unions Act 1982 requires the members of and the subscribers to a friendly society to be the same persons. However, some of the insurers which have SAD funds status are currently organised as subsidiaries in a group structure, with the individual subscribers to the insurer being members of the entity which owns the insurer instead of being members of the insurer itself. Significant restructuring costs would have to be incurred by these insurers in order to qualify for registration as friendly societies.

Officials agree that as a compliance cost savings measure a separate exemption should be provided to those SAD funds which have the required mutual characteristics of friendly societies. (Entities that are established in the future that wish to enjoy the friendly society income tax exemption should be organised as such from the outset.) In particular, the exemption should apply to an entity that satisfies the following requirements:

- Provides health insurance, accident insurance, life insurance or other health and welfare benefits to members.
- Has limitations on distributions made to members.
- Has previously been approved by the Commissioner of Inland Revenue as a SAD fund.
- Is separately approved by the Commissioner for the purposes of this exemption within six months of the date of enactment of this bill.

The new exemption would have the same ambit as the exemption applying to friendly societies and, in particular, would not apply to an amount derived by an entity from a business carried on beyond the circle of its membership. The exemption would apply to income derived after the date of enactment of the bill.

Recommendation

That the submissions be accepted.

Issue: Narrow ambit of proposed exemption for funeral expense funds

Clause 6

Submission
(39 – Institute of Chartered Accountants of New Zealand, 47W – CMC Superannuation Benevolent Fund)

The Institute of Chartered Accountants of New Zealand disagrees that the current use of SAD funds should be narrowed to apply only to funeral expenses.

The trustee of the CMC Superannuation Benevolent Fund submits that the wording of the proposed exemption for funeral expense funds should be amended so that the exemption also applies to funds established for the purpose of paying for surgical, medical or dental costs.

Comment

The bill contains a new, closely targeted income tax exemption for the investment earnings of funds established solely for the purpose of paying for the funeral expenses of employees and their spouses and dependants. The government has agreed to the current ambit only of this proposed exemption.

It is possible that the concerns of the CMC Superannuation Benevolent Fund may be addressed by the proposed separate exemption for existing SAD funds that exhibit the mutuality characteristics of friendly societies.

Recommendation

That the submissions be declined.

Issue: Tax treatment of distributions from funeral expense funds

Clause 6

Submission
(42W – KPMG)

The broad definition of a "unit trust" in the Income Tax Act could apply to the proposed funeral expense funds. For the sake of completeness, the definition of a unit trust in section OB 1 should list these funds in the list of exclusions.

Comment

Officials consider that distributions made by any funeral expense funds for the purpose of the payment of expenses associated with funerals would not be subject to tax. For the avoidance of doubt, officials agree that funeral expense funds should be included in the list of exclusions in the definition of a "unit trust" in the Income Tax Act 1994 to ensure that the dividend rules do not apply to any distributions from funeral expense funds.

Recommendation

That the submission be accepted.

Issue: Requirement that "potential beneficiaries" of a funeral expense fund be equally eligible for benefits

Clause 6

Submission
(44 – MinterEllisonRuddWatts)

The reference to "potential beneficiaries" in proposed new section CB 5(1)(ib)(iii) – referring to one of the conditions for the proposed new income tax exemption for funeral expense funds – should be replaced with "beneficiaries" as it is unclear as to who is a "potential beneficiary". A settlor of the trust will specify who the beneficiaries of the trust are to be.

Comment

The bill contains a closely targeted exemption for the investment earnings of funds established solely for the purpose of paying for the funeral expenses of employees and their spouses and dependants. One of the requirements of the exemption is that all "potential beneficiaries" of the trust must be equally eligible for benefits from the fund. Officials consider that this requirement could be equally achieved by the legislation referring to "persons eligible to benefit from the fund" instead of "potential beneficiaries".

Recommendation

That the submission be accepted to the extent of replacing the reference to “potential beneficiaries” with a reference to persons eligible to benefit from the fund.

Issue: Adjusting marginal tax rate thresholds for inflation

Clauses 23 and 25

Submission
(42W – KPMG)

The submission supports the proposal to increase income thresholds for family support, child tax credit and parental tax credit, to provide an adjustment for inflation for the year ended September 2003.

Marginal tax rate thresholds should be similarly adjusted for inflation, by way of a predetermined formula.

Comment

Adjusting thresholds for inflation is a spending proposal to be considered alongside other priorities. Thresholds and tax and tax credit rates are adjusted occasionally in the normal course of events to reflect circumstances and policy changes. Policy changes are designed to take future inflation into account. In a low inflation environment, the effects are not large, especially for low-income earners. Indexation of thresholds does not take these factors into account.

Recommendation

That the submission be declined.

Issue: Adjusting income-related rebates to allow for additional paydays

Clauses 23, 24 and 26

Submission
(42W – KPMG)

An extra pay rebate should be re-introduced. This rebate would compensate recipients of any income-related rebates for the reduction in entitlement attributable to the extra income received in years with additional paydays.

Comment

The extra pay rebate was repealed in 1999. Until this time, tax deduction certificates had been used by employers to record the number of pays employees received during an income year, and their abolition removed this avenue of communication with Inland Revenue. Re-instating the rebate would require the collection of this information by some other means, imposing compliance costs on employers and administrative costs on Inland Revenue.

During income years with additional paydays, recipients receive more income than they would in a normal year, and their entitlement for some income-related rebates may be reduced on this basis. However, this reduction is justified as income-related rebates are, by their very definition, contingent upon a taxpayer's income during the year from any source.

These considerations argue against the re-instatement of an extra pay rebate.

Recommendation

That the submission be declined.

TAX POOLING

Clauses 32-34, 40-42, 46-49, 60 and 66(21)

Issue: Notice from intermediaries to depositers

Submission
(30 – Institute of Chartered Accountants of New Zealand,
33 – PricewaterhouseCoopers, 46 – Tax Management)

The proposed change to the notification requirements in section MBB 4(3) should not proceed. Instead, the section should be amended to allow a period of time following each deposit (say 60 or 90 days) in which an intermediary can notify a taxpayer that payment to an intermediary does not satisfy any obligation of the taxpayer to make a payment to the Commissioner.

Comment

Section MBB 4(3) provides that an intermediary who accepts a payment from a taxpayer for deposit in a tax pooling account must, at the time of the payment, give notice to the taxpayer that the payment to the intermediary does not satisfy any obligation of the taxpayer to make a payment to the Commissioner.

The bill proposes that this be changed so that an intermediary is required to notify a taxpayer only once, before or at the time of the first payment

ICANZ and PricewaterhouseCoopers consider that it is important that taxpayers receive a notice in relation to each deposit. They state that, in its absence, the awareness that the taxpayer may be obliged to pay provisional tax again to the Commissioner may be lost.

Tax Management, a pooling intermediary, supports the amendment in its submission, noting that it keeps compliance costs down. It compares the situation of depositers to those who give tax payment cheques to their accountants for passing on to the Inland Revenue where there is no statutory obligation for the person receiving the cheque to give advice to the taxpayer that the payment to the accountant does not satisfy any obligation of the taxpayer to make a payment to the Commissioner.

Officials consider that, on balance, it is sufficient for an intermediary to notify a taxpayer once before or at the time of the first deposit. To require the intermediary to notify the taxpayer in relation to each deposit imposes excessive regulatory requirements. We recommend that the provision in the bill remain.

Recommendation

That the submission be declined.

Submission
(46 – Tax Management)

The wording of the notice from the intermediary to a depositer should be changed to:

> *"subject to section MBB 6 a payment to an intermediary will satisfy an obligation of the taxpayer to make a payment to the Commissioner when the amount is transferred from the pool account to the taxpayer's account".*

Comment

The current provision requires the intermediary to give notice to the taxpayer that the payment to the intermediary does not satisfy any obligation of the taxpayer to make a payment to the Commissioner.

The submission argues that the wording of the notice should be changed to emphasise that the taxpayer has taken a positive step in complying and to make clear the remaining step to complete the compliance process.

Officials consider that the current wording makes the point more directly and clearly that payment to an intermediary does not constitute tax paid to the Commissioner. We recommend that the current wording be retained.

Recommendation

That the submission be declined.

Issue: Imputation: Breach of continuity and pooling credit recorder mechanism

Submission
(30 – Institute of Chartered Accountants of New Zealand, 46 – Tax Management)

The provisions introduce a "pooling credit recorder" mechanism to prevent companies that deposit an amount into a pool losing excessive imputation credits when there is a significant change in shareholding following the deposit. This mechanism works but requires additional record keeping. Instead, a provision should be introduced based on the existing section MD 2(4), which achieves a similar purpose in relation to tax payments made direct to the Commissioner. Tax Management proposes wording for such a provision.

Comment

Officials agree that the objective of the pooling credit recorder mechanism is more easily achieved by adopting a rule similar to that in section MD 2(4). The type of rule proposed in the Tax Management submission appears to work.

Submissions from ICANZ and PricewaterhouseCoopers that propose minor drafting or technical changes to the pooling credit recorder mechanism are therefore no longer relevant.

Recommendation

That the submission be accepted.

Issue: Debits arising to imputation credit account on transfers or refunds from tax pooling account

Submission
(30 – Investment Savings and Insurance Association of New Zealand Inc, 33 – PricewaterhouseCoopers)

Proposed new sections ME 5(2)(eb) and ME 5(2B)(a) are not required and should not proceed. They state that where a refund or transfer exceeds the credit balance in the imputation credit account as at the date of the refund/transfer and at the previous imputation balance date, a debit will arise at the previous balance date equal to the entire amount of the refund. This will trigger penalties and is unfair relative to the existing rules in section MD 2(1) which the proposed new sections are intended to replicate.

Section MD 2(1) would be sufficient to prevent any perceived mischief. If necessary that section could be clarified to ensure it applies to the pooling provisions.

Comment

Section MD 2(1), which authorises the Commissioner to withhold refunds of income tax owing to a company where there is an insufficient balance in the company's imputation credit account, cannot apply to refunds from a pooling account to a taxpayer. This is because the Commissioner will not know who is entitled to the funds in the pooling account and therefore on whose behalf the refund is being sought.

However, the proposal in the next submission below addresses the concerns of PricewaterhouseCoopers and ISI about the unfairness of the provision in the bill relative to the existing section MD 2(1).

Recommendation

That the submission be declined.

