Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Bill

Commentary on the Bill

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CONTENTS

Policy issues 1

Venture capital 3
Deductibility for costs associated with patent and Resource Management Act consent applications that are not granted or are withdrawn 9
Horticultural plants – amortisation and replacements 10
Sale and leaseback of intangibles 11
Charitable donee status 15
Rebate for early payment of income tax 16
Imputation credits and transfers 18
"PAYE by intermediaries" rules – further improvements 22
Reduction of non-declaration rate for non-resident contractors who are companies 24
RWT on use-of-money interest 25
Incorporated societies 26
Income tax rates 28
Information-matching 29
Disputes resolution process 31
Self-assessment of GST 45
Penalties applicable to non-resident contractor if total double tax relief applies 47
Tax shortfalls – loss attributing qualifying companies 49

Remedial issues 51

Trans-Tasman imputation 53
Maori authorities 54
Branch equivalent tax accounts and losses 56
Allocation deficit debit rules for life insurance companies 57
Fund withdrawal tax 66
Deferred deduction rule 68
Date of taxpayer self-assessment 70
Assessments in disputed cases 71
Write-off – date of measurement of net loss 72
Miscellaneous technical amendments 73

Policy issues

VENTURE CAPITAL

(Clauses 4, 24, 30 and 145)

Summary of proposed amendments

The bill removes a tax barrier to unlisted New Zealand companies gaining access to offshore venture capital. The main change is to provide an exemption from income tax for certain non-residents that sell shares in certain unlisted New Zealand companies. Profits from the sale of such shares may currently be taxable if the non-resident has purchased them with the purpose of resale or the proceeds from the shares are a part of the non-resident's business income.

Non-residents will generally be eligible for the exemption if they are resident in a country with which New Zealand has a double tax agreement and would not be eligible for a credit in their home jurisdiction if the income were taxable in New Zealand – which would generally apply to residents that are tax-exempt in their own jurisdiction. The new rules also provide that certain foreign funds of funds (FFOFs) will qualify as eligible investors. In a venture capital context, a FFOF pools funds on behalf of a number of international investors and invests the capital in local venture capital funds.

The changes will also see the repeal of section HC 1 of the Income Tax Act 1994. This section currently prohibits special partners of special partnerships from offsetting special partnership tax losses against their other income.

Section 57 of the Partnership Act 1908, which requires a special partnership to re-register every seven years, is being repealed.

Application date

The amendments will apply from 1 April 2004.

Key features

A new exemption is being inserted into section CB 2(1) of the Income Tax Act 1994 that removes income tax for certain non-resident venture capital investors that invest in New Zealand. The rules target certain foreign investors that are tax-exempt in their own jurisdiction and foreign funds of funds. The new exemption applies to the proceeds from the sale of shares in New Zealand-resident, unlisted companies that do not have a number of prohibited activities as their main activity.

The current dividend rules will continue to apply to dividends that non-residents derive from eligible investments.

The provision that prevents special partners of special partnerships from offsetting partnership losses against their other income (section HC 1 of the Income Tax Act 1994) will be repealed.

Background

The term "venture capital" is typically used to describe a variety of private equity investments from funding of new companies and early stage expansion capital to management buy-in and buy-out transactions for established companies. As a rule, venture capital investment concerns investments into unlisted companies.

At present, there are no special tax rules for venture capital investment. Therefore a venture capital investor that purchases shares in an unlisted New Zealand company will be taxed on any gains according to ordinary tax concepts.

Under these principles, dividends will be taxed as gross income when they are derived, and profits derived on the sale of shares will be taxed if the shares were held on revenue account. Broadly, shares are held on revenue account if they were purchased with the dominant purpose of resale, or if the profits from sale form part of the investor's business income.

The application of these rules to non-resident investors is subject to the provisions of a double tax agreement (DTA) if the non-resident is resident in a country with which New Zealand has a DTA. In the context of venture capital investment, our DTAs will not generally remove New Zealand's ability to tax revenue account share profits. In other words, non-resident venture capital investors investing in New Zealand will be taxed on share profits if they hold the shares on revenue account.

The nature of venture capital investing, combined with the capital/revenue distinction, results in complexity and uncertainty for non-residents contemplating venture capital investment in New Zealand.

The changes proposed in the bill target non-resident venture capital investors that are sensitive to the imposition of New Zealand tax. Non-resident investors will generally be sensitive to such tax if they are tax-exempt in their own jurisdiction, since their tax-exempt status will mean that they will not be able to claim, or make use of, a credit for New Zealand tax paid. In the venture capital context this is an important issue because a number of institutional investors that invest in venture capital internationally (such as United States pension funds) are tax-exempt in their home jurisdiction.

The new rules use the availability of a tax credit (or other similar compensation) for New Zealand tax paid as a proxy for whether an entity is exempt from tax in its own jurisdiction. This is because of the difficulty in defining entities that are exempt, or effectively exempt, from income tax.

It is very common for tax-exempt institutional investors to invest in venture capital opportunities via FFOFs. In a venture capital context, FFOFs pool funds from a number of different investors and invest the capital in a number of different local fund managers. Therefore, to be effective, the new rules accommodate FFOFs that are established and resident in countries that represent the majority of our main investment partners.

The preferred method of venture capital investment internationally is through the use of limited liability vehicles that are "flow-through" for tax purposes. This means that any income of the entity is borne by the partners and not taxed at the entity level.

To properly facilitate the flow of international venture capital into New Zealand it is necessary to ensure that the special partnership rules that provide limited liability and flow-through treatment properly reflect the way international venture capital is carried out. Therefore section HC 1 of the Income Tax Act is being repealed. This is the provision that currently prevents special partners of a special partnership from offsetting their special partnership tax losses against their other income. The rule was introduced to counter a number of aggressive tax schemes that occurred in the 1980s. It is being repealed because the recently enacted deferred deduction rules (contained in sections ES 1 – ES 3 of the Income Tax Act 1994) should provide the necessary protection against abusive tax schemes. This will be helpful for venture capital investment in New Zealand because it will remove a barrier to local entities investing alongside international venture capital investors.

Detailed analysis

The venture capital exemption is provided by the addition of new paragraphs (g) and (h) to section CB 2(1) of the Income Tax Act 1994. It provides that the proceeds from the sale of shares by an eligible investor in certain unlisted New Zealand companies will be exempt from income tax if a number of criteria are met. The new provisions do not change the current treatment of dividends that non-residents derive from these companies.

Eligible investments (section CB 2(1)(g) and (h))

New section CB 2(1)(g) lists the new criteria under which an amount may qualify as "non-residents' exempt income" under this provision. To be exempt, an amount must be derived by a qualifying foreign equity investor from the sale of shares in a New Zealand-resident company. The shares in that company must be held for a period of at least 12 months.

In addition, the company may not be listed on a recognised exchange for 12 months after the acquisition of the shares, and if listed at the time of acquisition must be de-listed within 12 months. A recognised exchange is defined in section OB 1 of the Income Tax Act 1994. Broadly, it can be described as an exchange market established in New Zealand or anywhere else in the world that exhibits certain criteria that are likely to produce genuine market values for the stock that is traded.

The New Zealand resident company must not have a main activity that is one of the activities listed in new section CB 2(1)(g)(iii) or a combination of those activities. This includes a main activity of investing if that investing has as its main aim the derivation of interest, dividends, royalties or lease payments.

New section CB 2(1)(h) allows investments into New Zealand-resident companies that invest into companies that meet the criteria outlined above and themselves meet these criteria but for the fact that their main activity is providing capital to other companies (potentially a financial service under the list in section CB 2(1)(g)(iii)). To qualify, the company providing the capital must be in the same wholly owned group as the companies to which it provides the capital and must have as its main activity the provision of capital in the form of debt and equity funding to other companies. All members of the wholly owned group except the company providing the capital must satisfy the criteria of section CB 2(1)(g)(ii) and (iii).

Eligible investor (section CB 2(4))

The exemption is available only to certain non-resident investors. A qualifying investor is defined as a "qualifying foreign equity investor", of which there are two categories. The first targets non-residents that invest directly into New Zealand venture capital opportunities, while the second category targets FFOFs.

Investment directly in New Zealand

The rules concerning this category of investor are contained in paragraph (a) of the new definition of "qualifying foreign equity investor".

There are two criteria that a person must satisfy in order to qualify as an eligible investor under this category. The first is that the person must be a resident of a country that is listed on a Schedule to the Income Tax Act 1994 (List A). With the exception of Switzerland, this list will contain all countries with which New Zealand currently has a DTA in force. The new rules in section CB 2(7) contain the provisions for including countries on List A. The list will be amendable by Order in Council.

The presence of a DTA will allow Inland Revenue to invoke the exchange of information article of the DTA in order to receive information on particular investors and transactions. This will assist Inland Revenue in the administration of the new rules.

To be included on the list it will also be necessary for the DTA country to engage in effective exchange of information. It is for this reason that Switzerland will not be included on the list.

The second criterion that must be satisfied is that the non-resident investor must be unable to claim a tax credit or other compensation for any income tax that New Zealand tax laws may, but for the exemption in the new section CB 2(1)(g) and (h), have levied on the income. This inability must result from the investor's special status under the tax laws of its home jurisdiction. This formulation targets investors that are tax-exempt in their own jurisdiction owing to their special status under the tax laws in their home jurisdiction, rather than their particular circumstances at any point in time.

FFOFs

The rules concerning this category of investor are contained in paragraph (b) and (c) of the new definition of "qualifying foreign equity investor".

There are two types of FFOFs that can qualify as eligible investors under the new rules. The first is FFOFs that are structured as limited partnerships.

To qualify, a limited partnership established in another country must be similar in nature to special partnerships in New Zealand. In other words, it is not a separate legal entity, it provides limited liability status to its limited partners and is flow-through for tax purposes. In addition, the limited partnership must be established under the laws of a country listed on another Schedule to the Income Tax Act 1994 (List B), and all the general partners of the limited partnership must be resident in one of these countries. The countries that will be included on this list are the United States, the United Kingdom, Australia, Japan, Singapore, France, Germany or Canada. The new rules in section CB 2(7) contain the provisions for including countries on List B. The list will be amendable by Order in Council.

Furthermore, a limited partnership that meets these qualifications will not qualify as an eligible investor if partners holding 10 percent or more of the limited partnership's capital are not resident in a country that is on List A. A limited partnership will also not qualify if a limited partner that holds 10 percent or more of the capital does not have the status under the tax laws of its home jurisdiction that makes it unable to claim a tax credit or other compensation for any income tax that New Zealand tax laws may, but for the exemption in the new section CB 2(1)(g) and (h), have levied on the income. This formulation targets investors that are not tax-exempt in their own jurisdiction.

The second category of FFOFs consists of entities that have a separate legal status in their home jurisdiction but have the other key characteristics of a limited partnership. These entities can be described as "foreign hybrids". An example of a foreign hybrid is the limited liability company vehicle established under the United States law.

The criteria for a foreign hybrid qualifying as an FFOF are similar to those that apply to qualifying foreign limited partnerships. The main difference concerns the residence of the foreign hybrid. The new rules require a foreign hybrid to be established under the laws of a country specified on List B. The entity may, however, be resident in another List B country, provided that the country of residence treats that entity as being flow-through for tax purposes.

Special partnerships

At present, section HC 1 prevents special partners of special partnerships from offsetting their special partnership losses against their other income. Instead, it requires that these losses be carried forward and offset against future income of the special partnership. This provision is being repealed. The section will, however, continue to apply to special partnership losses incurred before 1 April 2004.

A new rule will permit only special partners to carry forward tax losses related to special partnerships if they earn New Zealand gross income during the year in which the loss is incurred. This new rule will be contained in section IE 1(2B).

Amendment to the Partnership Act 1908

Section 57 of the Partnership Act 1908, which requires special partnerships to re-register every seven years, is being repealed. The seven-year re-registration requirement does not reflect the normal life of venture capital funds (which generally exist for 10 to 15 years). The change is of a minor nature and will update the legislation to ensure that special partnerships reflect the way that venture capital investment is carried out internationally.

DEDUCTIBILITY FOR COSTS ASSOCIATED WITH PATENT AND RESOURCE MANAGEMENT ACT CONSENT APPLICATIONS THAT ARE NOT GRANTED OR ARE WITHDRAWN

(Clauses 10 and 11)

Summary of proposed amendment

Costs associated with patent and resource management consent applications that are not granted or are withdrawn are to be made deductible. At present, these costs cannot be claimed under the general deductibility rules because they are regarded as a capital expense. Nor can they be depreciated as there is no depreciable asset.

Application date

The amendment will apply from the 2004-05 income year for applications that are not granted or are withdrawn in that or a subsequent income year.

Key features

A new section DG 6(1A) is being added to the Income Tax Act 1994 to allow deductibility for costs associated with patent applications that are not granted or are withdrawn. Similarly, a new section DJ 14B is being added to allow deductibility for costs associated with resource management consent applications that are not granted or are withdrawn.

Background

Patents and certain consents issued under the Resource Management Act 1991 are depreciable intangible property. To the extent expenditure incurred in applying for a patent or resource management consent results in an application being granted, the costs must be capitalised and depreciated. However, if an application is unsuccessful or is withdrawn, any costs incurred up to that point are not depreciable as there is no depreciable asset. Nor can this expenditure be expensed under the general deductibility rules because it is capital in nature.

Under the proposed change, the costs that would have been depreciable if a patent or resource management consent was granted (such as the cost of filing the patent or resource management consent application) would become deductible if the application is unsuccessful or is withdrawn.

HORTICULTURAL PLANTS – AMORTISATION AND REPLACEMENTS

(Clauses 5, 12, 13, 14, 21, 65(4),(5),(7),(14),(16),(18),(19),(22),(23), 68 and 90)

Summary of proposed amendment

The Commissioner will be able to determine different amortisation rates for different plants, reflecting their estimated useful lives. Plants listed for this purpose will also qualify under rules for deducting a limited proportion of replacement plants. These new rules provide for greater certainty in law and flexibility for the treatment of replacement plants. The Commissioner will be able to set more accurate amortisation rates, in preference to the current single rate applied to all vines and trees.

Application date

The amendments will apply from the 2003-04 income year.

Key features

More accurate amortisation rates: new section DO 4C of the Income Tax Act 1994 will provide for the amortisation of plants at rates determined by the Commissioner, based on the estimated useful lives of plants.

Deductible replacement plantings: new section DO 4D will allow replacement planting expenditure as a current-year deduction. In effect, replacements in relation to a maximum of 15 percent of an orchard or vineyard over a three-year period will be treated as repairs and maintenance. Within this limit, replacements in any one year in relation to up to 7.5 percent of an orchard or vineyard will be allowed to be deducted in a current year. This is designed to average out at allowing up to 5 percent of an orchard or vineyard to replaced and deducted in a year. Any other replacements must be capitalised and amortised.

Commissioner to list plants and determine amortisation rates: amendments to the Tax Administration Act 1994 will provide for the Commissioner of Inland Revenue to specify the plants that the new replacement and amortisation rules will apply to.

Current provisions retained: section DO 4 will continue for vines, trees and other similar plants not covered by the new rules. It will be clarified that plants such as bushes and canes are included in these rules.

Background

At present, a current-year deduction is allowed only in relation to a vine or tree of the same species and variety that replaces one that has died or been destroyed. The Fruitgrowers Federation raised concerns about this, seeking both a more certain position in law and more flexibility to manage replanting activities using the most commercially desirable varieties without producing different tax effects.

SALE AND LEASEBACK OF INTANGIBLES

(Clauses 19 and 65)

Summary of proposed amendments

Amendments are being made to ensure that taxpayers entering into transactions involving the sale and leaseback of intangibles such as trademarks do not get deductions for what are, in substance, repayments of loan principal. The proposed amendments are designed to protect the tax base.

The tax rules for finance leases, which prevent deductions being taken for the principal amount of a deemed loan, will be amended to ensure that the transactions involving the sale and leaseback of intangibles that cause concern are caught by these rules.

Application date

The amendments will apply to arrangements entered into on or after the date of introduction of the bill.

Key features

Amendments to the finance lease rules in the Income Tax Act 1994 are being made to ensure that taxpayers entering into transactions involving the sale and leaseback of intangibles do not get deductions for what are, in effect, repayments of loan principal. They:

- Clarify that the finance lease rules in sections FC 8A to FC 8I apply to the granting of a licence to use intangible property. This will be achieved by amending paragraph (f) of the definition of "lease" in section OB 1, which applies for the purposes of the finance lease rules. The result of this amendment flows through to the other definitions that use the term "lease" such as "finance lease", "lease asset", "lease term", "lessee" and "lessor". In the definition of "lease asset", the personal property that is subject to the licence to use intangible property is the intangible property itself such as a trademark.
- Widen the application of paragraph (a) of the definition of "finance lease" in section OB 1 to include a lease under which ownership of the lease asset is transferred to the lessee or an associate of the lessee at or by the end of the lease term rather than only at the end of the lease term. Consequential amendments will also be made to section FC 8B(2) and (3) to refer to ownership of the lease asset being acquired on or by the date that the lease term ends.

- Expand the definition of "finance lease" in section OB 1 to include a sale and leaseback arrangement under which the lessor has no substantive rights and obligations of ownership, other that those relating to enforcement of the lease agreement. An example of this would be where the lessee or an associate of the lessee had always retained the ability, since the period of previous ownership, to reacquire or control the disposition of the lease asset directly or indirectly.
- Clarify that the finance lease rules apply if a feature referred to in the finance lease definition – such as a transfer of ownership to the lessee or an associate or an option granted to a lessee or an associate – is part of the lease arrangement but is not specified in the lease agreement itself.

The definition of "lessee" will also be amended by omitting the reference to "hires, or bails". This reference and a reference to licensing intangible property are unnecessary because reliance can be placed on the reference to "leases". Section 32 of the Interpretation Act 1999 means that this latter reference has a corresponding meaning to the paragraph (f) definition of "lease", which will include a hire, bailment or a licence to use intangible property. This amendment will also make the definitions of "lessee" and "lessor" consistent because the latter does not use hire or bailment terminology.

Background

The government announced in May 2003 that it was concerned about a scheme involving the sale and leaseback of intangibles under which tax deductions are claimed for what are, in substance, repayments of principal under a loan. The government said that it would propose remedial legislation to ensure that such deductions could not be taken.

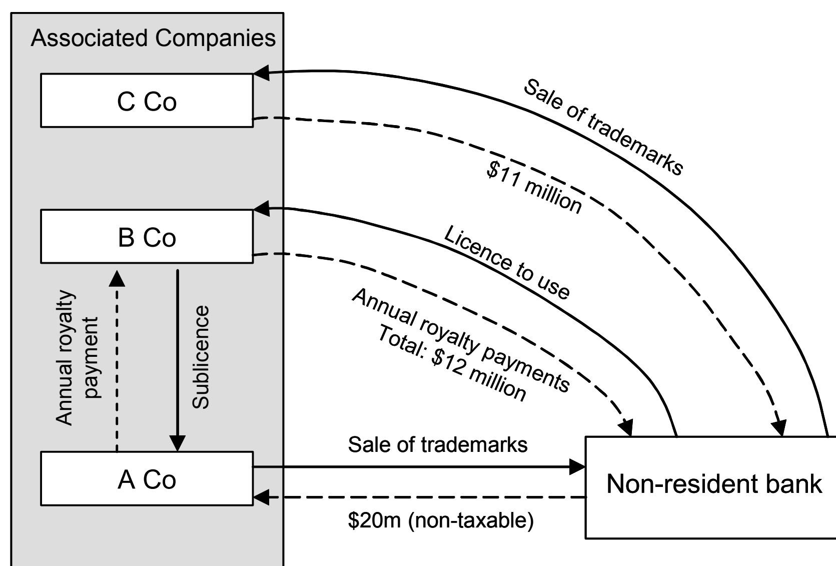
An issues paper was sent to interested parties in October 2003 proposing amendments to the tax rules for finance leases, which limit deductions for leasing arrangements that are essentially financing transactions, to ensure that the transactions causing concern are covered by these rules.

Schemes that may allow deductions for repayment of loan principal

Described below are the simplified features of a transaction that may allow deductions for what are, in substance, loan principal repayments.

A Co, B Co and C Co are associated. A Co sells its trademarks or brand names to a non-resident bank for, say, $20 million (which is non-taxable as any profit is a capital gain). The bank immediately grants to B Co an exclusive licence to use the trademarks for a fixed term in return for annual royalty payments totalling, say, $12 million that are deductible to B Co. B Co grants a sublicence to A Co on the same terms. The bank grants to C Co an option to purchase the trade marks, subject to the bank retaining the right to receive the licence payments from B Co. The exercise price under the option is, say, $11 million, the reduction in value of the trademarks from $20 million reflecting the bank's right to continue to receive the royalty income from B Co during the licence period. The option is exercised on the date that the bank buys the trademarks and the licence begins, so that the bank pays A Co $20 million

for the trademarks and immediately sells them to C Co for $11 million. The bank's net outgoing is $9 million, which it pays in return for future payments of $12 million.



In substance, the transaction is a loan of $9 million from the bank to the group and the bank treats the transaction for tax, regulatory and accounting purposes accordingly. By structuring the loan as a licence, a deduction may be available to B Co for what are, in substance, repayments of the $9 million principal, instead of only the $3 million interest that would be allowed if the transaction were in the form of a loan. This outcome is contrary to the policy intent underlying the tax treatment of debt transactions (and it may be that the tax avoidance provisions in the Income Tax Act 1994 apply to it).

Finance lease rules

The Income Tax Act 1994 contains provisions called finance lease rules that, in certain circumstances, recharacterise lease transactions as the purchase of the leased asset by the lessee, with the purchase funded by a loan from the lessor to the lessee. The lessee can depreciate the leased asset (if it is depreciable property) and, instead of obtaining a deduction for lease payments, obtains a deduction under the accrual rules for the interest component of the deemed loan. The treatment of the lessor mirrors that of the lessee – the lessor cannot depreciate the leased asset, and returns as income the interest component of the deemed loan. These rules were introduced in 1982 and revised in 1999. They recognise that certain lease transactions are, in substance, financing arrangements, under which the lessor finances the purchase of the leased asset by the lessee. Broadly, they are triggered when the lease arrangement provides for the transfer of the asset to the lessee or an associate of the lessee, or when the asset is leased for most of its effective life.

Application of finance lease rules

The finance lease rules should, in principle, apply to the transaction described in the example because on the day the lease begins the trademarks are sold to an associate of the lessee – the bank, in fact, owns them only momentarily.

The amended finance lease rules would apply in the following way to the transaction in the example. The trademarks are treated as sold from the bank to B Co on the day the lease starts. The bank is treated as giving B Co a loan of $9 million, and B Co is treated as using the loan to purchase the trademark. The interest component of the deemed loan is $3 million (being $9 million consideration payable to B Co less $12 million consideration payable by B Co). This amount is deductible to B Co and spread under the accrual rules. B Co is treated as owning the lease asset (the trademarks) but as trademarks are not depreciable property, there is no depreciation deduction. This treatment accords with the correct policy outcome.

CHARITABLE DONEE STATUS

(Clause 32)

Summary of proposed amendment

Medicine Mondiale, the New Zealand Jesuits in India Trust and the Operation Vanuatu Charitable Trust are to be given charitable donee status. This will enable donors to obtain tax relief on their donations.

Application date

The amendments will apply from the 2004-05 income year.

Key features

The following organisations are being added to section KC 5(1) of the Income Tax Act 1994, which lists the organisations that qualify for charitable donee status:

- Medicine Mondiale;
- New Zealand Jesuits in India Trust; and
- Operation Vanuatu Charitable Trust.

Background

Donations to qualifying organisations entitle individual taxpayers to a rebate of 33 $^{1}/_{3}$ percent of the amount donated, to a maximum of $630 a year. Donations by non-closely held companies, and closely held companies which are listed on a recognised stock exchange, qualify for a deduction to a maximum of 5 percent of their net income.

Medicine Mondiale

This organisation has been established to provide healthcare in developing countries in Africa and Asia.

New Zealand Jesuits in India Trust

This organisation is engaged in providing healthcare, rural development and education in India.

Operation Vanuatu Charitable Trust

This organisation provides healthcare in Vanuatu.

REBATE FOR EARLY PAYMENT OF INCOME TAX

(Clause 33)

Summary of proposed amendment

The bill introduces a 6.7% rebate of tax, or "discount", to encourage individuals who begin receiving self-employed or partnership income to pay tax voluntarily in the year before they begin paying provisional tax. This will relieve the financial strain faced by these taxpayers when they begin paying provisional tax and have two years' worth of tax payments to make, namely, income tax for the prior year and provisional tax for the current year.

Application date

The amendment applies from the income year beginning 1 April 2005.

Key features

A new section MBC is being added to the Income Tax Act 1994 to provide a 6.7% rebate of tax, or "discount", to individuals who begin receiving self-employed or partnership income, to encourage them to pay tax voluntarily in the year before they become liable for provisional tax.

Individuals will be able to choose whether to receive the rebate in their first year of business or in a subsequent year, but they must claim the rebate before they begin paying provisional tax, when qualification ceases.

Those who are provisional taxpayers before they begin receiving self-employed or partnership income will not be entitled to the rebate, since they do not face two years' tax payments in their second year in business.

The following example illustrates these points. A taxpayer derives solely business income for a four-year period. The business grows, and in the third year her residual income tax liability (tax not deducted at source) exceeds $2,500 and therefore she becomes a provisional taxpayer. She is required to pay provisional tax in her fourth year in business.

	Year 1	**Year 2**	**Year 3**	**Year 4**
Income	$3,000	$12,000	$25,000	$30,000
Residual income tax liability	$450	$1,950	$4,680	$5,730
Become a provisional taxpayer	No	No	Yes	Yes
Liable to pay provisional tax	No	No	No	Yes
Entitled to rebate	Yes	Yes	Yes	No

Taxpayers can claim the rebate once in either of the first three years, as they are not required to pay provisional tax. However, they would maximise the benefit of the rebate by claiming it in the third year in business. If the rebate has not been claimed before the fourth year, entitlement ceases.

The rebate will be calculated at the rate of 6.7% of the amount paid during the year or 6.7% of 105 percent of the individual's end-of-year residual income tax liability, whichever is the lesser. The rebate will be applied against the taxpayer's end-of-year tax liability for each dollar of tax paid during the year, regardless of the date of payment.

If their voluntary payments exceed their end-of-year tax liability, taxpayers will still qualify for the rebate up to a maximum of 105 percent of their end-of-year residual income tax liability. The overpaid amount plus the rebate will be refunded to them or can be offset against other tax owing.

The rebate can be claimed only once for a business. However, taxpayers who cease deriving partnership and self-employed income for a period of four years will again qualify for the rebate if they begin a new business.

Background

The policy intent is to reduce the financial strain that individuals in business face in their first three years in business. Income tax can contribute to this as individuals who begin in business are not required to pay provisional tax in their first year and can end up paying two years' tax in their second year in business.

As part of the government's growth and innovation strategy, proposals were considered to reduce the compliance costs for small businesses. One such proposal involved providing a rebate of tax to individuals who voluntarily pay tax in the year before that in which they are required to pay provisional tax, thereby aligning the payment of tax with when income is earned.