Submission
(30 – Institute of Chartered Accountants of New Zealand, 46 – Tax Management)

The proposed new sections ME 5(2)(e) and ME 5(2B) and the equivalent provisions applying to consolidated companies should be replaced. A fairer rule is that an imputation debit arising from the refund or transfer of funds in a tax pooling account be debited to the ICA in the following order:

- First, against any credit balance at the previous 31 March
- Second, against any credit balance at the time of the refund or transfer, and
- Third, on the previous 31 March – triggering an imputation penalty on this balance.

An updated imputation return for 31 March could be filed at the next 31 March unless the account was in debit, in which case the taxpayer should have to file an interim return.

Comment

Officials agree that the mechanism proposed is fairer than the equivalent provisions in the bill. If an imputation return for the year ending on the previous 31 March has been filed, we agree that a revised return be filed if the transaction has resulted in the imputation account being in debit. A revised return should also be required if the taxpayer becomes entitled to a refund of income tax that would be withheld by the Commissioner under section MD 2. We expect that this requirement will affect a small number of taxpayers.

Recommendation

That the submission be accepted, and that taxpayers be required to file a revised return for the year ending on the previous 31 March if the transaction has resulted in the imputation account going in debit at that date or if the taxpayer becomes entitled to a refund of income tax that would be withheld by the Commissioner because of insufficient funds in the taxpayer's imputation credit account.

Issue: Timing of imputation credit arising where taxpayer purchases funds in pooling account

Submission
(Matter raised by officials)

When a taxpayer purchases funds in a pooling account from an intermediary, imputation credits should arise in relation to that purchase as at the effective date at which the funds are transferred to the taxpayer's tax account with the Commissioner, or the date on which the funds are refunded to the taxpayer or transferred to the intermediary for on-sale to another taxpayer.

Comment

The bill provides that, when a taxpayer purchases funds in a pool from an intermediary, an imputation credit arises for the funds purchased. The credit arises on the date of the transfer to the taxpayer in the intermediary's books of account.

The timing of the credit enables a taxpayer to avoid the imputation shareholder continuity rules which provide that imputation credits are lost when a company is sold. For example, a company (A Co) that was to be sold on, say, 31 March 2004 could arrange for an associated company (B Co) to pay sufficient funds into the pool on provisional tax dates for the 2003-2004 year to cover A Co's provisional tax liability for that year. On 1 April 2004, after the sale of A Co's shares, entitlement to the funds deposited by B Co would be transferred to A Co. Under the timing rule in the bill, an imputation credit for those funds would arise to A Co's ICA on 1 April 2004. The imputation credits would thereby be preserved because they arise after the sale.

To avoid this, the imputation credit for funds purchased from the pool should arise on the effective date of transfer of the tax from the pool to the individual taxpayer's account with the Commissioner. For example, if A Co purchased funds from B Co on 1 April 2004, and the funds were transferred from the pool to the Commissioner to meet A Co's provisional tax liability due on 7 March 2004, the credit would arise on 7 March 2004. There would be no requirement to refile an imputation return that had already been filed, although taxpayers could choose to do so.

In the unlikely event that the funds were not transferred by the taxpayer to its tax account with the Commissioner, but were refunded from the pool to the taxpayer or transferred to another taxpayer, the credit would arise on the date of the refund or transfer.

Recommendation

That the submission be accepted.

Issue: Time period for requesting adjustments

Clauses 43(1) and 99

Submission

(33 – PricewaterhouseCoopers, 34 – Jeff Owens & Company Ltd, 39 – Institute of Chartered Accountants of New Zealand))

In any circumstances where Inland Revenue issues an assessment for FIT, the taxpayer involved should be allowed a period of two months from the date the assessment is issued, in order to be able to apply for relief from double taxation and extra penalties.

Comment

The proposed legislation provides relief from double taxation and extra penalties in relation to FIT liabilities.

The amendments are treated as coming into effect on 1 April 1998 (see references to sections 43(1) and 99 in clause 2 of the bill, which contains the commencement provisions). However, this general application date is limited by provisions within clauses 43(1) and 99, which restrict applications for adjustments relating to the imputation years beginning between 1 April 1998 and 1 April 2002 to a period of two calendar months from the date of enactment.

Submissions point out that the proposed legislation will not afford taxpayers relief from double taxation where the taxpayer has not been notified of tax liabilities or extra penalties within two months of enactment, and the liabilities or penalties relate to imputation years commencing between 1 April 1998 and 1 April 2002. Officials acknowledge that this situation could occur, say, for example, as the result of a tax audit.

This was not the policy intention.

Officials support the submission. A two-month period is consistent with the time frame in which a taxpayer must issue a notice of proposed adjustment if an assessment is being disputed.

Recommendation

That the submission be accepted.

Issue: Imputation credit account debit balances unchanged in successive years

Clause 43(1)

Submission

(33 – PricewaterhouseCoopers, 34 – Institute of Chartered Accountants of New Zealand)

Relief should be provided in situations where a FIT liability obligation is triggered more than once as a result of an imputation credit account (ICA) debit balance straddling more than one income year.

Comment

FIT is charged when a company has a debit balance in its imputation credit account at 31 March in any year. The amount charged is equal to the debit balance in the ICA. The rationale for FIT is that a debit balance in the ICA indicates that imputation credits allocated to dividends paid are greater than the tax payments made by the company. As the shareholders can use imputation credits to satisfy their own income tax liabilities, shareholders gain a tax advantage when imputation credits exceed the tax paid by the company.

The same ICA debit balance that exists at the end of one year (year one) can be carried over and remain in existence at the end of the next year (year two).

In these circumstances, FIT is correctly charged for the first year. However, the Income Tax Act also inappropriately requires a FIT assessment to be issued for year two. This is considered to be unfair where the actions which caused the ICA debit balance occurred in year one and no further "offending" occurred in year two.

Officials agree that this issue should be addressed. We suggest that relief should be allowed, upon application by the taxpayer, only if the ICA debit balance at the end of year one is greater than payments made during year two. Where this criteria is satisfied, the FIT liability for year two should be reduced by the difference between the ICA balance at the end of year one and the total payments made during year two.

Example

A company pays tax of $1,000 in year one and allocates imputation credits of $2,000. At the end of year one, therefore, the ICA has a debit balance of $1,000. In year two a payment of $700 is made. At the end of year two, the ICA has a debit balance of $300.

ICA

Description	Dr	Cr
Tax paid during year:		$1,000
Credits allocated to dividend	$2,000	
Debit balance at 31 March Y1 is $1,000		
Tax paid during year		$700
Debit balance at 31 March Y2 is $300		

Under current law, the company would incur a FIT liability of $1,000 for year one and another FIT liability of $300 for year two.

This is unfair because the ICA debit balance at the end of year two is the residue left from the debit balance in the ICA at the end of year one. There was no further "offending" in year two.

Under the proposal, relief is justified because payments made during year two ($700) are less than the ICA debit balance at the end of year one ($1,000). The FIT liability for year two would therefore be reduced by $300 (the ICA balance at the end of year one less payments made during year two).

In this example, the same result would have occurred if the maximum relief available had been the lesser of the year one and year two ICA debit balances. However, allowing relief on that basis in all instances is not appropriate because it could lead to a permanent deferral of the payment of income tax in some circumstances.

The proposed approach is consistent with the relief provisions already in this bill. Under those provisions, companies will be able to elect to have payments made during year two credited to a FIT liability for year one. Therefore it is not appropriate for those payments to be used to reduce the FIT liability for year two.

Recommendation

That the submission be accepted.

Issue: Reversal of dividends

Clause 43(1)

Submission
(34 – Jeff Owens and Company Ltd, 39 – Institute of Chartered Accountants of New Zealand)

A company should be able to reverse dividends if they were "paid" accidentally.

Comment

The bill allows companies which pay FIT to offset those payments against income tax liabilities.

Situations occur where an ICA falls into debit when a company pays an imputed dividend but has an insufficient balance in its ICA, and then the company is unable to offset the FIT payment against an income tax liability because it is no longer trading. Submissions argue that in these circumstances, dividends should be able to be reversed, so that a FIT liability no longer exists.

The reversal would be for tax purposes, but not for financial reporting or Companies Act purposes.

The treatment proposed by the submission is not appropriate. A dividend formally approved and paid should stand (subject to it not being ultra vires the Companies Act). The shareholder has received the dividend as a dividend. Tax of some sort is rightly payable in respect of the dividend. If the company has inappropriately attached imputation credits then the answer is that the company pays the tax, rather than the dividend being "cancelled" for tax purposes.

Recommendation

That the submission be declined.

Issue: Overdrawn dividend withholding payment accounts

Clauses 43(1) and 99

Submission
(33 – PricewaterhouseCoopers, 42W – KPMG)

Amendments should also apply to overdrawn dividend withholding payment accounts.

Comment

A company that is resident in New Zealand and receives dividends from a non-resident company is required to deduct dividend withholding payment from the dividend and pay it to Inland Revenue. Dividend withholding payment credits can be attached to dividends paid by the New Zealand resident company in the same way as imputation credits.

Companies may elect to maintain a dividend withholding payment account separately from an imputation credit account. Where a dividend withholding payment account has a debit balance at 31 March in any year, the company incurs a further dividend withholding payment liability. Under current law, the payment that satisfies the further withholding payment liability may also be credited in satisfaction of any dividend withholding payment for which the company becomes liable after the date the further dividend withholding payment was made.

It would be appropriate to mirror the further income tax amendments for the purposes of further dividend withholding payments.

Recommendation

That the submission be accepted.

Issue: Drafting

Clause 43(1)

Submission
(42W – KPMG)

New section ME 9(5D) should be amended to read "… Commissioner must treat the payment as being a credit against the specified liability on the date on which the payment was received, and make all such adjustments to use of money interest charges and penalties necessary to give effect to the meaning and intention of the subsection".

Comment

The purpose of the FIT changes is to provide that FIT payments can be credited to income tax and vice versa. Such actions will affect the calculation of use-of-money interest and penalties where an income tax or FIT liability was outstanding before an amount was credited.

The part of the provision which the submission considers should be replaced currently reads "the Commissioner must treat the payment as being a credit against the specified liability on the date on which the payment was received". The effect of the submission, therefore, would be to make explicit that adjustments to use-of-money interest and penalties need to be made.

Officials consider that the amendment is unnecessary. Treating the payment as a credit on the date it is received will automatically have the effect of requiring a recalculation of use-of-money interest and penalties, and providing explicitly for this is not necessary.

Recommendation

That the submission be declined.

BRANCH EQUIVALENT TAX ACCOUNTS AND FOREIGN LOSSES

Clauses 51-54

Submissions
(29, 29A – Russell McVeagh, 39A – Institute of Chartered Accountants of New Zealand, 26A – New Zealand Law Society)

The proposed amendments do not fully address situations where branch equivalent tax account credits can be created from foreign losses, and the current branch equivalent tax account rules do not work appropriately with current year domestic losses. The application date for the current proposed amendments should also apply to these amendments.

Comment

Officials agree with the submissions. With regard to the application date, however, the existing amendments in the bill, for revenue protective purposes, apply from 1 April 1995 unless a taxpayer has filed a return based on existing law. This involves amendments to the law before the reform to core provisions.

As the amendments proposed in this submission are only partly for revenue protection, officials prefer that they be retrospective only to the 1997-98 income year, from when the core provisions reform came into effect.

Recommendation

That the submission be accepted but only from the 1997-1998 income year, unless a taxpayer has filed on the basis of the existing law, when it would apply from the date of the introduction of the bill.

Issue: Dividend withholding payment issues
(42W – KPMG)

Submission

- Dividend withholding payment should be able to be reduced or offset by attributed foreign net losses and foreign investment fund net losses from the same jurisdiction of the foreign company that paid the dividend
- A refund of dividend withholding payment, when a company has net losses available to carry forward, should be available when dividend withholding payment has been paid, regardless of whether the company maintains a dividend withholding payment account.

Comment

Because this issue is outside the scope of the bill, officials have not been able to consider it. We recommend, however, that it be considered for inclusion in the work programme.

Recommendation

That the submissions be declined but that the matter be considered for inclusion in the work programme.

PROGRESSIVE SPECIFIED SUPERANNUATION CONTRIBUTION WITHHOLDING TAX

Issue: Extending the 6 percent concession

Clause 58

Submission
(21 – Council of Trade Unions, 42 – KPMG)

The Council of Trade Unions supports Clauses 57, 58 and 59 but submits that the SSCWT rate should be the marginal tax rate less 6 cents. They and KPMG, who make a similar proposal, argue that employees earning over $60,000 receive a benefit in being able to save for their retirement out of savings taxed at 33%, a saving of 6% on their top personal income tax rate. The same policy should apply to income earners earning less than $60,000. *(Council of Trade Unions, KPMG)*

CTU also submit that the incidence of employment-based retirement savings is in decline and should be encouraged by the 6% concession. *(Council of Trade Unions)*

Comment

Both the Council of Trade Unions and KPMG submitted that the SSCWT rate should be the marginal tax rate less 6 cents. Our response is that a general 6% concession would have a high fiscal cost (of $77 million per annum) and is unlikely to contribute substantially to reversing the decline in these employment-based schemes or increase savings. In particular, this is not the type of incentive that appears to change the behaviour of low and middle income earners. Recent evidence from the US supports this assertion.

We do not agree that arguments based on equity support a proposal to introduce a 6% concession across the board. Those benefiting from the 6% concession as it stands only do so because they are paying tax at a higher rate in the first place. The 39% tax rate is part of a progressive scale, and to that extent it is equitable. But there is a certain inevitable arbitrariness about any tax scale, and it cannot be argued that a limited relief from the top tax rate is necessarily unfair to other taxpayers. Furthermore, many taxpayers on lower rates do already obtain a significant relief from their effective marginal tax rates in respect of specified superannuation contributions. In some cases this is because the contributions are not taken into account in determining income-contingent entitlements such as family assistance and accommodation supplement. In other cases it is because the contributions are not added to total income and do not push other income up into the next rate band.

Recommendation

That the submissions be declined.

Issue: Additional compliance costs for employers

Clause 58

Submission

(27 – The Association of Superannuation Funds of New Zealand Inc, 33 – PricewaterhouseCoopers, 39 - Institute of Chartered Accountants of New Zealand)

The regime as proposed may impose additional compliance costs on employers, and this further layer of compliance cost may enhance the rate of decline of employer participation in superannuation savings. *(Association of Superannuation Funds of New Zealand)*

The applicable rate will be determined for each employee on 1 April. The progressive rate will apply for the full year, and no adjustment will be required if salary or wages and/or contributions change during the year to which the rate applies. This provision may create an additional compliance cost burden for employers. The application dates require more flexibility given that changes in employee salaries will not necessarily be aligned with the standard year. Allowing a change in the applicable rate of SSCWT at the same time as PAYE is not only the most equitable approach but will mirror the timing of the other compliance obligations for employers. *(PricewaterhouseCoopers)*.

The proposal does not accord with the Institute's target that the government should be adopting a broad-base, low rate tax policy, thereby restricting the conditions that make tax avoidance attractive. The new rules require additional compliance costs in determining which rate of deduction to apply by ascertaining which bracket of income tax an employee falls into. In respect of employees with a large element of commissions, bonuses, etc this might prove particularly burdensome *(Institute of Chartered Accountants of New Zealand).*

Comment

Different employers will no doubt find themselves in different positions with respect to the costs and benefits of this proposal. For some, the benefits to their employees will outweigh the compliance costs for the employer. Other employers may find that the compliance cost burden is too high to offer the progressive rates to their employees. This is why the proposed changes are voluntary for employers.

The proposed amendments are intended to address the current inequity between different savers in employment-based superannuation schemes. This is caused by the overtaxation of employers' contributions on behalf of low-income savers. However, addressing this inequity has to be balanced with the additional compliance costs on employers of determining a rate of SSCWT that more closely reflects the employee's marginal tax rate. This is a trade-off between the competing factors of equity and efficiency in the tax system.

Concerns were expressed during consultation that progressive SSCWT would impose further compliance costs on employers and possibly lead to a further reduction in schemes. Because there may be compliance costs involved with the lower rate, officials worked with those consulted on reducing the compliance costs of the proposed progressive SSCWT.

The sector representatives strongly supported an optional progressive SSCWT. Similarly, those consulted also supported basing an employee's progressive SSCWT rate on previous standard tax year salary and contribution information and that no adjustment be required if salary or wages and/or contributions change during the year to which the rate applies. We note the majority of those consulted represented employers. We view the proposal as representing a sensible balance between removing the inequity and minimising compliance costs.

Recommendation

That the submissions be declined.

Issue: Overtaxation of retirement savings of low-income earners

Clause 58

Submission
(33 – PricewaterhouseCoopers, 30 – Investment Savings and Insurance Association of New Zealand Inc)

The commentary on the bill states that the proposed amendment is "intended to reduce the overtaxation of the retirement savings of low-income people". The bill does not achieve this as, under current legislation, a superannuation fund's earnings are taxed at 33% and therefore taxpayers subject to the lower marginal rate are overtaxed. Although the amendment reduces the overtaxation of employer contributions, it only partially removes a disincentive for low-income earners to save through employment based schemes. *(PricewaterhouseCoopers)*

Changes to the tax treatment of retirement savings should be made within the context of a comprehensive framework for savings. In addition, the proposed change does not address the overtaxation of fund investment income, which is another area of inequity for low and medium-income savers, largely hidden, but with a substantial cumulative effect on the savings accumulated at retirement. The proposed changes also do not contain an incentive for employers to start new superannuation schemes and will, in fact, increase their compliance costs. *(Investment Savings and Insurance Association of New Zealand)*

Comment

We agree that the progressive SSCWT proposals will not address all the issues affecting savings. The proposed section NE 2AB deals only with the overtaxation of employer contributions and does not deal with the taxation on returns to savings in superannuation funds. Currently, all returns are taxed at a flat rate of 33%. Taxing savings returns at that rate penalises low-income earners through overtaxation.

Past work in this area demonstrates that other approaches may result in increasing compliance costs associated with managing superannuation schemes. This may in turn lead to a reduction of such employer-based superannuation schemes if employers find the costs of offering them to be too high. While the government is continuing to work on the retirement savings area, any possible changes would need to be balanced against costs.

There are a number of disincentive effects in relation to employment-based superannuation schemes, and the government plans to undertake further work in relation to these. This work will include looking at removing the disincentives for employers to offer schemes and addressing the inequity of the current tax law in overtaxing funds' earnings in relation to low-income savers.

With respect to employer compliance costs, our consultations were primarily with those affected by these costs, and this policy has endeavoured to minimise those costs wherever possible. The voluntary nature of the proposal underscores this point.

The government will continue to work with the savings industry to ensure that future proposals are feasible, and will also endeavour to align its proposals with any recommendations made by the Periodic Review Group on Retirement Income Policy.

Recommendation

That the submission be declined.

Issue: Truly progressive rates

Clause 58

Submission
(33 – PricewaterhouseCoopers)

The proposed amendments are deficient as they do not introduce a truly progressive rate. The current drafting of section NE 2AB does not provide for a truly progressive rate. For example, if an employee earns a salary of $36,000 and has employer contributions of $3,000, SSCWT on the employer contributions will be withheld at 33% (a tax cost to the employee of $990). A truly progressive rate would tax the $2,000 at the 21% rate and the remaining $1,000 at the 33% rate (a tax cost to the employee of $750).

Comment

Representatives of employer-based superannuation are concerned about the compliance costs associated with the proposal, while acknowledging this needed to be balanced against the equity issues of delivering more correct SSCWT to employees.

The majority of those consulted were representing employers. We consulted on an option that would base SSCWT on the average tax rate that applies to the employer's contribution. This option involved Inland Revenue preparing and supplying tables that would provide the average rate calculated with reference to an employee's combined annual salary or wages and superannuation contributions. This option was not favoured by the majority of those consulted. While it was acknowledged that it produced a more accurate and, therefore, more equitable result, it had the most significant compliance cost for employers. Concerns were expressed during consultation that imposing further compliance costs on employers would possibly lead to a further reduction in employment-based schemes.

Recommendation

That the submission be declined.

Issue: Defined benefit schemes

Clause 58

Submission
(11 – New Zealand Society of Actuaries, 27 – The Association of Superannuation Funds of New Zealand Inc)

- It is clear that section NE 2AB applies to defined contribution schemes. It is not clear that it applies to defined benefit schemes. The wording can be applied to defined benefit schemes in a satisfactory manner, provided the employer contribution rate is expressed as a percentage of employees' salaries.

  Accordingly, "the amount of specified superannuation contribution that is contributed by the employer on behalf of the employee" can be readily identified for each active member as the current employer contribution rate multiplied by the member's salary. The rules for determining salary as set out in section NE 2AB1 are perfectly adequate for defined benefit members as well as defined contribution members.