The proposal was included in the government discussion document *Making tax easier for small businesses* released in September 2003. It received significant support from submissions and from market research undertaken with small and medium-sized businesses.

IMPUTATION CREDITS AND TRANSFERS

(Clause 36)

Summary of proposed amendment

Taxpayers will be able to elect that a credit arises to the imputation credit account (ICA) or dividend withholding credit account (DWPA) in certain circumstances when overpaid tax was transferred before the transfer rules came into effect. The amendment provides relief for taxpayers who could have been disadvantaged under the law as it applied before the transfer rules became effective.

Application date

The amendment will have effect from the start of the 1997-98 year (when the now repealed section MD 4 was introduced) to the date when the section MD 4 was repealed (1 April 2003).

Key features

The now repealed section MD 4 provided that a credit did not arise to the ICA or DWPA if overpaid tax was transferred. New subsections (2) and (3) are being added to section MD 4.

Section MD 4(2) provides that section MD 4(1) does not prevent a credit (called a permitted credit) arising to the ICA or DWPA if:

- the transferred tax could have been refunded instead of transferred; and
- between the time when the tax which gave rise to the overpayment was paid and the date of the request for the transfer was made, the company suffered a breach in shareholder continuity and a debit arose accordingly to the ICA or DWPA; and
- the taxpayer elects that the permitted credit arises.

The permitted credit will arise under section ME 4(1)(a) or section MG 4(1)(a) as tax or dividend withholding payment "paid". For the purposes of those sections, "paid" includes "distributed, credited, or dealt with in the interest of" and, therefore, includes an amount transferred.

New subsection (3) provides that the amount of the permitted credit is the amount transferred less the amount of the debit that would have arisen under section ME 5(1)(e) if the overpayment had been refunded.

Background

The company imputation system ensures that company shareholders are not taxed twice on company income – once in the hands of the company, and again when profits are distributed as dividends.

Briefly, companies keep an ICA which records the tax payments made by the company as credits and amounts allocated to dividends as debits. If a company's ICA has a debit balance at 31 March in any year, the company is liable to pay further income tax. This ensures that imputation credits attached to dividends do not exceed the net amount of tax paid by the company.

To ensure that imputation credits are associated with whoever owns the company when the tax is paid, there is a "continuity debit" to the ICA whenever there is a significant change in ownership (direct or indirect) of the company. If a company that has suffered a continuity debit is also due a tax refund for a tax overpayment that arose before the continuity debit, this refund (to the extent of the debit) can still be paid without further affecting the ICA balance.

Similar rules apply to dividend withholding payments.

The problem that the amendment seeks to resolve is in relation to the now repealed section MD 4 of the Income Tax Act 1994. That section ensured that a taxpayer could not take undue advantage of the imputation or dividend withholding payment rules when transferring overpaid income tax or dividend withholding payment to another year or to another tax type (such as PAYE or GST) or to another taxpayer. However, where there had been a prior breach in shareholder continuity, section MD 4 did not work appropriately.

Example

Company A makes an income tax payment of $100, taking the ICA balance to $100. Subsequently there is a breach of shareholder continuity, leading to a debit in the ICA. Later, it is determined that the $100 is an overpayment and a refund is sought. After the overpaid tax is refunded, the company pays the amount back to Inland Revenue (say, in satisfaction of the next provisional tax payment due).

For the purposes of determining whether a refund can be made, the balance in the ICA can be increased by the breach of continuity debit of $100 under section MD 2(4). Therefore the refund could be made in this case.

A second debit relating to the refund is recorded only if the refund is greater than the breach in continuity debit (section ME 5(1)(e)(iii)). Therefore no further debit would arise to the ICA when the refund is made.

When the refund had been subsequently paid back to Inland Revenue for offset against the next provisional tax liability, a credit would arise in the ICA for the payment:

Imputation credit account

Transaction	Debit	Credit	Balance
Payment		$100.00	$100.00Cr
Breach in shareholder continuity	$100.00		Nil
Refund	Nil		Nil
Payment of provisional tax		$100.00	$100.00Cr

Under current law, section MD 4 denies the second imputation credit if a transfer was made instead of a refund and repayment.

Generic transfer rules introduced in 2002 produce a better result than section MD 4, so section MD 4 was repealed by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003.

Detailed analysis

Section MD 4(2) will be satisfied if:

- a company was entitled to a refund of overpaid income tax (section MD 2(4)); and
- a company requested a transfer of that overpaid tax; and
- a breach of shareholder continuity occurred between the time when the tax that led to the overpayment was paid and the time the transfer was requested; and

- a credit would have arisen to the ICA if the:
  - overpayment had been refunded; and
  - the refunded amount had been repaid in satisfaction of a tax liability that would have caused a credit to apply to the ICA; and
- the company requests that section MD 4(2) and (3) apply to the transfer.

New subsection (3) provides that the amount of the permitted credit is the amount transferred less the amount of the debit that would have arisen under section ME 5(1)(e) if the overpayment had been refunded.

Example

Company B's ICA balance at 31 March 2000 is $100. A breach in shareholder continuity occurs on 30 June 2000. As a result, a debit arises to the ICA of $100, and the ICA balance is now nil.

Company B pays tax of $50 on 7 July 2000, bringing the ICA balance to $50.

On 30 April 2001 an income tax overpayment of $150, which arose before the breach in shareholder continuity, is identified. Company B applied to have $150 transferred to 2002 provisional tax. This was done, but under section MD 4, as it applied in 2001, no credit arose to the ICA for the transfer. At that stage there was no provision that allowed a debit to arise relating to a transfer of overpaid tax.

In 2004 Company B requests that subsections MD 4(2) and (3) be applied.

Under section MD 4(3) the permitted credit will be the amount transferred less the debit that would have arisen if the amount transferred had been refunded instead of transferred. Section ME 5(1)(e)(iii) provides that a debit arises to the ICA when a refund is made, except to the extent of a debit that arose upon a previous breach in continuity.

In the example, a previous debt of $100 arose upon a breach of continuity. Therefore, had $150 been refunded, the debit that would have arisen to the ICA would have been $50. Accordingly, the permitted credit will be the amount transferred ($150) less the debit that would have arisen under section ME 5(1)(e)(iii) if the transferred tax had been refunded ($50). The permitted credit is, therefore, $100. Entries to the ICA would be:

Imputation credit account

Transaction	Debit	Credit	Balance
Balance 31 March 2000			$100
Breach in shareholder continuity	$100		Nil
Payment 7 July 2000		$50	$50
Transfer		nil	$50
Permitted credit		$100	$150

This is the result that would have occurred had the overpaid tax been refunded and repaid.

"PAYE BY INTERMEDIARIES" RULES – FURTHER IMPROVEMENTS

(Clauses 54, 55, 56, 57, 65(17), 65(37), 101, 111, 112, 113 and 114)

Summary of proposed amendment

The bill introduces amendments to the recently enacted "PAYE by intermediaries" rules to further improve their operability. The rules allow accredited intermediaries to largely assume an employer's obligations under the PAYE rules (calculate PAYE, pay it to Inland Revenue and file PAYE returns). The changes:

- allow PAYE intermediaries to make payments of net salary and wages directly to employees' bank accounts (from an employer's account) provided the associated PAYE is simultaneously transferred, or is transferred before the payment to employees is made, into an intermediary's trust account;
- clarify that "officer" in the "PAYE by intermediaries" rules means a director, secretary or statutory officer; and
- require PAYE intermediaries to represent at least ten employers.

Application date

The amendments will become effective from the application date of the "PAYE by intermediaries rules" – pay periods beginning on and after 1 April 2004.

Key features

Sections NBB 2(1)(c) and 2(4)(b) of the Income Tax Act 1994 are being amended to clarify that an "officer" means a director, secretary or statutory officer.

Section NBB 4(1) of the Income Tax Act 1994 is being replaced and new section NBB 5(1B) added to give greater flexibility to PAYE intermediaries in how they can make payments to employees. When the gross pay of employees is not transacted through a PAYE intermediary's trust account, replacement section NBB 4(1)(a) requires employers to make available sufficient funds to a PAYE intermediary to cover both employees' net salary and wages and the PAYE. New section NBB 5(1B) then requires a PAYE intermediary, when making payments of net salary and wages directly to employees, to transfer the associated PAYE into the trust account simultaneously (or transfer the PAYE before the payment to employees is made).

As a result, a number of consequential amendments are required, including the addition of a new section NBB 4(1B), changes to sections NBB 4(2), NBB 4(3), NBB 4(4)(c) and (d), NBB 5(1), NBB 5(2B) and NBB 6(2) and changes to sections 120OB(1), 141JB(1), 167(2B), 168(4) and 169(1B) of the Tax Administration Act 1994.

The definition of "PAYE intermediary" in section OB 1 of the Income Tax Act 1994 is being amended to require PAYE intermediaries to represent at least ten employers.

Background

An amendment is required to provide greater flexibility to PAYE intermediaries in how they make payments to employees. At present, the "PAYE by intermediaries" rules require employers to deposit the gross salary or wages of employees into a trust account operated by the intermediary. The intermediary is then responsible for disbursing the deposited funds – for example, net pay to employees and PAYE to Inland Revenue. However, the current model could result in a number of unnecessary risks and transactions costs being incurred by prospective intermediaries.

To address those concerns, an amendment is proposed to allow PAYE intermediaries to make payments of net salary and wages directly into employees' bank accounts (from an employer's account) provided the associated PAYE is simultaneously transferred, or is transferred before the payment to employees is made, into an intermediary's trust account. The amendment will also cover third party deductions from employees' net salary and wages (such as health insurance premiums and social club fees). Employers and PAYE intermediaries will, however, still have the option of using the trust account for gross salary and wages, if so desired.

An amendment is also needed to clarify the term "officer" in the context of the accreditation requirements in the "PAYE by intermediaries" rules. The intent of the rules is to ensure that directors and other statutory officers of entities wanting to be accredited as PAYE intermediaries are of suitable character for the role (such as not having been convicted of offences involving fraud) rather than the requirement applying to all employees, many of whom will have no direct role in the PAYE intermediary function. However, with the current lack of a definition for "officer" in the "PAYE by intermediaries" rules, the potential exists for employees, generally, to be classified as "officers" for the purposes of accreditation. An amendment is therefore proposed to define the term "officer" in the "PAYE by intermediaries" rules to have the same meaning as the definition of that term in section 3 of the Tax Administration Act 1994. The term "officer" is defined in section 3 as being a director, secretary, or other statutory officer of a corporate body.

Finally, an amendment is needed to reduce the risk of the "PAYE by intermediaries" rules being abused by entities registering as intermediaries who do not intend to represent any employers. The rules, as currently drafted, have created incentives to do so. An amendment is therefore proposed requiring PAYE intermediaries to act on behalf of a minimum of ten employers.

REDUCTION OF NON-DECLARATION RATE FOR NON-RESIDENT CONTRACTORS WHO ARE COMPANIES

(Clause 59)

Summary of proposed amendment

Employers who make withholding payments to non-resident contractors are required to withhold tax from the payments. This amount is increased if the contractor makes no declaration. An amendment reduces this non-declaration rate to a more reasonable rate for companies.

Application date

The amendment will apply to withholding payments made on or after 1 April 2005.

Key features

Section NC 7(2) provides if a person who is making a withholding payment has not received a withholding declaration from the contractor that person must increase the amount withheld by 15%.

Section NC 7(2) is being amended to change the non-declaration rate for companies. A special provision will apply to non-resident contractors, as that term is defined in the Income Tax (Withholding Payments) Regulations 1979, that are companies. The extra amount that needs to be withheld in the absence of a withholding declaration is being reduced to 5%.

A specific anti-avoidance rule is being added to the provision. It is intended to prevent abuse of the reduction in the rate applicable to non-resident contractor companies by individuals re-characterising themselves as companies.

Background

Withholding payments made to non-resident contractors are subject to the non-resident contractors' withholding tax. Non-resident contractors are required to make a withholding declaration under the Income Tax Act 1994. If no declaration is made an extra withholding payment is imposed. The amendment reduces the amount that has to be withheld if the non-resident contractor is a company and it does not make a declaration.

The reason for lowering the rate is that companies will have overheads while carrying out contract activities in New Zealand. Consequently, the net amount earned by non-resident companies in most cases will be significantly lower than their gross earnings, to which non-resident contractors' withholding tax applies. A lower total withholding tax rate of 20%, if no tax code declaration is made, is more appropriate for non-resident contractors that are companies, to reflect the typical difference between net and gross earnings.

RWT ON USE-OF-MONEY INTEREST

(Clause 62)

Summary of proposed amendment

Provisions are being introduced to remove the Commissioner's obligation to deduct resident withholding tax ("RWT") from use-of-money interest ("UOMI") paid to a taxpayer in respect of overpaid tax.

Deducting RWT from UOMI paid by the Commissioner has proved overly complex for taxpayers, especially in relation to RWT credits. The proposed amendment will reduce these compliance costs faced by taxpayers and will also result in a small administrative saving to Inland Revenue.

Application date

The amendment will apply to interest payable as of 1 April 2005.

Key features

An amendment is being made to section NF 1(2)(a) of the Income Tax Act 1994, excluding UOMI paid by the Commissioner from being subject to the RWT rules. Sections NF 1(2)(a)(x), NF 1(3) and (3A) are being repealed, as they will become unnecessary as a result of this amendment

Under the proposed amendment, UOMI paid by the Commissioner will no longer be subject to withholding at source, although it will still be gross income for tax purposes. It will become part of the taxpayer's residual income tax calculation and will either be added to the taxpayer's provisional tax payments or paid at the terminal tax date.