  Pensioner-only schemes have no active members, so the employer contribution cannot be expressed as a percentage of salaries. However, since there are no active members, there are no SSCWT overtaxation "anomalies" to address, and clearly the normal 33% rate is appropriate. *(New Zealand Society of Actuaries)*

- It is imperative that employers sponsoring defined benefit schemes are able to take advantage of the progressive rates. The New Zealand Society of Actuaries has been working in this area to recommend appropriate mechanisms for this to occur. *(Association of Superannuation Funds of New Zealand)*

Comment

We agree that the rules for determining salary as set out in section NE 2AB(1) are perfectly adequate for defined benefit members as well as defined contribution members. It is clear the proposal extends to defined benefit schemes where an employer's contribution is expressed as a percentage of the employee's salary.

Recommendation

That the submissions be accepted to provide for defined benefit schemes where the employer contribution rate is expressed as a percentage of employees' salaries.

Issue: Salary re-characterisation

Clause 58

Submission
(19 – Business New Zealand)

Business New Zealand remains unconvinced that "income re-characterisation" would be a significant problem in practice – in particular, it seriously doubts whether employees would agree to forgo significant amounts of income that could otherwise be consumed immediately. In any event, the motivation to re-characterise income is exacerbated by high tax rates faced by those earning over $38,000. Ultimately the best way to deal with the problem would be to reduce and "flatten" tax rates.

The provisions for a progressive rate of SSCWT should proceed, but in circumstances where wages and salaries are under $38,000, the 21% rate should still apply to the total.

Comment

The private sector was consulted on three options including that proposed by Business New Zealand (option 1). Option 1 proposed to base the SSCWT rate for each employee on the annual salary or wages of the employee. Where salary/wages are under $38,000, the 21% rate would apply to superannuation contributions.

Business New Zealand is correct in stating that while private sector parties preferred option one, those consulted agreed that there was not a significant difference between option one and option two (the option preferred by officials). Option two bases the SSCWT rate for each employee on the annual salary/wages and superannuation contributions of the employee. Where salary/wages and superannuation contributions are under $38,000, the 21% rate would apply to the contributions.

The preference for option two is that it will provide a calculation that is less likely to be manipulated. Although Business New Zealand is unconvinced "income re-characterisation" would be a significant problem in practice, there is some evidence to suggest that salary/wages are being re-characterised as superannuation contributions

by employees earning over $60,000 in order to access the 33% rate, or to reduce child support assessments. The fund withdrawal tax is applicable to these employees. This early withdrawal tax applies where employees take out superannuation contributions from their employment based superannuation funds within two years of the contribution. There is some evidence that this may not be deterring recharacterisations.

Therefore, if implemented, option one would create a risk that employees may take superannuation contributions instead of additional salary and subsequently withdraw those contributions from the fund. It is perhaps less likely those employees on incomes less than $60,000 will be in a financial position to organise their affairs so that their salary/wages can be re-characterised as superannuation contributions. It is not, however, proposed to extend the fund withdrawal tax to the proposed progressive SSCWT proposal.

Recommendation

That the submission be declined.

Issue: Trust deed calculation

Clause 58

Submission
(27 – The Association of Superannuation Funds of New Zealand Inc)

In crafting the final legislation, drafters need to be aware that the trust deeds schemes vary in relation to the way in which employer contributions are expressed. These differences will result in different outcomes for members and employers.

Comment

We appreciate that in the case of net contributions there will be a saving to employers. However, a change to trust deeds would be required to ensure all savings are passed to employees, and this would create additional compliance costs. The particular wording of trust deeds is a matter to be negotiated between the parties concerned.

Recommendation

That the submission be declined.

Issue: Seasonal employees

Clause 58

Submission
(27 – The Association of Superannuation Funds of New Zealand Inc)

Section NE 2AB(1) provides for employer "estimates" of salary and wages and specified superannuation contributions to be made in respect of employees who have been employed for less than a year.

Subsection (2) then prescribes how these "estimates" must be made. The wording of subsection (2) is too prescriptive and does not adequately take into account the seasonal nature of some people's employment and the variability that can occur in employer contribution rates over time. ASFONZ would like to see an option for an employer to use best estimates if it is considered, on reasonable grounds, that the prescriptive formulae will produce a poor "estimate".

Comment

We agree with the submission. We consider that the new section should be reworded to enable the most accurate estimates in all circumstances.

Recommendation

That the recommendation be accepted.

Issue: Rebate proposal

Clause 58

Submission
(42 – KPMG)

Employees should be able to claim an income tax rebate for the difference between their income tax paid on their salary and wages (including their employer contributions) and the SSCWT deducted from their superannuation contributions.

There are three key reasons that support a rebate approach over current proposals:

- Current proposals impose yet more compliance costs on employers.
- The degree of accuracy a rebate approach gives over the proposals
- A lower rate of SSCWT allows taxpayers more cash in their hand to be disposed of as they see fit.

Comment

The submission argues that the equity that the proposed amendments are designed to achieve could also be achieved by better aligning the rates of SSCWT with employees' marginal tax rates and allowing lower-income earners a tax rebate on their contributions. A rebate mechanism was considered when the proposals (consulted on) were being developed. The conclusion reached was that a rebate mechanism would have some benefits but would also present a number of difficulties, such as increased compliance costs for employers and employees and administration impacts for Inland Revenue.

The rebate mechanism would effectively re-introduce an annual interaction with Inland Revenue for significant numbers of taxpayers who have only recently been freed from the requirement to file an annual tax return. Employers would still face compliance costs in having to issue certificates to qualifying employees, and employees would also face increased compliance costs in having to obtain certificates and send claims to Inland Revenue.

The administrative impact would include an increase in taxpayer contacts that would require resourcing. Initially, Inland Revenue would not know who would be likely to be eligible for a rebate, so it would not know who should be sent rebate claim forms and explanatory material. Also, rebate refunds to superannuation funds would be administratively complex for Inland Revenue.

When these factors were considered, it was decided that the rebate mechanism would be too cumbersome and would undermine the recent moves towards simplification of the tax system. Another consideration is that the approach adopted in the bill ensures that the benefit of the lower tax rate supports saving, rather than being cashed out.

Recommendation

That the submission be declined.

Issue: Drafting error

Clause 58

Submission
(33 – PricewaterhouseCoopers, 30 – Investment Savings and Insurance Association of New Zealand Inc)

Proposed section NE 2AB (2)(a) provides that, when estimating the level of employer contributions and the salary or wages of the employee for a particular year, the employee's salary or wages from all sources is included. *(PricewaterhouseCoopers)*

There appears to be a drafting error in section NE 2AB (1)(a). When estimating the level of employer contributions and the salary or wages of the employee, salary or wages from all sources is included whereas only salary or wages from the employer making the estimate should be included. *(Investment Savings and Insurance Association of New Zealand)*

Comment

We agree with the submissions. Clause 58 should be clarified to ensure that only salary or wages from the employer making the estimate are included.

Recommendation

That the submissions be accepted.

Issue: Clarification of intention of clause 58

Clause 58

Submission
(Matter raised by officials)

The current use of the word "otherwise" in clause 58 may confuse employers and cause them to think they may use income from the previous year or make an estimate when calculating the appropriate rate.

Comment

The wording the new section NE 2AB (1), relating to the calculation of the rate, should be clarified to reflect the intention that employer may use an estimate only if the employee did not work for that employer the previous year. Officials recommend that it be made clear that if an employer has employed the employee for all of the year immediately proceeding the year to which the specified superannuation contribution relates, this is the income figure that must be used when calculating the appropriate rate.

Recommendation

That the submission be accepted.

Issue: Clarification is needed to show that SSCWT is not payable when employee not resident in New Zealand

Clause 58

Submission
(42 – KPMG)

The law should be clarified to confirm that SSCWT is not payable on employer contributions when an employee is not resident in New Zealand and the income does not have a source in New Zealand. This amendment should apply retrospectively for the reason that, while there is unlikely to be any argument about the correct policy, IRD investigators understandably apply the rules as written.

Comment

We consider that KPMG has raised a valid point. However, this issue should be considered for inclusion in the tax policy work programme to ensure that any legislative solution is appropriate.

Recommendation

That the submission be declined but that the matter be considered for inclusion in the work programme.

CONFIRMATION OF ANNUAL INCOME TAX RATES

Clause 3

Issue: Reduction in the tax-to-GDP ratio and in overall tax rates

Submission
(1W – New Zealand Business Roundtable, 19 – Business New Zealand)

The tax-to-GDP ratio and tax rates overall should be reduced, requiring lower government expenditure relative to GDP. Current tax rates constrain New Zealand's international competitiveness, appeal to investors, and sustainable economic growth rate.

Business New Zealand submitted that the "headline" company tax rate should be reduced over time to 20%. This would increase New Zealand's international competitiveness in the face of lower and declining average corporate tax rates in the OECD, the EU, and particularly Asia-Pacific. The resulting larger revenue base would over time offset much of the revenue cost. Revenue leakage would only occur where imputation credits are not being utilised (for example, by non-resident shareholders).

Comment

It has been a long-standing practice of Parliament to confirm the tax rates annually. The bill confirms that the annual income tax rates for the 2003-04 income year will be the same as the rates that applied for the 2002-03 income year.

The rates being confirmed reflect the government's current policy as to the rates of income tax it wishes to levy on businesses and other taxpayers. The government's main concern in setting rates has been to generate sufficient revenue to meet its policy commitments. Alignment of the "headline" corporate tax rate with the middle personal tax rate has revenue, administration and compliance benefits.

Recommendation

That the submissions be declined.

Issue: New Zealand should study tax and economic growth rates internationally to ensure that New Zealand's tax rates are not discouraging investment or high-income residents

Submission

(42W – KPMG)

New Zealand should study income tax and economic growth rates in comparable foreign jurisdictions to ensure that New Zealand's rates are not discouraging further investment in productive capacity in New Zealand or the retention or immigration of high-income earners. KPMG's international survey released in January this year indicates average rates of 30.79% in the OECD, 30.36% in Asia Pacific, 31.68% in the European Union and 30.55% in Latin America.

Comment

Treasury and the Ministry of Economic Development are researching the many influences on growth rates internationally, including the impact of tax systems. Adding research into the impact of income tax rates on economic growth to the tax policy work programme would displace other work. Many of the projects on the programme are expected to contribute to economic growth, for example by reducing compliance costs.

Recommendation

That the submissions be declined.

Issue: Extending scope to all low-income activities

Clauses 7, 20, 66(26), 66(28), 74, 79 and 86

Submission
(42 – KPMG)

The services to which the proposals to apply should be extended in scope to all activities when small amounts of income are paid, not just home-based services.