Background

When UOMI paid by the Commissioner was introduced, it was considered appropriate that it should be assessable and subject to the RWT rules. This ensured that from the taxpayer's perspective, UOMI paid by the Commissioner was treated, as much as possible, like interest received from a bank.

In practice, however, it has resulted in an overly complex system with significant compliance costs for taxpayers and increased administrative costs to Inland Revenue.

INCORPORATED SOCIETIES

(Clauses 65(26), 65(29), 65(30), 67 and 142)

Summary of proposed amendments

Incorporated societies will be allowed to carry forward tax losses and offset income and losses against the income and losses of companies in the same group. They will also be allowed, for a limited period, to offset income and losses against those of their commonly owned incorporated societies.

The amendments ensure that incorporated societies that are treated as companies for tax purposes can avail themselves of the same rules that allow other corporate entities to carry forward losses and offset them against those of companies in the same group.

Application date

The amendment allowing incorporated societies to carry forward losses and offset income and losses against the income and losses of companies in the same group will have two application dates. In relation to the carry forward of tax losses, the amendment will apply from the 1992-93 income year. In relation to the offsetting of income and losses by incorporated societies and companies that are in the same group, the amendment will apply from the 1992-93 income year, but only if the relevant assessment for tax is not affected by the time bar under sections 107A(1) or 108(1) of the Tax Administration Act 1994.

The amendment relating to the offsetting of income and losses between commonly owned incorporated societies will apply from the 1997-98 income year to the 2002-03 income year if the incorporated societies have taken this tax position in relation to tax returns filed for those years.

Key features

The definition of "special corporate entity" in section OB 1 of the Income Tax Act 1994 is being amended to include any body incorporated under the Incorporated Societies Act 1908 that has no shares on issue to the members of the society. This will allow incorporated societies to be treated as "special corporate entities" and, therefore, able to carry forward tax losses and offset income and losses, against those of companies in the same group, despite the fact that they do not issue shares.

New section OD 3(4) of the Income Tax Act 1994 will allow incorporated societies to offset income and losses against those of their commonly owned incorporated societies. Although the application of this provision will be limited to the income years 1997-98 to 2002-03, it will provide that if shares have been issued by the incorporated society, it will be deemed to have issued shares to its members and those shares will carry all the shareholding decision-making rights. The result is that a voting interest is created that can be used for the purposes of subpart IG of the Act.

Background

Under current legislation, incorporated societies, cannot carry forward tax losses or offset their income or losses against the income or losses of companies in the same group. Incorporated societies that do not issue shares cannot satisfy the ordinary shareholder continuity test, and they cannot be exempted from this requirement because they do not fall within the definition of "special corporate entity". Including these incorporated societies within the definition is seen as the most practical solution.

Extending the definition of "special corporate entity" to include these incorporated societies will not allow commonly owned incorporated societies to offset their income and losses. Special corporate entities are treated as "notional persons" and are, therefore, unable to group with commonly owned entities. A separate provision is required, therefore, to allow commonly owned incorporated societies to offset their income and losses within a group structure.

INCOME TAX RATES

(Clause 3)

Summary of proposed amendments

The bill sets the annual income tax rates that will apply for the 2004-05 income year.

In the 2004-05 income year, new tax rates will apply to the income of Maori authorities and to some specified superannuation contributions.

Application date

The provision will apply for the 2004-05 income year.

Key features

The annual income tax rates for the 2004-05 income year will be set at the rates specified in Schedule 1 of the Income Tax Act 1994.

The rates in Schedule 1 that apply for the 2004-05 year vary from those that applied for the 2003-04 year in the following ways:

- A rate of 19.5% now applies to Maori authorities.
- Two new progressive rates of specified superannuation contribution withholding tax apply if an employer has made an election under section NE 2AB of the Income Tax Act 1994.

Background

The Income Tax Act 1994 provides for the rates of income tax to be fixed by an Act of Parliament from time to time. It has been a long-standing practice of Parliament to confirm for each income year that the rates of income tax are the basic rates specified in Schedule 1 of the Income Tax Act 1994.

The new Maori authorities rate was inserted into Schedule 1 by the Taxation (Maori Organisations, Taxpayer Compliance and Miscellaneous Provisions) Act 2003. The new rates of specified superannuation contribution withholding tax were inserted into Schedule 1 by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003.

INFORMATION-MATCHING

(Clauses 70(7), 70(8), 72, 73 and 74)

Summary of proposed amendment

Student allowance recipients (or the partner of a student receiving the married student allowance rate) will be included in the data exchanges which currently take place between Inland Revenue and the Ministry of Social Development to identify those in employment and/or to locate those who have an amount payable to the Ministry. In addition, the information which Inland Revenue may supply to the Ministry regarding beneficiaries or student allowance recipients in employment will be increased.

The purpose of the information-matching is to identify any overpayments of student allowances.

Application date

The amendments will apply from the date on which the bill is enacted.

Key features

The secrecy provisions in sections 81, 82 and 85 of the Tax Administration Act are to be amended to include student allowance recipients (or the partner of a student receiving the married student allowance rate) in data matches between Inland Revenue and the Ministry of Social Development to establish whether they have been working while in receipt of an allowance. That information will be used by the Ministry to establish whether entitlement to the allowance had ceased due to the level of the recipient's (or partner's) income.

A further change to the Tax Administration Act increases the information which Inland Revenue may supply to the Ministry regarding beneficiaries or student allowance recipients in employment to include their:

- employer's telephone number and/or e-mail address;
- tax code; and
- name and date of birth.

This additional information will enhance the accuracy of the match and thus reduce unnecessary contact with beneficiaries, students and their employers.

Background

Student allowances are paid by the Ministry of Social Development. There is a cap on the amount of income that recipients (or their partner) may earn while in receipt of an allowance. This is similar to the position of beneficiaries who may only earn a set amount before their benefit begins to abate. A data exchange already takes place between the Ministry and Inland Revenue to identify beneficiaries in the work force. The Ministry uses this information to carry out further checks to ensure that the benefit is being paid at the correct level.

Another data match takes place to locate people who have an amount payable to the Ministry.

DISPUTES RESOLUTION PROCESS

(Clauses 9, 34, 70, 76, 77, 78, 79, 80, 81, 82, 83, 84, 95, 97, 99, 102, 104, 129, 134, 141, 143 and 144)

Summary of proposed amendments

The environment within which tax disputes are resolved is critical to maintaining an efficient tax administration. The current process for resolving disputes, introduced in 1996, followed recommendations made by Sir Ivor Richardson as part of the Organisational Review of the Inland Revenue Department.[1] The main objective of the disputes process is to have legislation and administrative practices which encourage disputes to be dealt with fairly, efficiently and quickly before they get to court.

As part of the generic tax policy process, a post-implementation review of the disputes process was undertaken. Following the July 2003 discussion document *Resolving Tax Disputes: A legislative Review*, the amendments proposed in the bill further improve the framework within which tax disputes are resolved, to ensure that the process is meeting its objectives.

To provide greater certainty and consistency for both Inland Revenue and taxpayers in relation to their returns, the amendments clarify the timeframes for claiming refunds in relation to goods and services tax and income tax.

Application date

The amendments to the disputes procedure will apply to disputes commenced under Part IVA of the Tax Administration Act 1994 on or after 1 April 2005, the time of commencement usually being the issue of a notice of proposed adjustment by either Inland Revenue or the taxpayer. Amendments to timeframes within the process (the response periods) will apply to notices issued on or after 1 April 2005. If that response period relates to a GST return, the amendments apply to notices issued in relation to GST return periods starting on or after 1 April 2005. Amendments relating to income tax refunds and the Commissioner's statute bar period for amending assessments will apply from the 2004-05 income tax year. The amendment relating to GST refunds will apply for GST return periods starting on or after 1 April 2005. Amendments relating to situations where an assessment can be issued without starting the disputes process apply to assessments for which notices are issued on or after 1 April 2005.

Amendments to the challenge procedures apply from the date of enactment.

[1] *Organisational Review of the Inland revenue Department; Report to the Minister of Revenue (and on tax policy, also to the Minister of Finance)* from the Organisational Review Committee, April 1994.

Key features

Completing the process

Proposed amendments which ensure that the various steps required to facilitate the resolution of a dispute are completed as the legislation intended include:

- clarifying that the Commissioner must, other than in prescribed circumstances, apply all the legislated steps of a dispute (proposed new section 89N Tax Administration Act 1994 (TAA));
- replacing the current six-month period within which the parties may agree to extend the time available for a dispute with a 12-month period (section 108B); and
- expanding the circumstances in which a document that is provided late by the taxpayer will be accepted by the Commissioner (amending section 89K).

Ensuring the process is efficient and cost-effective

To ensure that the disputes resolution process is accessible to taxpayers, the costs incurred in preparing the various documents should be no greater than is necessary for each particular case to meet this objective, proposed amendments include:

- simplifying the documentation required by both parties to progress a dispute (amended sections 89F and 89G);
- extending the time for taxpayers to initiate a dispute to their self-assessment from two months to four months (amendment to the definition of "response period" in the TAA);
- introducing an accessible small claims process which includes raising the threshold for such cases from $15,000 to $30,000 and clarifying that a "precedent" case is one that has wider implications for other taxpayers (sections 13B of the Taxation Review Authorities Act 1994, 89E of the TAA and regulation 18 of the Taxation Review Authorities Regulations 1998); and
- allowing the disputes process to be stayed pending the outcome of a test case if both parties agree (proposed new section 89O).

The provision of clear, consistent timeframes in the context of tax administration is necessary to achieve certainty and finality in respect of a taxpayer's tax affairs. To achieve this, the timeframes within which tax refunds are allowed (sections MD 1(1), MD1(2) and MD 1(3) of the Income Tax Act 1994 and section 45 of the GST Act) are being amended to provide for a four-year refund period, unless the taxpayer has made a clear mistake or oversight, when the period will remain eight years. Refunds arising in other circumstances will be limited to four years.

If a taxpayer is retrospectively claiming a GST input tax deduction in circumstances where the issue may be more complex and/or disputable – for example, one arising from new case law or a new interpretation that the taxpayer had not previously considered – a period of two years will be allowed. The taxpayer's ability to claim an input tax credit in a current period return relating to a past transaction will be retained for straightforward cases, such as those involving a clear mistake or simple oversight.

Background

Over the last decade a broad package of tax administration reforms has been introduced in response to developments such as increased technology and self-assessment. The areas of reform included:

- compliance and penalties legislation;
- binding rulings;
- a progressive rewrite of the income tax legislation;
- the introduction of legislation supporting taxpayer self-assessment; and
- tax simplification, including removal of the requirement for most wage and salary earners to file returns.

It was within this environment of tax administration reform that the disputes resolution process was introduced, in 1996, in response to the recommendations of the Organisational Review of the Inland Revenue Department, which was chaired by Sir Ivor Richardson.

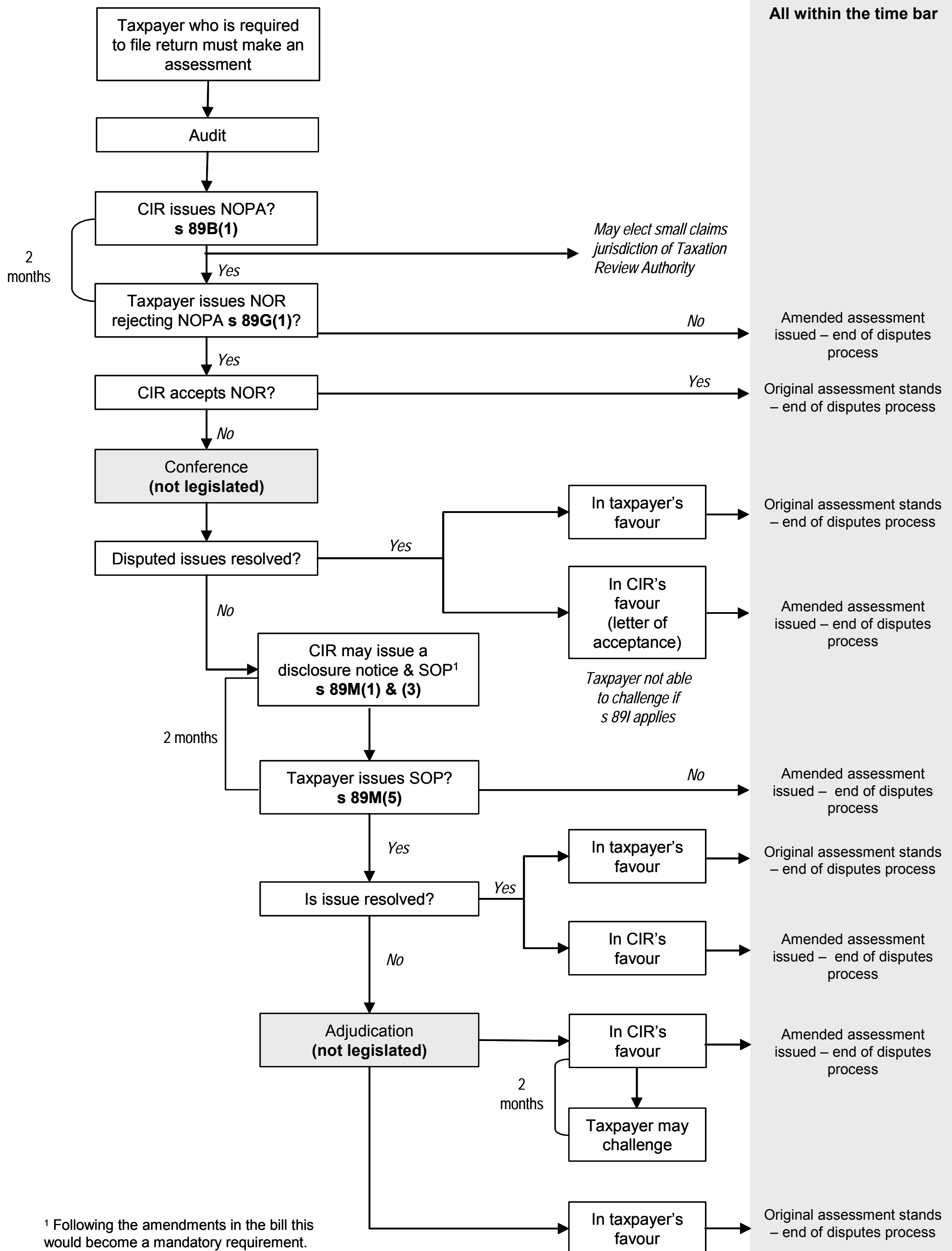
The disputes procedures at that time were perceived as deficient in that they did not adequately support the early identification and prompt resolution of issues leading to tax disputes. A new disputes resolution process was subsequently introduced to address these concerns.