Comment

The purpose of the proposed measure is to address the relatively high compliance costs associated with industries where taxpayer income is relatively low. The proposed amendment allows the Commissioner to trade off the benefits of reducing taxpayer compliance costs against the costs of effecting that reduction, specifically the loss of tax revenue, administrative costs and any risk of inaccuracy.

A broad provision giving the Commissioner a wide discretion has been used so that various industries can be considered in the future. However, home-based services are the most appropriate activity to be covered by the legislation at this stage because they are the most widespread.

Recommendation

That the submission be declined.

Issue: Reflecting different costs within New Zealand

Clauses 7, 20, 66(26), 66(28), 74, 79 and 86

Submission
(48 – National Council of Women of New Zealand)

The Commissioner determines standard costs that reflect the different costs within New Zealand.

Comment

The provisions as drafted do give the Commissioner the power to determine standard costs that differ between areas. Whether this occurs depends on several factors, including a balancing of the accuracy of the standard costs against the demands on the resources of the Commissioner.

Officials note that standard costs are approximations and as such will not be perfectly accurate for all taxpayers. Any inaccuracy will be limited as the Commissioner can only determine standard costs for industries where they will be sufficiently accurate. However, to increase accuracy beyond such a level would result in increased administration and compliance costs, thereby reducing the effectiveness of the provisions.

Consultation with the home-based childcare industry has suggested that while major costs such as rental and heating may vary between areas, they tend to even out overall. For example, rental is more expensive in Auckland than in Invercargill, although heating is less expensive.

Recommendation

That it be noted that the provisions do give the Commissioner the power to determine standard costs that differ between areas.

SHORTFALL PENALTIES – LOSS ATTRIBUTING QUALIFYING COMPANIES

Issue: Who should bear the penalty?

Clause 95

Submission
(38W – Data Analysis International Partnership, 39 – Institute of Chartered Accountants of New Zealand)

Only the shareholders should be subject to a shortfall penalty. *(Data Analysis International Partnership)*

An exemption should apply to the loss attributing qualifying company (LAQC), to the extent that the shortfall results in a reduction in tax losses attributed to shareholders. *(Institute of Chartered Accountants of New Zealand)*

Comment

The bill provides for the removal of the double incidence of shortfall penalties when loss attributing qualifying companies and their shareholders are penalised for what is effectively the same underlying offence. If the LAQC pays its penalty in full, the shareholder will receive an offset of his or her penalty.

Both submissions argue that the LAQC/shareholder should be treated in the same way as a partnership/partner relationship. Only the partners are subject to shortfall penalties if partnership income is overstated because the partnership is not a taxpayer.

However, an LAQC is not a partnership. Although the qualifying company rules aim to treat shareholders and partners in similar ways for tax purposes, the tax treatment are not exactly the same.

Where an LAQC earns income it will pay tax on that income, in the same way that an ordinary company does. If the submissions were to be accepted, one offence that converted an LAQC income to loss would cause two penalties, one to the shareholders in respect of the loss and one to the LAQC in respect of the profit.

Further, such a change would cut across a related court case that is currently under appeal and would therefore be inappropriate at this stage.

Accordingly, officials consider that no change should be made at this stage.

Recommendation

That the submission be declined.

Issue: Shareholder guarantee

Clause 95

Submissions
(44 – MinterEllisonRuddWatts, 49W – NSA Ltd)

A better approach to this issue might be to impose shortfall penalties only on the LAQC, with the shareholder guaranteeing payment of the penalty, just as it guarantees other tax payments. *(MinterEllisonRuddWatts)*

The definition of "income tax" for the purposes of the LAQC provisions should be amended to include shortfall penalties. This would effectively create a liability for the shareholders of the LAQC for the penalties of the company and overcome the issue of double penalties. *(NSA Ltd)*

Comment

For a company to be eligible for the status of an LAQC, the shareholders must agree to be liable for any income tax payments due by the company. For this purpose, the definition of "income tax" excludes civil penalties (including shortfall penalties) and interest.

The effect of both submissions would be that there would be no need to impose shortfall penalties on shareholders of LAQCs. One penalty would be imposed on the LAQC, and if the LAQC did not pay the penalty, shareholders would become proportionally liable for the penalty. The shareholder would not be separately penalised for accepting any LAQC loss.

Such a change would cut across a Court case on the point that is currently under appeal and would therefore be inappropriate at this stage.

These submissions have merit, and may well offer better solutions for future impositions of penalties. However, further consultation is required on the issue.

Recommendation

That the submissions not be accepted at this stage.

Issue: Pro rata apportionment

Clause 95

Submissions
(39 – Institute of Chartered Accountants of New Zealand, 26 – New Zealand Law Society, 44A – MinterEllisonRuddWatts)

- The offset mechanism should contain an exemption for the pro rata proportion relating to the period of ownership.

  The shareholding period qualification should be amended to apply from the start of the year of offence to the end of the year of offence. *(Institute of Chartered Accountants of New Zealand)*
- There should be no shareholder continuity requirement. *(New Zealand Law Society, MinterEllisonRuddWatts)*

Comment

Under the proposed legislation, if the LAQC pays its penalty in full, the shareholder will receive an offset to his or her penalty. However, for the shareholder to receive the offset, he or she must have held the shares for the whole of the period from the start of the income year when the tax shortfall occurred to the date the penalty was imposed.

Officials consider that the requirement for the shareholder to hold the shares for the whole period should be abandoned because a better policy outcome is achieved without the restriction – that is, only one penalty is imposed for one offence.

However, abandoning the restriction presents a difficulty for taxpayer confidentiality: Inland Revenue would be unable to advise an ex-shareholder who applied for a remission why the application was declined, if the reason was that the LAQC had not paid its penalty. ICANZ has verbally suggested that the solution to this problem is that shareholders should be required to show that the LAQC penalty had been paid. Officials agree with this suggestion.

Recommendation

That the proposed shareholder continuity rule for offsets of penalty be abandoned and that shareholders who apply for remission be required to show that a LAQC penalty has been paid.

Issue: The *Chapman* case

Clause 95

Submission
(26 – New Zealand Law Society)

It should be made clear that the enactment of section 141FC should not be read as supporting the interpretation of the Commissioner in *Chapman v CIR,* which is under appeal.

Comment

The Law Society points out that at issue in the *Chapman* case is whether the double incidence of shortfall penalties is in fact possible under current law. The enactment of clause 95 should not be read to confirm that the double incidence can apply under current law. That is a question for the court to decide at this stage.

Officials confirm, as stated in the commentary on the bill, that clause 95 does not cut across the technical arguments in the *Chapman* case. Other solutions have been suggested that could impinge on that decision. These solutions will be reconsidered, if necessary, once the *Chapman* appeal has been decided.

Recommendation

That the submission be noted.

Issue: Written application for relief

Clause 95

Submission
(26 – New Zealand Law Society)

The protection offered by section 141FC should be automatic, rather than applying only if a taxpayer elects in writing.

Comment

This is a practical matter. The penalties for a LAQC and the shareholder might be imposed by different Inland Revenue officers or offices in different years. The shareholder can be presumed to have knowledge of double penalties and resultant payments and can therefore make application.

Recommendation

That the submission be declined.

Issue: Credits

Clause 95

Submission
(39 – Institute of Chartered Accountants of New Zealand)

The legislation should be amended to allow for the amount the individual has actually paid (on behalf of the company) as a credit against his shortfall.

Comment

This submission is conditional on ICANZ's primary submission on who should bear the penalty, which officials do not agree with for the reasons given above.

Recommendation

That the submission be declined.

APPLICATION OF INCOME TAX OR DIVIDEND WITHHOLDING PAYMENTS NOT REFUNDED

Issue: Drafting

Clause 38

Submission
(39 – Institute of Chartered Accountants of New Zealand)

The wording of the proposed section MD 5(1)(a) should be amended to "transfers of tax paid in excess that is not refunded and to which section MD 2(5) applies".

The wording of the proposed section MD 5(1)(b) should be amended by replacing the words "refunds" with the word "amounts".

Comment

Section MD 5 is being redrafted to improve its clarity.

Recommendation

That the submission be noted.

Remedial and other changes

CONTROLLED FOREIGN COMPANIES – EXEMPTION FOR INTERESTS IN CERTAIN LISTED COMPANIES

Clauses 9B to 9D contain provisions that provide a limited exemption from the requirement to attribute income from controlled foreign companies (CFCs). These clauses were not in the bill when it was introduced. Instead, they were introduced at the Committee stage of the bill at the request of the government.

The CFC rules in sections CG 4 to CG 13 of the Income Tax Act 1994 tax New Zealand residents on their interests in foreign companies that they control. For countries outside the "grey list" (the grey list comprises Australia, Canada, Germany, Japan, United Kingdom, United States and Norway), the CFC rules attribute to the New Zealand owner their share of the foreign company's income. Generally there is no attribution from grey list countries.

However, income will be attributed when the grey list company (first tier CFC) has interests in a company in a non-grey list country (second tier company). In these cases, the income from the second tier company must be attributed directly to the New Zealand resident. To do this, the New Zealand resident must generally obtain detailed financial information about the second tier company from the first tier CFC. In the vast majority of cases this will be possible because the first tier CFC will not be listed and the New Zealand resident shareholder will have effective control over the CFC.

This amendment concerns the rare situations where the first tier CFC is a listed company. The fact that the CFC is listed can mean that the shareholder cannot receive the requisite information from the CFC about second tier interests in non-grey list countries. This is because the country in which the CFC is resident is likely to have stock exchange listing rules that mean that, if the CFC provides the requisite financial information to the New Zealand shareholder, it must also provide the information to the market. The CFC will be likely to refuse a New Zealand resident shareholder's request for such information on the basis that the information is commercially sensitive and its release to the market would be harmful to the commercial interests of the CFC.

The amendment addresses this issue for New Zealand residents that have an interest in a CFC that is resident in a grey list country and the CFC is listed on recognised stock exchange (eligible CFC). Broadly, the rules provide that the attributed foreign income or loss, or foreign investment fund income or loss, of the New Zealand resident is nil if the interest arises as a result of an interest in an eligible CFC, provided that the laws of the country in which the eligible CFC is resident, or rules of the stock exchange, effectively prevent the disclosure of the requisite information to the New Zealand resident shareholder.

The rules apply for the 2001-02 to 2005-06 income years. The amendment is temporary to provide officials with the opportunity to ascertain whether a more appropriate proposal can be developed to address the issue on a permanent basis.

The Committee called for submissions on the amendments but none were received. However, two minor amendments have been suggested by officials. These are discussed below.

Issue: Application date

Clause 9D

Submission
(Matter raised by officials)

The application date for the provision should be amended so that the exemption is available to people that have filed a return of income on or after 31 March 2003.

Comment

Clause 9D(1) contains the substantive amendment that would provide a limited exemption from the attribution of income from a controlled foreign company (CFC). Clause 9D(2) provides that the exemption apply from the 2001-02 to 2005-06 income years. Clause 9D(3) further provides that the exemption does not apply to a person that files a return of income before 13 August 2003.

Clause 9D(3) was inserted to prevent people who had applied the CFC rules to attribute income for past income years to claim the exemption in respect of these income years. The date of 13 August 2003 was chosen because this is the date that the proposed amendment could, conceivably, have become public.

The limited CFC exemption is being proposed because a taxpayer approached the Minister of Finance and Revenue outlining that their unusual situation of owning a listed CFC in a grey list country meant that they could not apply the CFC rules to attribute income.

Officials have learnt recently that the taxpayer in question has filed a nil return of income in relation to the CFC for the 2001 income year. We understand that a nil return was filed on the basis that insufficient information could be gained to attribute income under the CFC rules.

The limited exemption is being proposed precisely to deal with the rare cases where taxpayers cannot attribute income under the CFC rules because the controlling interest is in a listed CFC. Therefore we consider that it is appropriate that the one case that we are aware of where this is causing a problem in practice should be catered for by the exemption. In order to achieve this for the 2001 income year, it is necessary to amend clause 9D(3) to cover people that have filed returns of income on or before 31 March 2003. Aside from the taxpayer in question, we are not aware of any other people that would qualify for the proposed exemption.

Recommendation

That clause 9D(3) is amended so that it does not apply to people who have filed a return of income before 31 March 2003.

Issue: Drafting clarification

Clause 9D

Submission
(Matter raised by officials)

The effect of clause 9D(1)(c) is to require a person seeking to apply the exemption, to satisfy the Commissioner that, owing to the circumstances outlined by paragraph (b), they are unable to obtain the information necessary to calculate their attributed foreign income.

While the wording contained in the current clause 9D(1)(c) achieves this result, we consider that the clause should be amended to make its wording clearer

Recommendation

That the words beginning clause 9D(1)(c) which currently read:

> *"the person satisfies the Commissioner that an effect of the aspects of the person's situation that satisfy* ***paragraph (b)*** *is that…"*

be replaced with the words:

> *"the person satisfies the Commissioner that an effect of the laws or rules that satisfy paragraph (b) is that…".*

GROSS CARELESSNESS

Issue: Amendment not required

Clause 94

Submission
(26 – New Zealand Law Society, 33 – PricewaterhouseCoopers, 39 – Institute of Chartered Accountants of New Zealand)

"Gross carelessness" is defined in section 141C(3) as "doing or not doing something in a way that, in all circumstances, suggests or implies complete or a high level of disregard for the consequences". It is difficult to see how making a mistake could ever suggest or imply a complete or high disregard for the consequences of the mistake. Logically, if a person was aware of the consequences of an action, that action could not be characterised as a "mistake". *(New Zealand Law Society)*

Creating the potential for a taxpayer who has made a calculation or recording error to be subject to the shortfall penalty for gross carelessness is a disproportionate and unnecessary extension of the penalties regime. *(PricewaterhouseCoopers)*

This amendment is not necessary. The existing rules on what constitutes gross carelessness should be sufficient to determine whether the penalty should be imposed and will be determined on the facts of the case. The inclusion of all processing errors into the gross carelessness penalty is unnecessary. *(Institute of Chartered Accountants of New Zealand)*

Comment

Officials accept the issues raised in submissions and agree that the amendment should be withdrawn. Current section 141A(4) adequately addresses the issue of a taxpayer making a mistake in the calculation or recording of numbers in a return by providing that such a taxpayer is not excluded from being liable for a penalty for not taking reasonable care.

Recommendation

That the submission be accepted.

Issue: Amend the definition of "gross carelessness"

Submission
(26 – New Zealand Law Society)

The amendment to section 141C can be read to enlarge the gross carelessness net to catch taxpayers who make mistakes. This is objectionable and opposed by the

Society. However, if it is the desired outcome, Parliament should take the straightforward and upfront route and change the definition of "gross carelessness" in section 141C(3).

Comment

It was never the intention of this amendment to enlarge the gross carelessness net to catch taxpayers who make simple mistakes. As noted in the commentary on the bill the mistake would need to be of such a magnitude that the taxpayer breaches the gross carelessness standard. As noted above, officials are recommending that this amendment not proceed.

Recommendation

That the submission be declined.

Issue: No need to amend legislation to refer to unacceptable tax position

Submission
(39 – Institute of Chartered Accountants of New Zealand)

As stated in ICANZ's submission on the Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill 2002, filed 16 August 2002, there is no need to change the shortfall penalty imposed under section 141A from unacceptable interpretation to unacceptable tax position.

Comment

The amendment the submission refers to was made in the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003. Because this issue is outside of the scope of this bill officials have not been able to consider it.

Recommendation

That the submission be declined.

Issue: Penalties in excess of underlying shortfall

Submission
(34 – Jeff Owens and Company Limited)

While it is outside the scope of the present bill, other tax legislation can give raise to penalties far in excess of any underlying shortfall, and these should be addressed as a matter of urgency.

Comment

Because the issue raised in the submission is outside the scope of the current bill officials have not been able to consider them. Mr Owens has indicated that he will raise this matter in the future.

Recommendation

That the submission be declined.

PAYE BY INTERMEDIARIES

Datacom Employer Services Ltd (Datacom) has made a submission on the bill about the recently introduced "PAYE by intermediaries" rules (principally on section NBB of the Income Tax Act 1994), which apply from 1 April 2004. The rules allow accredited intermediaries to largely assume an employer's obligations under the PAYE rules – calculating PAYE, paying it and filing returns. Employers' obligations under the rules are limited to paying their employees' gross salary and wages to the PAYE intermediary (to be held in trust prior to disbursement to Inland Revenue and employees) and providing basic payroll information.

While Datacom's submission is not directly related to those aspects of the "PAYE by intermediaries" rules covered by the present bill, officials consider that it raises some valid concerns that should be addressed prior to the commencement of the rules.

Issue: Scope of tax payments handled by PAYE intermediaries

Submission

Datacom has submitted that PAYE intermediaries should be able to assume responsibility for an employer's obligations in relation to Specified Superannuation Contribution Withholding Tax (SSCWT), in addition to PAYE. Consequently, employers should be able to deposit deductions of SSCWT into a PAYE intermediary's trust account prior to on-payment by the intermediary to Inland Revenue.

Comment

Datacom has commented that if the services provided by a PAYE intermediary were less than comprehensive, thereby leaving employers with significant compliance or other administrative tasks (for example, payment of SSCWT to Inland Revenue), employers will be less inclined to use a PAYE intermediary.

Officials consider that if PAYE intermediaries wish to extend the services offered to include deduction and payment of SSCWT to Inland Revenue, on behalf of an employer, they should have the legislative authority to do so. A key aspect of the "PAYE by intermediaries" rules is shifting the tax compliance obligation from employers to payroll specialists, thereby reducing the costs to employers and improving the level of compliance. The extension of the rules to include SSCWT should reduce compliance costs for employers and increase the efficiency of the tax system.

Recommendation

That the "PAYE by intermediaries" rules be extended to give PAYE intermediaries the option to assume employers' obligations to deduct and pay SSCWT.

Issue: Inland Revenue's ability to refund overpayments of tax

Submission

The "PAYE by intermediaries" rules prevent overpayments of PAYE by an intermediary to Inland Revenue from being refunded if the overpayment is the result of an error. This creates a significant and unnecessary risk for PAYE intermediaries.

Comment

Officials agree that the legislative scope for refunding overpayments of PAYE to PAYE intermediaries needs to be widened to include overpayments that are a result of an external error (for example, a bank error). Currently, the rules in section NBB 7 of the Income Tax Act 1994 allow payments of tax to be refunded to PAYE intermediaries only if an intermediary has paid PAYE to Inland Revenue but the underlying payment by the employer has been dishonoured.

Recommendation

That section NBB 7 of the Income Tax Act 1994 be amended to widen the scope for Inland Revenue to refund overpayments of PAYE to PAYE intermediaries.

Issue: Use of PAYE intermediaries' trust accounts

Submission

The requirement for the net salary and wages of employees to be transacted through a PAYE intermediary's trust account is unworkable. Net salary and wages should be able to be credited to employees' bank accounts at the same time tax and other disbursements are paid into a PAYE intermediary's trust account. Further, there may be instances when an employer will need to pay employees in cash, outside their normal pay run. These payments will be outside the "PAYE intermediary rules" because net pay will not be able to be transacted through the trust account.

Comment

The reason for requiring PAYE intermediaries to use the trust account in respect of both tax and net salary and wages (gross salary and wages) is to safeguard against the risk that if insufficient funds are available to meet both obligations employers are likely to authorise payment of the latter at the expense of the former, as the net pay of employees will be their earliest liability. If an employer is required to deposit gross salary or wages into a PAYE intermediary's trust account, the risk that tax will bear the brunt of any shortfall is mitigated to the extent that even if insufficient funds are available, the PAYE intermediary will be responsible for ensuring that at least a portion of those funds are paid to Inland Revenue. While Datacom has commented that the processes they would employ would ensure that both net salary and wages and tax are transacted at the same time (to different accounts), thereby offering the

required protection to the revenue, the "PAYE by intermediaries" rules are expected to be applied by a number of other entities as well, who may have different processes. The rules, and therefore the associated safeguards, need to be viewed in that wider context.

Datacom has, however, raised valid concerns in relation to instances when an employer pays employees in cash (for example, in the case of a dismissal or if an employee is granted an advance on pay), but requests the intermediary to handle the PAYE. These payments are outside the scope of the current rules as they violate the requirement that an employer must deposit the net pay of employees (along with PAYE) into a PAYE intermediary's trust account. Equally, officials are aware that certain third party deductions may relate to amounts owing to the employer (such as social club fees and repayments for purchases made from the employer). Employers may wish to retain the right to make these deductions from their employees' gross pay before transferring funds to a PAYE intermediary. Currently, the "PAYE by intermediaries" rules require these deductions to be deposited in a PAYE intermediary's trust account prior to remittance back to employers. This will impose transaction costs on employers and their PAYE intermediaries.

Officials recommend that a legislative exemption from the trust account requirements (in section NBB 6 of the Income Tax Act 1994) be allowed in respect of payments made by an employer to an employee that are outside the normal payment date for salary and wages of the employee (but still represent payment of salary and wages) and in the form of cash or a cheque. Equally, if employers wish to retain certain specified deductions from employees' gross salary and wages, these deductions should also be exempt from the trust account requirements.