The objective of the disputes process is, therefore, to deal with any disputes over tax liability fairly, efficiently and quickly. The early resolution of disputes is intended to be achieved through a series of steps prescribed in legislation, the main elements of which are:

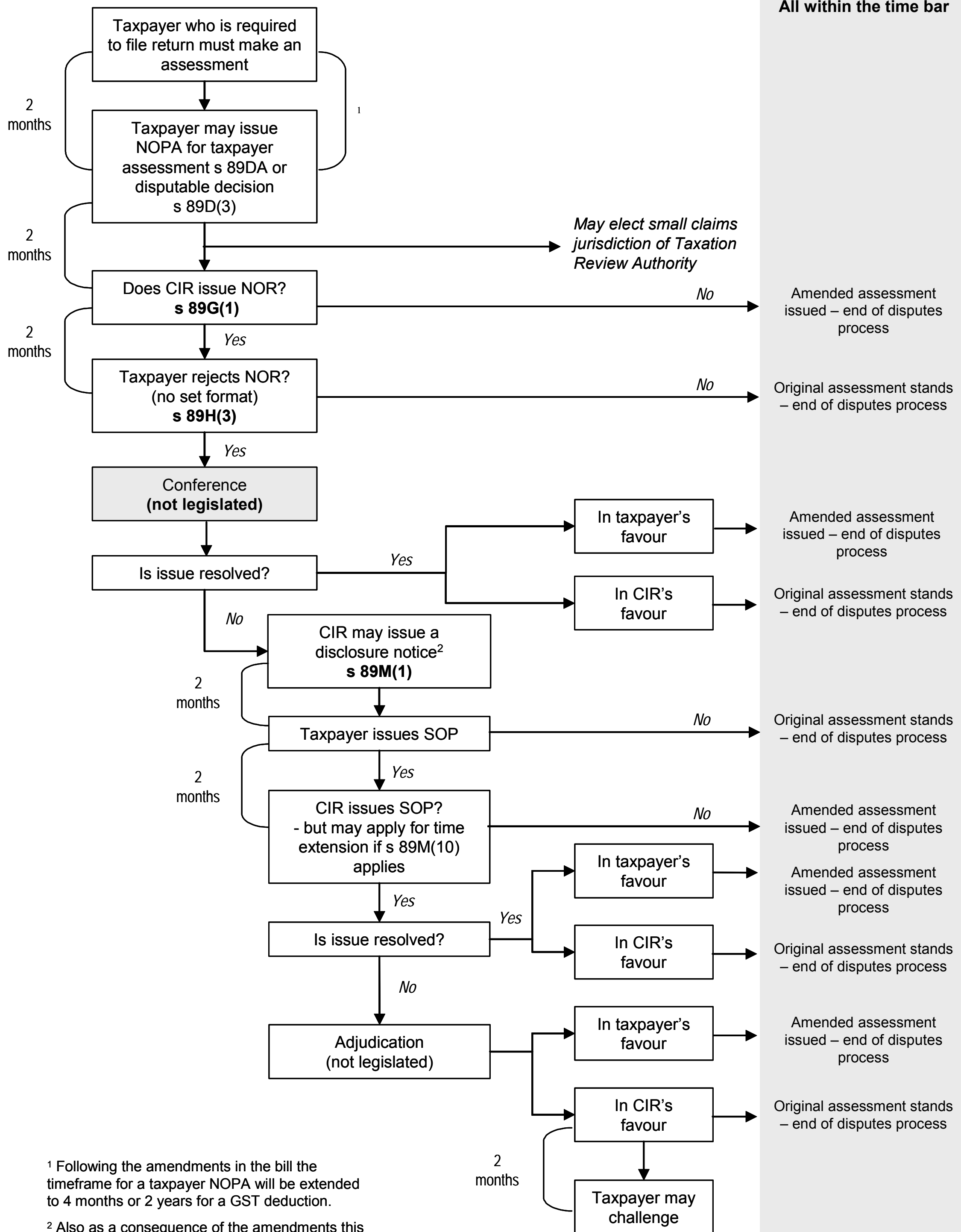
- A notice of proposed adjustment (NOPA). This is a notice by either the Commissioner or a taxpayer to the other that an adjustment is sought in relation to the taxpayer's self-assessment.
- A notice of response (NOR). The NOR is a notice of response issued by the party receiving the NOPA if they disagree with the NOPA.
- A disclosure notice and statement of position (SOP). A disclosure notice triggers the issue of a SOP. A SOP contains the detailed facts and legal arguments to support the position taken and again is issued by both parties. It is an important document because it limits the parties to their respective facts and arguments if the case goes to court – this is referred to as the "evidence exclusion rule".

The prescribed documents are intended to encourage an all "cards on the table" approach to dispute resolution that ensures that all the relevant evidence, facts, and legal arguments are canvassed before a case goes to court. There are also two administrative phases in the process – the conference and adjudication phases. The conference is a relatively formal meeting between Inland Revenue and the taxpayer which aims to clarify and, if possible, resolve the issues. Adjudication involves the independent consideration of the dispute by Inland Revenue and is the final phase in the process before the taxpayer's assessment is amended.

Commissioner-initiated dispute



Taxpayer-initiated dispute



The government discussion document *Resolving tax disputes: A legislative review* was released on 2 July 2003. The purpose of the discussion document was to ensure that the government's objective of making the dispute resolution procedure fairer, faster and generally more efficient was being supported by the legislation. The review therefore focused on particular ways in which the legislative process could be improved for both taxpayers and Inland Revenue. It recognised, however, that the process for resolving disputes is dependent on efficient administrative practices and noted that Inland Revenue is undertaking a separate review of these practices.

The document covered five broad subject areas:

- the need for the Commissioner to follow the full process set out in the legislation;
- the content and the level of detail of the various documents required by the Commissioner and the taxpayer during the dispute;
- the increasing incidence of taxpayers seeking to adjust their own returns in relation to issues that are likely to be disputed;
- providing certainty regarding timeframes, including timeframes for GST; and
- miscellaneous issues.

The measures proposed in this bill aim to ensure that the administration is operating efficiently at the lowest possible cost and to promote voluntary compliance as a result of disputes being handled fairly and resolved promptly.

Detailed analysis

Completing the process – new section 89N

The Commissioner is generally limited to a four-year period within which to amend a taxpayer's assessment following an investigation or in certain other circumstances. The assessment is amended following the disputes process and the intention at the time the legislation was introduced was, therefore, that the various steps involved in the process would be undertaken within the four-year period.

Owing to the manner in which it has been possible to apply the disputes process the various steps in the process have not been completed as the legislation intended in all cases.

To address this, the Commissioner of Inland Revenue will be required to follow the legislated steps of the disputes process, other than in specific circumstances. These circumstances are where:

- the dispute involves alleged criminal matters;
- a taxpayer involved in a dispute, or an associated person of the taxpayer, may take steps as to the location of the taxpayer's assets to avoid or delay the collection of tax;

- the taxpayer has begun judicial review proceedings in relation to the dispute or an associated person of the taxpayer involved in another dispute involving similar issues has begun judicial review proceedings;
- the taxpayer fails to comply with a statutory obligation or a request for information relating to the dispute;
- the taxpayer elects to have the dispute heard by the Taxation Review Authority acting in its small claims jurisdiction;
- the taxpayer and the Commissioner agree in writing that the dispute should be resolved by the court or the Taxation Review Authority without the completion of the disputes process;
- the taxpayer and the Commissioner agree in writing to suspend the disputes process pending the outcome of a test case; and
- the Commissioner applies to the High Court for an order to allow more time for completion of the dispute, or to allow the disputes process not be completed.

If any of the excepted circumstances apply the Commissioner will be entitled to issue an assessment without completing the disputes process.

The exception relating to the location of the taxpayer's assets is designed to address situations where a taxpayer or associated person of the taxpayer may seek to dispose of assets which may be required to meet an outstanding tax liability, and the issue of an assessment becomes urgent.

The exception for judicial review proceedings reflects that the parties' resources may be directed away from progressing the dispute through the process towards addressing the facts and issues in the judicial review application.

Failure by a taxpayer to comply with a request for information if that information is necessary to resolve the dispute or to comply with another matter relating to the dispute may, similarly, delay the progression of the dispute within the four-year time bar.

An order from the High Court may be sought if the Commissioner considers that there are reasonable grounds, other than those specifically prescribed, for not following the full statutory process. Whether or not there were reasonable grounds could depend, for example, on the complexity of the issues, whether the taxpayer had caused prolonged delays and whether there were significant matters that were unforeseen by either party that provided a justification for delay.

The remaining exceptions in section 89N are relatively self-explanatory: alleged criminal activities may mean the Commissioner needs to act quickly; the small claims process is a simpler separate process; and an agreement between the parties not to follow the full process, either when there is a test case or for other reasons, allows the parties to reduce compliance and administrative costs in smaller or more straightforward disputes.

The new section will not affect the Commissioner's ability to agree to make an adjustment to an assessment in cases of clear mistake or oversight, for example. Therefore the Commissioner will still be able to amend an assessment under section 113 (which contains the general power to amend assessments) subject to new section 89N.

Disclosure notices – section 89M

A disclosure notice is a simple document which triggers the application of the "evidence exclusion" rule. The rule restricts what the Commissioner and the disputant may raise in a court challenge to matters raised in their respective statements of position. The policy behind the introduction of the evidence exclusion rule into the disputes process was to ensure that the parties to the dispute had all the information necessary to facilitate resolution before the case got to court. To protect witnesses in sensitive cases, the Commissioner was therefore given the discretion not to issue a disclosure notice so that the evidence exclusion rule would not apply. However, the application of this discretion is uncertain.

An amendment to section 89M will require that disclosure notices must be issued, except in situations where the Commissioner does not have to complete the disputes process. To address the consequential issue with regard to the protection of witnesses, new subsection 89M(6B) will clarify that "evidence" when referring to the evidence exclusion rule will refer to the available documentary evidence and does not include a list of witnesses or types of witnesses. Therefore witnesses in sensitive cases will continue to be protected, without undermining the effect of the evidence exclusion rule. The amendment will also provide more flexibility at the stage where cases need to be prepared before they go to court.

The documentation required as part of the disputes process – sections 89F and 89G

The content of the notice of proposed adjustment is prescribed in section 89F. The amended section 89F requires that both documents issued by the taxpayer or the Commissioner must contain sufficient detail to identify the issues arising and be in the prescribed form. The section then details what further requirements are necessary, depending on whether the document is issued by the Commissioner or the taxpayer.

Subsection 2 requires the Commissioner to identify the adjustments and state concisely the facts and law relevant to the adjustment and how the law applies to the facts. The term "concisely" is intended to convey a document that is relatively brief but at the same time covers all the issues relevant to the dispute.

One of the main reasons taxpayers may choose to initiate a NOPA is to eliminate their exposure to shortfall penalties. At present, a taxpayer can file a return on a conservative basis and then file a NOPA on a less conservative basis. As penalties are calculated by reference to the tax position taken in a self-assessment, rather than in a NOPA, the risk of shortfall penalties applying is reduced.

Subsection 3 requires the taxpayer NOPA to contain a clear and detailed statement of the facts and law and copies of all material documentary evidence that the taxpayer is aware of at the time the notice is issued in support of the claim.

The need for the taxpayer to provide more detail than the Commissioner in a NOPA was highlighted in chapter 5 of the July 2003 discussion document. The main advantage of the proposal is that, because of the greater level of detail that will be required, potential disputes may be resolved at an earlier stage – ideally, without the need for further investigation.

The document issued in response to a NOPA by either the Commissioner or the taxpayer will require that the parties state concisely the facts, law and arguments the issuer of the notice of response considers to be wrong in the NOPA and the reasons for this. They must also state any facts and legal arguments relied on by the issuer of the response notice and how those arguments apply to the facts.

These amendments will ensure that there is a balance between allowing some flexibility for taxpayers and the Commissioner of Inland Revenue in preparing the documents, so that costs are reduced, and ensuring that both parties have all the information required to adequately address the issues raised in the dispute.

The requirement that the legal arguments are applied to the facts will ensure that the proposed adjustment is not a statement which appears out of context in relation to the rest of the document but is, rather, a logical conclusion.

Timeframe for taxpayer-initiated notice of proposed adjustment – definition of "response period"

In recognition of the requirement on taxpayers to provide detailed information to the Commissioner when they initiate a dispute, the definition of "response period" is being amended to give taxpayers four months, instead of the current two months, to initiate a dispute to their self-assessment. The period will apply from the date a taxpayer's notice of assessment is received at an office of Inland Revenue.

In the definition of "response period", the provision of a two-month period starting on the date of issue of a notice from the disputant rejecting an adjustment proposed by the Commissioner is being removed because it is redundant.

Four-year time bar waiver period – section 108B

The Commissioner is generally limited to a four-year period within which to amend a taxpayer's assessment following an investigation of the taxpayer or in certain other circumstances.

Currently, taxpayers may agree to extend this four-year time bar by up to six months if more time is required to complete the disputes process. The extension takes the form of a waiver, which must be in the prescribed form and signed and delivered to the Commissioner by a taxpayer before the expiry of the relevant four-year period.

The existing time bar waiver period of six months is problematic because in some cases six months is insufficient to complete the process, and taxpayers are reluctant to grant the waiver because of the risk that Inland Revenue may identify new issues during the waiver period.

The amendment extends this six-month period to 12 months to provide sufficient time to complete the disputes process in cases where this time is needed. Again, the extension will apply only when the parties agree. In addition, the Commissioner will not be able to raise new issues during the waiver period that are not identified and known to both parties before the start of the period.

The statute bar override – section 108(2)

The four-year time restriction for the Commissioner to amend a taxpayer's assessment does not apply if the taxpayer has acted fraudulently or has omitted to include income of a particular nature or source in a tax return.

For the provision relating to the omission of gross income to operate effectively, the amount of tax at stake would need to be taken into account, as was suggested in the case of *Babington v CIR*.[2] This limitation is not, however, expressly provided for in the legislation.

If a taxpayer overstates an expense claim or tax deduction in a tax return, however, an exception to the four-year period may not apply, even though the overstatement is material and might, in certain situations, be classed as tax avoidance.

To clarify the application of this provision, the omission of income will need to be material. A further exclusion to the statute bar will be added to cover instances of the taxpayer materially overstating deductions.

An exception for overstated deductions was not seen in the past as necessary because taxpayers would file full information on deductions claimed in their returns which would then be audited by Inland Revenue. This is no longer the case, since taxpayers must now self-assess their own income tax liability. Taxpayers are now charged with the responsibility to ensure their assessment is correct and that they have complied with all obligations imposed on them by the tax laws. The amendment in relation to materially overstated deduction is consistent with these responsibilities.

Timeframes for refunds of excess tax and GST input credits

If tax has been paid in excess, the excess amount is refunded to the taxpayer. The refund cannot be made after eight years from the year in which the original assessment was made. The long period for refunds was established in the 1950s, in an era when the administrative environment was based on assessments made by the Commissioner.

Taxpayers are able to claim in a current period return GST input tax credits which have not been previously deducted. The time within which these claims may be made is unspecified but is practically limited by the seven-year statutory period for which business records must be retained.

[2] [1957] NZLR 861 (CA).

Neither the general refund period nor the timeframe for claiming GST input tax credits differentiates clearly between cases of obvious mistake or error. Nor do they differentiate clearly cases where the refund or claim may be more disputable, such as those where the taxpayer seeks to apply an argument based on new case law or a new interpretation.

The current position in relation to GST input tax claims and the long period for refunds of overpaid GST and income tax is not appropriate because the government is exposed to a significant but unquantifiable revenue risk from large, backdated refund claims. Nor do the current rules provide the certainty for taxpayers and the government that is consistent with a modern tax administration. Importantly, also, an eight-year period is inconsistent with the Commissioner's four-year statute bar period and, as a result, can cause confusion.

Therefore the refund provisions in the Income Tax Act 1994 (sections MD1(1), MD1(2) and MD1(3)) and section 45 Goods and Services Act 1985 are being amended to limit the eight year refund period to four years, with the Commissioner being able, in the case of clear mistakes and simple oversights, and for rebate claims, to extend the period to eight years. Retaining the eight-year period in cases of clear mistake and simple oversight protects existing taxpayer rights to refunds.

The proviso to section 20(3) of Goods and Services Tax Act 1985 is being amended to limit the circumstances in which a GST input credit can be claimed in the current period return to those situations where a tax invoice has not been obtainable or where there has been a clear mistake or simple oversight. Allowing these kinds of adjustments to be made in the current year return prevents the compliance costs that taxpayers might otherwise face if they continually had to amend past returns. The amendment limits to its intended scope the existing taxpayer right to claim GST input credits in current period returns.

When there is a disputable GST input credit claim – for example, when the taxpayer's ability to claim is backdated following arguments based on new case law or a new interpretation – section 89DA(1) of the TAA 1994 is being amended to provide for a two-year period within which the taxpayer must initiate a dispute to the GST return. The adjustment must be made in the return to which the transaction relates – not the current period return. This restriction will not apply to cases of clear mistake or simple oversight referred to in the proviso to section 20(3) of the GST Act.

This two-year period for GST input tax claims can be compared with other instances where taxpayers initiate a dispute to their GST return, or to their income tax return when the taxpayer NOPA period is four months. The difference is justified as it takes into account the need for taxpayers to reconcile GST against their financial accounts annually and the fact that claiming GST input tax credits may depend on a taxpayer's ability to obtain a GST invoice.

These measures will protect the government's fiscal position from large, backdated refund claims and further provide greater certainty for both Inland Revenue and taxpayers in relation to their tax returns.

Exceptional circumstances – section 89K

The exceptional circumstances provision allows the Commissioner to accept a late document within the response period if exceptional circumstances apply. The current definition of "exceptional circumstance" is too restrictive and is, therefore, being extended.

Section 89K is being amended to give the Commissioner the discretion to accept a late document outside of the applicable response period if the lateness is minimal – for example, if the document is filed one or two days late or the document is late owing to one or more statutory holidays falling within the response period.

Test cases – new section 89O

New section 89O is being inserted into the TAA to allow for the suspension of a dispute as the result of the outcome of a test case. The section will apply if a dispute between a taxpayer and the Commissioner has been identified and the Commissioner has designated a case involving another taxpayer as a test case.

If the section does apply, the taxpayer and the Commissioner may agree to suspend the dispute from the date of the agreement if there is similarity between the facts and questions of law in the dispute and the case that has been designated as a test case. In such a case, any time bars affecting the dispute are stayed until the earliest of the date of the court's decision, the date on which the test case is otherwise resolved, or the date on which the dispute is otherwise resolved.

Enabling the Commissioner to designate a case as a test case earlier in the disputes process will reduce administrative and compliance costs that might otherwise arise if the case involves, say, a taxpayer who is one of a number involved in a single scheme or in a series of similar transactions.

Small claims process

The cost of the disputes process should not be a deterrent to using the disputes process, especially for smaller taxpayers for whom the cost of progressing the dispute may far outweigh the amount of tax in dispute.

An amendment to section 89E and consequential amendments to the Taxation Review Authorities Act 1994 and the Taxation Review Authorities Regulations 1998 make the small claims process more accessible to taxpayers by:

- raising the threshold of the amount of tax in dispute from $15,000 to $30,000; and
- clarifying that "precedent" means the case will be of precedence for taxpayers other than the taxpayer in question.

Disputable decision

A clarification to the definition of "disputable decision" in the interpretation section of the TAA excludes from the definition particular sections of the disputes process that are left to the discretion of the Commissioner.

The decisions left to the Commissioner's discretion that will not be disputable decisions include:

- section 89K, relating to late actions occurring within the response period;
- section 89L, which allows the Commissioner to apply for a High Court order to issue a notice rejecting an adjustment proposed by a taxpayer that the Commissioner has accepted or is deemed to have accepted;
- section 89M(8), which allows the Commissioner to provide additional information to the Commissioner's statement of position in response to the disputant's statement of position;
- section 89M(10), which allows the Commissioner to apply for a time extension to reply to a disputant's statement of position; and
- section 89N(3), which allows the Commissioner to apply to the High Court for an order allowing more time to complete the process, or that completion is not required.

The amendments ensure that only substantive issues are disputed and that mechanical sections of the disputes process do not in themselves give rise to disputes.

When assessments can be issued without a NOPA – section 89C

Section 89C lists the circumstances when the Commissioner may make an assessment without issuing a NOPA. They include when the assessment reflects an agreement between the Commissioner and the taxpayer or when the Commissioner believes a notice may cause the taxpayer to leave New Zealand.

Two new subsections are being added to the list of circumstances when the Commissioner may issue an assessment without first issuing a NOPA. New section 89C(db) enables the Commissioner to issue an assessment when that assessment is made in relation to a matter that is identical to an assessment of the taxpayer for another income year that is at the time subject to court proceedings. In this situation the disputes process would have been completed in relation to the earlier assessment, and the purpose of the amendment is to reduce compliance costs.

New section 89C(eb) provides that an assessment can be issued if the taxpayer has left New Zealand and may have been involved in fraudulent activity. The new subsection is a natural extension to existing subsection (e), which allows the Commissioner to issue the assessment if the Commissioner believes a NOPA may cause the taxpayer to leave New Zealand.

Minor amendments to the challenge procedures – sections 138B(3)(b) and 138F(2)

Section 138B(3) provides taxpayers with the ability to challenge an assessment when the Commissioner has rejected (by issuing a notice of response) a notice of proposed adjustment issued by the taxpayer and the Commissioner does not subsequently issue an amended assessment. The taxpayer must file proceedings within the response period of the written disputable decision from the Commissioner, which may include another form of written correspondence by the Commissioner.

Some confusion has arisen for taxpayers in respect of the response period of the written disputable decision from the Commissioner provided for in section 138B(3)(b). Taxpayers can challenge an assessment if they file proceedings within that response period. This written disputable decision was not intended to be restricted to the notice of response referred to in section 138B(3)(a).

Therefore, the amendment clarifies this point by providing that the reference to "within the response period of the written disputable decision from the Commissioner" is not restricted to the notice of response issued by the Commissioner.

The effect of the proposed amendment is that the full disputes process will more clearly be provided for in the case of a taxpayer-initiated dispute as the time for challenging the Commissioner's decision will not be limited to the two months after the Commissioner's notice of response.

Section 138F gives taxpayers the right to challenge an assessment made by the Commissioner that takes account of a disputable decision. This section does not then provide for a response period within which the challenge must be commenced because there is no cross-reference to sections 138B and 138C, which do provide a response period.

The amendment clarifies that for a challenge made under the section to be effective, the taxpayer must commence the challenge within the response period from the date of the Commissioner's notice of assessment.

SELF-ASSESSMENT OF GST

(Clauses 69, 77, 78, 91, 93, 94, 96, 97, 98, 123, 124, 126, 127, 128, 130, 132, 133, 134 and 136)

Summary of proposed amendments

Amendments are being made to the Goods and Services Tax Act 1985 and the Tax Administration Act 1994 (TAA) to confirm that GST is a self-assessed tax. GST, like income tax, relies on taxpayers making the initial assessment of their own tax liability. The amendments aligning the GST legislation with the practice of self-assessment follow the legislative approach used for income tax.

Although not involving significant policy change, the introduction of self-assessment into the GST legislation will add to and enhance other improvements being made to simplify tax administration. The proposed GST self-assessment provisions will also achieve a better interface between the GST Act and the TAA.

Application date

The amendments will apply to GST return periods starting on or after 1 April 2005.

Key features

Part IV of the GST Act, relating to the assessment of GST, will be repealed, with its main effect being achieved by new section 92B of the TAA. A taxpayer (as defined in section 3 of the TAA) who is required to provide a return under the GST Act for a taxable period must make an assessment of the tax payable for the period. The self-assessment provision will also apply to any person required to provide a special return under section 17 of the GST Act or a return under section 19B of the GST Act for a change in accounting basis.

The Commissioner will retain specific powers to amend a taxpayer's assessment under section 113 of the TAA or make an assessment under section 106 if a taxpayer fails to self-assess.

Consequential amendments are being made to the time bar provision for amending GST assessments in section 108A of the TAA, reflecting the move to self assessment. This will be based on the model used in the income tax time bar provision in section 108.

A number of provisions in the GST Act are being repealed because their effect is replicated by existing provisions in the TAA. For example, the effect of section 29 of the GST Act (assessments deemed correct except in challenge proceedings) is replicated in section 109 of the TAA, so section 29 can be repealed.

Background

Tax administration practices currently recognise that taxpayers have the best information about their own activities. As such, taxpayers are better placed than the Commissioner to assess their tax liabilities by making the appropriate calculations and furnishing their returns.

Despite current practice, self-assessment for GST is not fully provided for in the legislation. Legislating for self-assessment for GST will provide a more consistent framework by aligning the legislation with practice, thus allowing taxpayers' obligations to be provided for more clearly and directly in the GST Act.

PENALTIES APPLICABLE TO NON-RESIDENT CONTRACTOR IF TOTAL DOUBLE TAX RELIEF APPLIES

(Clauses 106, 107, 118 and 119)

Summary of proposed amendment

An amendment imposes a penalty of $250 per employer monthly schedule if an employer fails to make a required deduction from the withholding payment to a non-resident contractor. This penalty is capped at $1000 per employer monthly schedule. The amendment applies only in cases where the non-resident contractor that the withholding payment is made to is totally relieved from paying tax in New Zealand. The amendment replaces the present shortfall penalty because that penalty is not appropriate in these circumstances.

Application date

The amendment will apply to withholding payments made on or after 1 April 2005.

Key features

New section 141AA imposes a penalty on an employer who makes a withholding payment to a non-resident contractor for the purposes of the Income Tax (Withholding Payments) Regulations 1979 if that employer does not withhold the correct amount of tax. The penalty applies only if a double tax agreement relieves the non-resident contractor from all liability to pay tax on the withholding payment.