In these instances, an employer will only be required to deposit the PAYE component (and any third party deductions not retained by the employer) into a PAYE intermediary's trust account.

Recommendation

We recommend that:

- the submission to remove the requirement that net salary and wages be deposited into a PAYE intermediary's trust account be declined; and
- an exemption from use of a PAYE intermediary's trust account be allowed (in section NBB 6 of the Income Tax Act 1994) for net salary or wages paid by an employer to an employee in cash or cheque outside the normal payment date for salary and wages and for specified deductions retained by the employer.

Issue: Numbering of section 167 of the Tax Administration Act 1994

Submission
(Matter raised by officials)

That sections 167(3) and 167(4) of the Tax Administration Act 1994, introduced in the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, be repealed and re-inserted as sections 167(2B) and 167(2C), respectively.

Comment

There is a numbering error in section 167 of the Tax Administration Act 1994 with section numbers 167(3) and 167(4) being used twice. An amendment is needed to correct this error.

Recommendation

That the submission be accepted.

Issue: Drafting error in section NC 20(1) of the Income Tax Act 1994

Submission
(Matter raised by officials)

A drafting error in section NC 20(1) of the Income Tax Act 1994 should be corrected.

Comment

Section NC 20(1) was amended by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003, with the addition of "PAYE intermediary," after the words "any employer". That insertion should be repealed and replaced by ", PAYE intermediary".

Recommendation

That the submission be accepted.

CHILD SUPPORT AND THE PERSONAL PROPERTY SECURITIES ACT 1999

Clause 134

Submission
(Matter raised by officials)

The Child Support Act 1991 should be amended so that it reflects the policy outcome intended when the Personal Property Securities Act 1999 was enacted, that is, Inland Revenue should be able to register charges over the property of persons who default in the payment of child support.

Comment

The bill contains amendments to the Tax Administration Act (clause 98) and the Personal Property Securities Act (clauses 132 and 133) to ensure that charges created under the Tax Administration Act for unpaid tax may be registered on the Personal Property Securities register. As the Child Support Act contains a similar provision to that in the Tax Administration Act in relation to unpaid child support, similar amendments are required to the Child Support Act and the Personal Property Securities Act to ensure that such charges over property for unpaid child support can be registered and are valid.

Recommendation

That the submission be accepted.

GST AND TELECOMMUNICATIONS SERVICES – INITIATOR TEST

Submission
(4W – Telecom, Matter raised by officials)

The GST treatment of telecommunications services should be clarified by removing the phrase "…to a person outside New Zealand…" from section 11AB(b), and amending the definition of "initiator" in section 8(9) to make the application of the place of supply and zero-rating rules for supplies of telecommunications services more certain.

These amendments should apply from 1 July 2003, which is the date from which sections 11AB(b) and 8(9) applied.

Comment

The Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 contained provisions that clarified the GST treatment of cross-border supplies of telecommunications services by inserting a new place of supply rule, zero-rating provisions and definitions. These changes were arrived at after extensive consultation with the telecommunications industry.

Fundamental to the operation of the new place of supply and zero-rating rules is determining which party has initiated a supply. In general, when a person in New Zealand initiates a supply of services those services will be subject to GST in New Zealand, and when a person outside New Zealand initiates a supply of services those services will be zero-rated and, therefore, not be subject to GST in New Zealand. Section 8(9) sets out factors to help determine which party to a supply of telecommunications services has initiated the supply. The initiator test lists the following factors:

- Who pays for the services.
- Who commences the supply.
- Who terminates the supply.
- Who contracts for the supply.

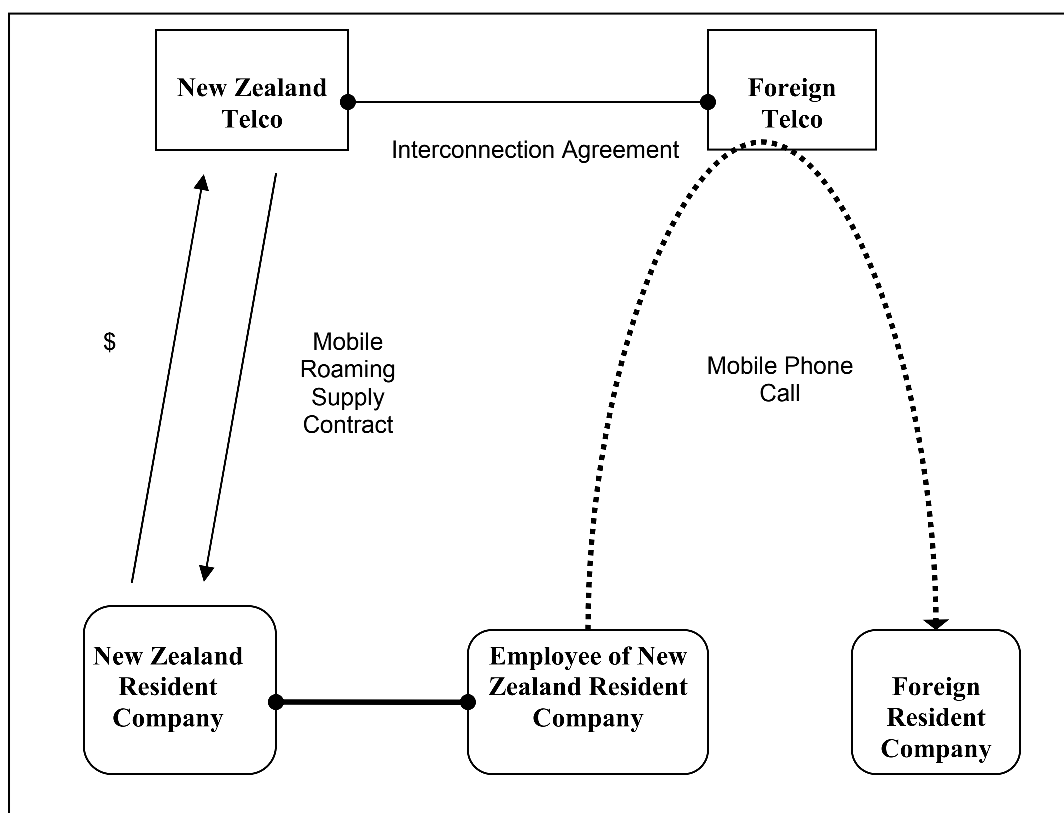
As section 8(9) does not have a formal hierarchy of factors, or a "tie breaker" if two different persons fulfil the factors, officials had planned to clarify the application of the section through a *Tax Information Bulletin* article.[14]

[14] As noted in Taxation (Annual Rates, Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Bill: Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill, page 71.

New issues

Officials have been in discussions with telecommunications suppliers relating to issues with the zero-rating and place of supply rules. Concern was raised with the wording of one of the zero-rating provisions, section 11AB(b), specifically the phrase "…to a person outside New Zealand…", and the likely interpretation of this phrase as meaning to a person outside New Zealand in a contractual sense. This would in effect negate the initiator test limb of section 11AB(b), which is intended to focus on who "uses" the telecommunications services.

In particular, when a New Zealand company has a cellular roaming agreement with a New Zealand telecommunications supplier and an employee of the New Zealand company uses a cellular phone outside New Zealand (as shown in the diagram below) the supply may be subject to GST, because of the contract with the New Zealand company.



As the New Zealand employee who is outside New Zealand is making the phone call, and therefore "using" the services, officials consider that the employee should be considered the initiator of the supply of telecommunications services and the supply should therefore be zero-rated, as the initiator is outside New Zealand.

The initiator test is intended to be the pivotal test for the new place of supply rules for telecommunications service, and, therefore, the location of the initiator of the supply of services should be determinative of zero-rating under section 11AB(b). The phrase "…to a person outside New Zealand…" should therefore be removed from section 11AB(b).

In the course of discussions with telecommunications suppliers, concerns were also raised more generally about the operation of the initiator test, specifically the relative weight of each of the factors, the ability to apply the test to achieve the most tax efficient outcome, and the suitability of a *Tax Information Bulletin* article to provide certainty in the application of the test.

The initiator test, while providing a pragmatic proxy for consumption in most situations, is difficult to apply when there are two possible initiators of a supply – for example, where one party contracts and pays for a supply of telecommunications services but another party "uses" the services.

Officials consider that, rather than relying on a *Tax Information Bulletin* article, an amendment should be made to section 8(9) to clarify the operation of the initiator test in relation to the relative importance of the factors, particularly which party contracts for a supply of services.

We consider that an ordering rule (similar to section CI 3(10) of the Income Tax Act 1994) ranking the factors would provide the requisite certainty and limit the scope to apply the initiator test in a manner that would create inappropriate tax advantages. This would mean that if more than one person satisfied the factors in the initiator test, the initiator would be the person who satisfies the factor which appears highest on the list of factors in the test. The order of factors should be:

1. The person who controls the commencement of the supply.
2. The person who pays for the services.
3. The person who contracts for the supply.

In discussions with telecommunications suppliers the necessity of the "termination" factor in the initiator test was raised, with concerns that it was confusing and unnecessary. Officials therefore recommend removing the "termination" factor from the initiator test in section 8(9).

We recommend that these amendments apply from 1 July 2003, the date from which the amendments in the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 apply.

Officials note that Telecom New Zealand Limited (submission 4W) supports these changes, and that other telecommunications suppliers consulted have expressed general support for the changes.

Recommendation

That the submission be accepted.

REGULATORY IMPACT AND BUSINESS COMPLIANCE COST STATEMENTS

Submission
(19 – Business NZ)

Officials should be asked to provide best quantitative estimates on the financial and economic impacts of the changes contained in the bill.

Comment

Business NZ has commented that compliance cost reduction rates as among the top priorities for the business community, particularly for small businesses, and while it welcomes many of the government's initiatives to reduce these costs it says that there is much room for improvement. In particular, Business New Zealand has expressed concern in relation to the analysis of compliance cost implications of proposed legislation contained in Regulatory Impact and Business Compliance Cost Statements attached to bills. It has commented that there is often very little quantitative analysis in Regulatory Impact and Business Compliance Cost Statements (for example, the degree to which compliance costs are expected to change) and, equally, a lack of analysis of the wider economic impacts, thereby making it difficult for submitters to assess the financial and economic impact on compliance costs, either individually or in aggregate.

It is often quite difficult to quantify the compliance impacts of proposed changes, as the impact can vary across the population according to factors such as taxpayer size and behaviour. While high-level estimates of compliance costs impacts are provided where possible, more often the impacts can only be qualitatively analysed. Inland Revenue is, however, planning to improve its capacity to analyse the compliance cost impacts from proposed changes to the tax system, to better comply with Regulatory Impact and Business Compliance Cost Statement requirements. For example, the department has recently commissioned research into businesses' tax compliance costs, which should, among other things, allow the compliance impacts of proposed tax policy initiatives to be tested in an experimental way and therefore be known before they are implemented. Preliminary results from the research are expected to be available by end-2004.

It is also worth noting that the Generic Tax Policy Process ensures that proposed changes to the tax system are publicly consulted on at a very early stage, a fact acknowledged by Business NZ, which has commented that it finds Inland Revenue to be one of the better agencies for consulting the business community. This process allows affected parties the opportunity to raise concerns they may have in relation to the compliance cost impacts of proposed tax changes prior to the legislative stage.

Recommendation

Note that officials are doing further work to improve the analysis of compliance cost impacts in Regulatory Impact and Business Compliance Cost Statements.

REQUISITION OF OFFSHORE INFORMATION

Clause 76

Issue: Inability to comply with information-gathering provisions

Submissions
(39 – Institute of Chartered Accountants of New Zealand, 42W – KPMG)

Section 17(1B) fails to recognise the reality that although a New Zealand resident may control a foreign entity, it is not always possible to access records and information as if the foreign entity were resident in New Zealand. The proposed amendment linking this section to the relevant offence provisions will only compound this problem and as such should not proceed.

Both submissions note that their organisations had made submissions against the introduction of section 17(1B) in the previous Act.

Comment

Section 17(1B) was introduced to ensure that Inland Revenue can requisition from New Zealand residents information on documents held by offshore entities controlled by New Zealand residents. The proposed amendment ensures that the relevant offence provisions can apply if a taxpayer fails to comply with section 17(1B). Failure to make the proposed amendment would allow those who are in effective control of an offshore entity to fail to provide information they are legally required to provide. These taxpayers would have no risk of penalty as the relevant penalty sections were not correctly updated to take account of the amendment to the definition of control made in the previous Act.

Recommendation

That the submissions be declined.

Issue: Consistency of terminology

Submission
(Matter raised by officials)

An amendment should be made to the information-gathering provisions in section 17 of the Tax Administration Act 1994 (and related penalty provisions in sections 143 and 143A) so they refer to information in the knowledge, possession or control of a non-resident.

Comment

Section 17(1B) was recently enacted by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 to ensure that Inland Revenue can requisition from New Zealand residents information or documents held by offshore entities controlled by the New Zealand residents. This bill contains a clarifying amendment to ensure that the effect of section 17(1B) is carried through to the relevant offence provisions, which was always the legislative intention.

Sections 143(2) and 143A(2) state that no person may be convicted of the offence of not providing information to the Commissioner if they prove that the information was not in their knowledge, possession or control.

It would be desirable for the information-gathering provisions and related offence provisions to use consistent terminology, and therefore section 17(1B) should refer to information that is in the knowledge, possession or control of a non-resident. The use of consistent terminology would also improve the effectiveness of these provisions.

Recommendation

That the submission be accepted.

ELECTING THE APPROPRIATE TAX RATE ON EXTRA EMOLUMENTS

Submission
(42W – KPMG)

The amendment to section NC 8(1A) of the Income Tax Act 1994 in clause 55(2) of the bill should not proceed.

Comment

The submission has commented that it is not until an employee's income exceeds approximately $146,000 that their effective marginal tax rate starts to exceed 33%. For employees with incomes below this, taxing their extra emoluments at 39 percent is overtaxation.

On an income of $146,000 a taxpayer's average tax rate is approximately 33%, not their marginal tax rate (which is the amount payable on the next dollar earned). On this level of income the marginal tax rate is 39%.

Section NC 8(1A) of the Income Tax Act 1994 deals with marginal, not average, tax rates. The amendment to that section clarifies that only employees with annual taxable income of $60,000 or less can apply to have any extra emoluments taxed at the 33 percent marginal tax rate. This is consistent with the rates of tax (and associated income thresholds) prescribed in schedule 1 to the Income Tax Act.

Recommendation

That the submission be declined.

Other amendments proposed by officials

QUALIFYING TRUST STATUS

Submission
(Matter raised by officials)

An amendment should be made to the definition of "qualifying trust" in the Income Tax Act 1994. It would allow a trust that is a non-qualifying trust because all of the trustee's income tax obligations have not been satisfied to become a qualifying trust retrospectively if the trustee's income tax obligations are satisfied, including the payment of use-of-money interest and any penalties.

Comment

Most trusts established in New Zealand by New Zealand resident settlors come within the Income Tax Act definition of a "qualifying trust". This definition includes the requirement that all of the trustee's income tax obligations have been satisfied since the beginning of the trust. The main benefit of a qualifying trust status is that all distributions from a qualifying trust of amounts other than beneficiary income (current year trust income distributed to beneficiaries) are not taxable to beneficiaries.

A draft Inland Revenue statement has recently been issued for external consultation which addresses the issue of what is the tax treatment if the trustees of a qualifying trust have underpaid income tax in the past and subsequently make a distribution without rectifying the underpayment. The statement says that such a trust is not a qualifying trust for the period that the underpayment has not been rectified and any distributions made in the period will be taxable distributions taxed at the rate of 45%.

A result of the draft Inland Revenue interpretation is that a small underpayment of income tax by a trustee of a trust can have disproportionately penal consequences for beneficiaries. For example, in the case where a home is owned by a family trust an underpayment of tax of $100 several years ago by the trust could result in the beneficiaries living in the home being taxed on the value of that accommodation when they normally would not be.

Officials consider that such disproportionate consequences are not an appropriate policy result. Officials note that when the trust taxation rules were developed, in 1988, the current comprehensive use-of-money interest and penalty provisions were not in place. The requirement in the qualifying trust definition that all of the trustee's income tax obligations must be satisfied was intended as an incentive to comply with the trust taxation rules. This incentive can now be more appropriately provided by the current use-of-money interest and penalty provisions.

The policy underpinning the qualifying trust rules is that full New Zealand tax is paid on a current basis on the worldwide trustee income of trusts settled by New Zealand residents. This policy objective can be met by applying the use-of-money interest and penalty rules to any underpayment of tax by a trustee of a qualifying trust. It is not necessary for such a trust to lose its qualifying trust status so that beneficiaries are taxed at a 45% rate on certain distributions.

Under this proposed amendment a non-qualifying trust will be able to become a qualifying trust retrospectively if all of its income tax obligations are satisfied, including the payment of use of money interest and penalties. Any taxable distributions that were made by the trust during the period when there was an underpayment of tax on trustee income would be unwound.

The tax treatment of foreign trusts, which are trusts settled by non-residents, will not be affected by this amendment.

Recommendation

That the submission be accepted.

GST DEREGISTRATION

Issue: Allowing notification of GST deregistration to be made over the telephone

Submission
(*Matter raised by officials*)

The requirement that notification of GST deregistrations be made in writing be relaxed to allow notification over the telephone.

Comment

This matter was raised by officials in consultation with small businesses. Officials agree that the "in writing" requirement is unnecessary. When taxpayers deregister for GST they are required to notify Inland Revenue in writing. Taxpayers already correspond via telephone with Inland Revenue requesting the form used for GST cessations. The entire cessation process can be completed in this one telephone call without need for the form to be sent, completed and returned. This will result in a significant reduction in both taxpayer compliance costs and administrative costs.

Officials recommend that section 52 of the Goods and Services Tax Act 1985 be amended to allow notification of GST deregistrations be made over the telephone.

Recommendation

That the submission be accepted.

AN AMENDMENT TO THE SECRECY PROVISIONS TO PROVIDE FOR INFORMATION TO BE TRANSFERRED TO THE MINISTRY OF HEALTH

Submission
(Matter raised by officials)

Section 81(4) of the Tax Administration Act should be amended to provide for information to the Ministry of Health.

Comment

Schedule 6 of the Gambling Act 2003 amends section 81(4) of the Tax Administration Act to enable gaming information to be disclosed by Inland Revenue to the Department of Internal Affairs so the latter can determine the problem gambling levy rate. The problem gambling levy is imposed on gaming operators to provide funding for provision of problem gambling services.

Officials have recently become aware that gaming information will also need to be transferred to the Ministry of Health to enable the Ministry to determine the problem gambling levy rate in conjunction with the Department of Internal Affairs.

Officials recommend that:

- section 81(4) of the Tax Administration Act be amended to provide that information can be transferred from Inland Revenue to both the Department of Internal Affairs and the Ministry of Health for the purposes of determining the problem gambling levy rate; and
- this proposed amendment apply from the date the bill is assented to.

Recommendation

That the submission be accepted.

MINOR DRAFTING CHANGES

Issue: Redundant provision

Submission
(Matter raised by officials)

Section 141FB(2)(b)(i) of the Tax Administration Act 1994 should be repealed.

Comment

Section 141FB was inserted by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003 and provides for the reduction of shortfall penalties where the taxpayer has a previous history of good behaviour. Section 141FB(2)(b)(i) refers to reducing the shortfall penalty for "evasion or similar act" which is already dealt with in section 141FB(1). Section 141FB(2)(b)(i) is therefore redundant.

Recommendation

That the submission be accepted.

Issue: GST – domestic transportation services supplied to non-residents

Clause 109

Submission
(35W – KPMG on behalf of the New Zealand Overseas Movers' Association)

The submission supports the amendment as drafted.

Comment

The proposed change was referred to the Finance and Expenditure Committee by the Minister of Finance and Revenue on 18 July 2003 for inclusion in this bill. Interested parties were then invited to make submissions on the proposals.

The purpose of new section 11A(1)(cb) is to clarify that transportation services supplied under contract to a non-resident international removals company in relation to the movement of household goods in New Zealand are treated as zero-rated supplies.

Recommendation

That the submission be noted.

Issue: GST Act drafting improvement

Clause 109

Submission
(Matter raised by officials)

The drafting of the GST Act provision allowing the zero-rating of services supplied in relation to exported goods should be improved.

Comment

Section 11A(1)(m) of the GST Act was enacted in 2000 and zero-rates services supplied directly in connection with exported goods if the services are supplied to a non-resident who is outside New Zealand at the time the services are performed.

Officials consider that the drafting of this zero-rating provision should be improved to make it completely clear that the relevant services must be supplied to a non-resident. This drafting improvement does not result in a policy change.

Recommendation

That the submission be accepted.