The employer is liable for a shortfall penalty of $250 for each return period for which the employer failed to make a required tax deduction from a withholding payment. The amendment provides that in these circumstances the employer will not be subject to the normal shortfall penalty provisions. The penalty is capped at $1000 per employer monthly schedule.

The new section requires a consequential amendment to section 141(2). This is to ensure no tax shortfall calculation is required if the new penalty applies. Section 183A(1) is also being amended to ensure that the "remission for reasonable cause" section of the Tax Administration Act 1994 apply to the new penalty. Section 183D(1)(b) is being amended to ensure that the new provision is applied consistently with the requirement for the collection of the highest net revenue over time.

Background

New Zealand employers are required to withhold non-resident contractors' withholding tax from contract payments to non-resident contractors. This is regardless of whether the non-resident qualifies for total tax relief under a double tax agreement. There is a provision that allows the Commissioner to issue an exemption certificate in these situations, but in some situations, obtaining the certificate may be overlooked.

If the contractor qualifies for total double tax relief the contractor will be refunded the tax paid when a tax return is filed at the end of the year. However, if the New Zealand employer does not withhold tax, a shortfall penalty will become payable. The shortfall penalty will be imposed on the New Zealand employer even if no New Zealand tax is payable by the non-resident contractor.

The new section changes this by providing for a different penalty to apply. A penalty is needed because it ensures that non-resident contractors apply for a certificate of exemption, which in turn provides useful information to the Commissioner of Inland Revenue.

TAX SHORTFALLS – LOSS ATTRIBUTING QUALIFYING COMPANIES

(Clauses 109 and 110)

Summary of proposed amendments

To the extent an adjustment reduces a net loss of a loss attributing qualifying company (LAQC), any penalties will be charged to the shareholder, not the company. If the shareholder has not claimed a deduction for the attributed loss, no penalty will be charged.

The change provides a better mechanism for providing relief from the double incidence of penalties if an LAQC and its shareholders are each penalised for what is virtually the same shortfall.

Application date

The amendment will apply to shortfalls that relate to periods starting on or after 1 April 2005.

Key features

New section 141FD applies if a loss attributing qualifying company attributes a net loss to a shareholder, and that loss is subsequently reduced or reversed. Only the shareholder will be charged a shortfall penalty in these circumstances. If the shareholder has not claimed a deduction for the attributed loss, no penalty will be charged.

If an adjustment results in net income to the loss attributing qualifying company, however, existing law will apply and the company will be charged the shortfall penalty.

Section 141FC, which allows a shareholder in a loss attributing qualifying company to apply for an offset of a shortfall penalty if a penalty is charged to both the shareholder and the company, is being consequentially repealed.

Background

Net losses of an LAQC are attributed to shareholders. Before the enactment of the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003, the law allowed shortfall penalties to be charged to both the LAQC and the shareholders if a loss claimed by an LAQC was adjusted and caused a shortfall for the shareholder as well.

The Act was retrospectively amended last year to add section 141FC, allowing a shareholder in an LAQC to receive an offset to his or her penalty if the LAQC paid its penalty in full. This approach was adopted because it did not cut across *Chapman v Commissioner of Inland Revenue* (HC M402-SD02). At the time the Amendment Act was passed, the case was under appeal.

The problem with the offset provision is that it relies on taxpayer application. Further, if a former shareholder applied for remission on the understanding that the LAQC had paid its penalty, Inland Revenue would be unable to inform the applicant if the company had or had not paid its penalty, for reasons of taxpayer confidentiality. Thus, the offset mechanism is clumsy from both a taxpayer's and Inland Revenue's perspective.

Remedial issues

TRANS-TASMAN IMPUTATION

(Clauses 22, 37-41, 65 and 105)

A number of clarifying or minor corrective amendments are being made to the recently enacted trans-Tasman imputation rules.

- Section FDB 1(1)(e) of the Income Tax Act 1994 is being repealed and section FDB 1(2)(ab) is being added to clarify that an imputation group must include all members of a consolidated group or no members of a consolidated group.
- Section FDB 1(2)(b) is being amended to clarify that it is only when members of more than one consolidated group form or join an imputation group that the credits in a consolidated group imputation credit account must have the same shareholder continuity profile.
- The formula in section ME 1C is being clarified that it is a x b - dividend times the exchange rate (rather than a + b as at present). This will come into force on 1 October 2003, the date Australian companies can pay imputed dividends.
- Section ME 10(1D)(b) is being clarified to ensure that all entries to the imputation account from the New Zealand members of a trans-Tasman imputation group go to the resident imputation group, whether or not they could be considered to be “transactions”. This clarification will come into force on 1 April 2003, the date that imputation grouping came into force.
- Section ME 12(1)(b)(i) is being removed and sections ME 18(1)(a), ME 18(3)(b)(i) and (ii), ME 19(3)(a), and (b) are being amended to ensure that, for companies within an consolidated or imputation group, transfers can still be made between the individual company’s imputation credit account and policy holder credit account. These amendments also come in to force on the 1 April 2003, the application date for imputation grouping.
- The definition of “resident in Australia” in section OB 1, paragraph (a), is being omitted. This is to ensure companies which are also resident in New Zealand, dual resident companies, are eligible to elect to become imputation credit account companies. This amendment comes in to force on 1 April 2003, the date Australian companies became eligible to elect to be imputation credit account companies.
- Section 139A(5) of the Tax Administration Act 1994 is being amended to omit annual imputation returns from this provision. This is to ensure consistent treatment of the late filing penalty rules. This amendment also applies from 1 April 2003.

MAORI AUTHORITIES

(Clauses 26, 27, 28, 29, 35, 53 and 117)

Summary of proposed amendments

The recently enacted Maori authority rules are being amended to align them with the recently amended company imputation rules, resolve minor technical problems and provide greater certainty with respect to the election start date for entities that wish to be taxed as a Maori authority.

Application date

The amendments will apply from the 2004-05 income year, the application date of the new Maori authority rules.

Key features

- Row 4 of Table HI 8 is being amended so that when a Maori authority elects to be taxed as a trust the income under the Maori authority rules which is still to be distributed is treated as trustee income and, therefore, can be distributed tax-free.
- Section HI 5 is being amended so that a taxable bonus issue made by a Maori authority that is a company is included in the definition of "taxable Maori authority distribution".
- Section HI 3(3), which provides for the Commissioner of Inland Revenue to determine the effective start date of an election to become a Maori authority, is being replaced with a provision that sets an explicit start date for an election. The amendment will require that elections start from the beginning of the income year in which the election notice is provided to the Commissioner unless the authority wishes to start the election from the immediately following income year.
- New section MD 2B(1B) clarifies that a Maori authority can be refunded income tax if there is a credit balance in its Maori authority credit account at the end of the relevant imputation year, without the need for multiple returns to be filed by the authority. The amendment is relevant to Maori authorities that have an extension of time for filing returns.
- New section MD 2B(4B) clarifies that any excess tax paid by a Maori authority can be credited as at a date on which there is no liability to pay provisional tax but from which use-of-money interest applies in relation to underpaid provisional tax.

- Section MK 8(5) is being replaced by new subsections, MK 8(5) and (5B). New subsection (5) provides that payments of further income tax may be credited to an income tax liability (including provisional tax) that arises at any time when the Maori authority is required to establish and maintain a Maori authority credit account. New subsection (5B) provides that payments of income tax may be credited against the further income tax liability as long as the payment was made after 31 March in the year when the Maori authority credit account debit caused the further income tax liability.
- New section 181D of the Tax Administration Act 1994 provides for the remission of use-of-money interest and late payment penalties on further income tax liabilities when income tax liabilities are outstanding at the same time. The remission will apply to the extent that the amount of further income tax charged is equal to or less than the amount of the unpaid income tax liability.

Background

The proposed amendments are required because:

- The company imputation rules, on which the Maori authority rules were based, have recently been amended by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 and the Taxation (Relief, Refund and Miscellaneous Provisions) Act 2002, but no corresponding amendments were made to the Maori authority rules.
- There were two unintended omissions from the Maori authority rules when these rules were originally drafted.
- There is a need to provide greater certainty with respect to the election start date for entities wishing to be taxed as a Maori authority. While the Commissioner's current ability to determine the start date provides flexibility, it does not give adequate certainty of tax treatment.

BRANCH EQUIVALENT TAX ACCOUNTS AND LOSSES

(Clauses 43-46)

A number of clarifying or minor corrective amendments are being made to the recently amended branch equivalent tax account rules.

- Sections MF 4(2)(a) and MF 8(3)(a) are being amended to omit paragraph (b) because this paragraph in MF 4(1) and MF 8(2) no longer exists following the simplification of the branch equivalent tax account credit rules.
- Sections MF 5(6B) and MF 10(5B) are being amended to clarify that the excess is grossed up into a loss, rather than the excess being the amount that becomes a loss.
- Section MF 8(2)(a) is being amended to ensure that item d in the formula also includes the foreign tax credits of consolidated group members in section LC 16. Item e in the formula is also being amended to ensure that it includes all branch equivalent tax debits used to offset the income tax liability of the consolidated group.

The branch equivalent tax account amendments apply to the 1997-98 and subsequent income years, unless a taxpayer has filed before 26 June 2003 a return of income for the income year; and the return of income relies on the sections before the enactment of the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003.

ALLOCATION DEFICIT DEBIT RULES FOR LIFE INSURANCE COMPANIES

(Clauses 40, 42, 47-49, 51-52, 64 and 65)

Summary of proposed amendments

The allocation deficit debit rules for life insurance companies are being amended to prevent the inappropriate results that can arise under the current rules.

The new rules are designed to ensure that the ratio by which dividend withholding payment (DWP) credits are attached to shareholder dividends does not exceed the equivalent ratio for policyholders.

To the extent that the shareholder ratio exceeds the policyholder ratio, an allocation deficit debit will arise in the life insurer's DWP account. This debit, in appropriate circumstances, will result in a corresponding credit to the policyholder credit account (PCA) of the life insurer.

The general policy approach in section MG 8(5) of the Income Tax Act 1994, which is to discourage refundable DWP credits from being streamed to shareholders so they are advantaged relative to policyholders, will remain unchanged.

Application date

The new allocation deficit debit rules for life insurance companies will apply generally for the 2004-05 and subsequent imputation years.

Taxpayers will also be able to elect to apply the new rules retrospectively. It is expected that only taxpayers that have previously incurred allocation deficit debits under the current rules will do so. If a taxpayer makes such an election, the new rules will apply to the imputation year specified in the election and subsequent imputation years. An amalgamated company will also be entitled to make an election on behalf of an amalgamating company (which has ceased to exist on amalgamation) for the latter to apply the new rules retrospectively up to the date of amalgamation.

Key features

The current formula used in section MG 8(5) can give rise to distorted and inappropriate results, including the imposition of excessive allocation deficit debits. For example, it is possible for a life insurance company to incur a large allocation deficit debit even when it has not paid a dividend to its shareholders and, therefore, by definition, could not have streamed any DWP credits to its shareholders.

The bill proposes a new basis for the allocation deficit debit rules in section MG 8 to address the rules' current deficiencies. The new rules should prevent the distorted and unintended results produced under the current allocation deficit debit rules.

The new allocation deficit debit rules will no longer compare the fraction of DWP credits transferred to the PCA to the fraction of imputation credits transferred to the PCA. Instead, the DWP crediting ratio for shareholders (measured by DWP credits attached to dividends / amount of dividends) will be compared against the equivalent ratio for policyholders (measured by DWP credit transfers to PCA / policyholder base income).

The new rules will apply only to an imputation year in which a dividend payment (with DWP credits attached) is made. However, for the purposes of the allocation deficit debit calculation, the relevant period of time to be considered will be from the end of that imputation year back to the start of the imputation year following the imputation year in which a shareholder dividend was last paid – the DWP reference period. The first DWP reference period will start no earlier than 1 April 2004 unless a taxpayer elects to apply the new rules from an earlier date.

Specifically, the proposed changes are:

- Sections MG 8(5) to (7) are being repealed.
- New section MG 8B is being added to replace the repealed provisions. Under this new section an allocation deficit debit arises when the shareholder DWP ratio exceeds the policyholder DWP ratio in a DWP reference period.
- "Shareholder DWP ratio" is defined as total DWP credits/total dividends paid.
- "Policyholder DWP ratio" is defined as DWP credits transferred to the policyholder credit account/ net policyholder income.
- "DWP reference period" is defined as the current imputation year plus previous years if no dividend was paid with DWP credits attached.

Therefore the proposed method is based on ensuring that the ratio by which DWP credits are attached to shareholder dividends does not exceed the equivalent ratio for policyholders.

If an allocation deficit debit arises in the DWP account under the new rules, a corresponding credit will be recorded in the PCA to the extent the DWP account has a closing credit balance. If the allocation deficit debit exceeds the DWP account closing credit balance, that excess will not be creditable to the PCA. The legislative proposals are as follows:

- New sections ME 18(1)(bb) and ME 26(2)(d) allow a credit to the policyholder credit account of the allocation deficit debit if it is less than or equal to the closing credit balance of the DWP account.
- New sections ME 18(1)(bc) and ME 26(2)(e) allow a credit to the policyholder credit account equal to the closing balance of the DWP account if the allocation deficit debit exceeds the closing credit balance of the DWP account.

Background

The current section MG 8(5) is intended to operate as an anti-avoidance rule to discourage life insurance companies streaming refundable DWP credits to their shareholders in preference to their policyholders. It works by recording a debit, called an allocation deficit debit, to a life insurer's DWP account when the fraction of DWP credits transferred to the PCA in an imputation year is less than the fraction of imputation credits transferred to the PCA in the same imputation year.

The provision was enacted as part of the new rules for the taxation of life insurance companies in 1990. It is intended to operate as an anti-avoidance provision to prevent a life insurer streaming refundable DWP credits to its shareholders and non-refundable imputation credits to its policyholders. At the time the rules were enacted, the Commissioner of Inland Revenue stated in Tax Information Bulletin Vol 2, No 3, October 1990 (Appendix C) at paragraph 17.4:

> ". . . The life insurer is able to elect to make transfers to its PCA from its WPA [DWP account]. However, as dividend withholding payments are refundable if not fully utilised by the person who ultimately receives them, there are provisions to ensure that a life insurer is unable to stream these credits to its shareholders as opposed to its policyholders . . ."

Some of the larger distortions under the current rules arise because the current calculation focuses on credits and debits arising to the memorandum accounts in one imputation year. It does not take into account opening and closing balances and, therefore, does not recognise that some life insurers may not clear out their DWP and imputation credit accounts each year by either transferring credits to the PCA or attaching them to dividends. If, for example, a life insurer has a substantial opening credit balance in its imputation credit account (ICA) and it elects to transfer a large proportion of these credits to the PCA, the imputation credit transfer fraction may well be significantly higher than the DWP transfer fraction, even if the company has transferred all available DWP credits to the PCA.

The following policy issues were taken into account when developing the proposed new allocation deficit debit rules:

- The application of the legislation should be limited to potential streaming events. Potential streaming events would arise in years when DWP credits are attached to dividend payments to shareholders.
- Once the threshold event has occurred, the penalty calculation should take a cumulative approach rather than focusing on memorandum entries in separate imputation years.
- The calculation should not rely solely on memorandum account entries but should have regard to distributions to both shareholders and policyholders.
- The deemed DWP account debit should, when appropriate, result in a corresponding credit to the PCA.

The calculation should not result in inappropriate or disproportionate penalty amounts.

Detailed analysis

The basis for the proposed new allocation deficit debit rules is to regard policyholders and shareholders as equity participants in a life insurance company. Shareholders receive rewards by way of dividends, and policyholders receive rewards by way of deemed distributions measured using the policyholder base.

To the extent that the shareholder DWP ratio is greater than the policyholder DWP ratio, a debit will arise in the DWP account.

These ratios will have specific DWP reference period rules for the purpose of calculating the numerator and denominator. The DWP reference period will be from the end of the imputation year in which a dividend (with DWP credits attached) was paid, back to the start of the imputation year following the year in which the previous shareholder dividend (with DWP credits attached) was paid. For example, if DWP credits are attached to dividends paid on 15 March 2008, and the previous dividend with DWP credits attached was paid on 15 March 2005, the DWP reference period concerned would be 1 April 2005 to 31 March 2008.

The first DWP reference period will start no earlier than the date the new rules first apply to a taxpayer. This will be 1 April 2004 unless the taxpayer elects to apply the new rules from an earlier date.

The proposed rules will require each life insurer to make the following calculations in the year that DWP credits are attached to dividends paid to shareholders:

Step 1: Determine DWP reference period

This will include the current imputation year plus any imputation years immediately before the current imputation year in which no dividends with DWP credits attached were paid.

Step 2: Determine whether policy holder income is positive

If the total of the policyholder income and net loss for the DWP reference period is zero or a net loss, the following allocation deficit debit rules do not apply – section MG 8B(2)(a).

Step 3: Determine shareholder DWP ratio

The formula for determining the shareholder DWP ratio will be:

$$\frac{f}{g}$$

Where:

f = total DWP credits attached to the dividend(s) in the DWP reference period
g = total amount of dividends paid in the DWP reference period

Step 4: Determine policyholder DWP ratio

The formula for determining the policyholder DWP ratio will be:

$$\frac{c}{d \times (1 - r)}$$

Where:

c = total net transfers from the DWP account to the PCA in the DWP reference period
d = policyholder base income in the DWP reference period
r = the rate of tax

Policyholder base income in the denominator will be the aggregate of policyholder base income in respect of the income years the PCA has been debited to meet the company's policyholder base liability in the DWP reference period. This definition is consistent with the PCA debit timing rules in sections ME 18(3)(a) and ME 18(4)(a). For example, if a life insurer has a 30 September balance date and attached DWP credits to dividends paid on 15 March 2004, the policyholder base income would include the 30 September 2003 income year results, but not the 30 September 2004 income year results. This is because the DWP reference period rule would only include the 31 March 2004 imputation year. The debit to the PCA in that imputation year would be made on 30 September 2003 in respect of the 2003 income year income tax liability.

For the purposes of calculating item "d", if the policyholder base has recorded a loss then this loss can be offset against other policyholder base income in the DWP reference period. Item "d" will, therefore, be the net amount of policyholder income in respect of the DWP reference period.

As the policyholder base income is the pre-tax amount in the current section CM 15 formula, the factor (1-r) is needed to make policyholder base income net of tax, in the same way that shareholder dividends are net of tax.

Step 5: Determine whether an allocation deficit debit is required in the DWP account

If the shareholder DWP ratio f/g is greater than the policyholder DWP ratio c/d(1-r), streaming is deemed to have occurred and the DWP account must be debited. This debit may result in a corresponding credit to the PCA, an allocation deficit debit solely in the DWP account, or a combination of both (as calculated in steps 6 and 7, below).

If the shareholder ratio f/g is smaller than the policyholder ratio c/d(1-r), no adjustment is required as new section MG 8B(2)(b) would not apply.

Step 6: Allocation deficit debit when the DWP account balance remains in credit

The amount to be debited to the DWP account depends on whether the DWP account will be in debit or credit after the debit is made.

The first step will require calculation of the potential DWP allocation deficit debit or "maximum deficit debit", as set out in new section MG 8B, which is calculated as follows:

Maximum deficit debit = (shareholder DWP ratio – policyholder DWP ratio) × d (1-r)

Then the maximum deficit debit is compared with the balance of the DWP account at year end (before any allocation deficit debit is imposed).

If the DWP account balance is greater than or equal to the maximum deficit debit – that is, if it will remain in credit or be zero after the allocation deficit debit is imposed – the amount of the maximum deficit debit is debited to the DWP account and credited to the PCA – refer new sections ME 18(1)(bb) and ME 26(2)(d).

This places the accounts in the same position as if the transfer had been made at the time the dividend was paid and no streaming would be involved.

Step 7: Reduced allocation deficit debit when the DWP account balance goes into debit

If the DWP account balance is less than the "maximum deficit debit" (before any allocation deficit debit is imposed), the allocation deficit debit would leave the DWP account in debit. In this case, a reduced allocation deficit debit is calculated.

The purpose of this further formula is to ensure that the credit ratio is the same for both policyholders and shareholders. It is designed to ensure that inappropriate or disproportionate debits do not arise.

While the reduced deficit debit is one formula, in substance, it consists of two parts. The first part takes into account that for both parties (shareholders and policyholders) the maximum DWP credit ratio that can be supported is:

$$\frac{\left(\begin{array}{c}\text{DWP credits attached to dividends} + \\ \text{Total net transfers from DWP account to PCA} + \text{DWP closing balance}\end{array}\right)}{\text{Shareholder dividend} + \text{(net) policyholder base income}}$$

Expressed algebraically, this reads:

$$\frac{\text{f} + \text{c} + \text{DWP closing balance}}{\text{g} + \text{d}(1 - \text{r})}$$

The DWP closing balance is the DWP closing balance before the initial allocation deficit debit is imposed and is represented by "e" in the reduced deficit debit formula in section MG 8B.

The maximum credits that can be attached to dividends is, therefore, the maximum DWP ratio, f + c + e multiplied by the dividends paid g divided by g + d(1-r).

On this basis, the reduced allocation deficit debit would be:

> The closing DWP balance before any allocation deficit debit is made, e, plus DWP credits attached to dividends, f, minus:
>
> $$\text{g} \times \frac{(\text{f} + \text{c} + \text{e})}{\text{g} + (\text{d} \times (1 - \text{r}))}$$
>
> which makes the complete formula for the reduced deficit debit as:
>
> $$\text{e} + \text{f} - \text{g} \times \frac{(\text{f} + \text{c} + \text{e})}{\text{g} + (\text{d} \times (1 - \text{r}))}$$

After the reduced deficit debit is imposed, the closing debit balance in the DWP account will be subject to a 10% dividend withholding payment penalty tax under section 140C of the Tax Administration Act 1994.

Although the PCA will receive a credit equal to the amount of the DWP account closing credit balance before the initial allocation deficit debit is imposed – new sections ME 18(1)(bc) and ME 26(2)(e) – it will not be credited with any other part of the reduced deficit debit.

The reason for not crediting the PCA with the full amount of the reduced deficit debit is linked to the nature of this debit. The DWP account closing debit balance indicates shareholders have received more DWP credits than were available (if streaming had not occurred). The payment required from the company to clear the balance, therefore, represents DWP credits which have been used by the shareholders inappropriately and so must be repaid. The repayment would leave the tax base in a neutral position. However, if the payment was also creditable to the PCA the tax position would no longer be neutral. Effectively, the shareholders would continue to receive a benefit because fewer imputation credits and DWP credits would need to be transferred to the PCA in the future.

Consequential amendments

New sections ME 18(2)(bb) and ME 26(3)(d) ensure that the credits to the PCA are made on the last day of the imputation year in which an allocation deficit debit arises.

Section MG 5(1)(f) is being clarified that it applies only to allocation deficit debits arising under section MG 8(4)and that sections MG 5(1)(g) and MG 15(1)(g) apply to debits arising under new section MG 8B.

Section MG 16A(1) is being amended to ensure that any dividends paid within a consolidated group do not form part of the calculation in new section MG 8B.

Examples

The following examples illustrate the calculations:

(a) Suppose one year is involved and, during that year, a (net) dividend of $10m is paid with $4m DWP credits attached. The (net) policyholder base income is $50m and, during the year, net credits of $15m were transferred from the DWP account to the PCA. At year-end the closing balance in the DWP account was a credit of $8m (before any allocation deficit debit). The DWP reference period in this case is the imputation year.

The shareholder DWP ratio (f/g) is: 4/10 = 40 %

The policyholder DWP ratio (c/d(1-r)) is: 15/50 = 30 %

As the ratio for shareholders is greater, section MG 8B(2)(b) streaming has occurred and an allocation deficit debit must be recorded. The maximum deficit debit is:

(Shareholder DWP ratio – policyholder DWP ratio) × (net) policyholder base income

$$\frac{4}{10} - \frac{15}{50} \times \$50\text{m} = 10\,\% \times \$50\text{m, which is } \$5\text{m.}$$

This $5m maximum deficit debit is less than the $8m DWP account credit balance, so $5m is transferred from the DWP account to the PCA. After the transfer, $3m credit remains in the DWP account.

This places the insurer in the same position as if it had transferred net credits of $20m from the DWP account to the PCA during the imputation year. The crediting ratio would then have been 40% for both shareholders and policyholders.

(b) The facts are the same as in the preceding example but at year-end only $2m remains in the DWP account (before any allocation deficit debit).

Now the maximum deficit debit of $5m exceeds the $2m credit balance in the DWP account. In order to prevent an inappropriate or disproportionate penalty amount, the allocation deficit debit will need to be capped at the level of the reduced deficit debit.

The first step is to calculate the maximum DWP ratio used in this calculation.

$$\frac{\left(\begin{array}{c}\text{DWP credits attached to dividends} + \\ \text{Total net transfers from DWP account to PCA} + \text{DWP closing balance}\end{array}\right)^{3}}{\text{Shareholder dividend} + \text{(net) policyholder base income}}$$

Expressed algebraically, this reads:

$$\frac{f + c + e}{g + d(1 - r)} = \frac{\$4m + \$15m + \$2m}{\$10m + \$50m} = 35\%$$

The reduced deficit debit is:

$$e + f - (35\% \times g) = \$2m + \$4m - (35\% \times \$10m) = \$2.5m$$

A debit is made to the DWP account of this amount and a credit is made to the PCA of the DWP closing balance – section ME 18(1)(bc).

After this transfer, the DWP account will be $0.5m in debit and must be cleared by a cash payment which will not get credited to the PCA.

[3] These figures are the DWP account transfers to the PCA and the DWP closing balance *before* the initial allocation deficit debit is imposed.

FUND WITHDRAWAL TAX

(Clauses 7 and 8)

Summary of proposed amendments

Amendments to the fund withdrawal tax rules clarify that these rules do not apply to superannuation fund members who have made an election that a higher rate (39%) of specified superannuation contribution withholding tax apply, or that the specified superannuation contribution made by their employer be treated as salary or wages. The amendments also clarify the cessation of employment exemption, which is an exemption for withdrawals on or after, or shortly before, cessation of employment.

Application date

The amendments clarifying that the fund withdrawal tax rules contained in section CL 4 of the Income Tax Act 1994 do not apply to fund members who have made an election under section NE 2AA(1) or section NE 2A(1) will apply from 14 September 2000, the date the fund withdrawal tax rules came into effect.

The amendments to clarify the cessation of employment exemption in section CL 8(2) will apply from the date of enactment.

Key features

The main amendment relates to employees that have elected to have all or part of their employer specified superannuation contribution taxed either at a higher rate of 39% (section NE 2AA (1)) or treated as salary or wages (section NE 2A (1)). It is not the policy intent of the legislation that the fund withdrawal tax rules apply to the withdrawal of these amounts from superannuation funds.

The fund withdrawal tax is intended to remove an avoidance concern that is not present when such an election is made. This exclusion is not sufficiently clear in the existing rules, and the amendment will ensure that employer contributions that are subject to the 39% rate or treated as salary or wages are not subject to fund withdrawal tax.

The remaining amendments concern the exception for withdrawal when a member ceases employment, contained in section CL 8. The fund withdrawal tax should not apply to funds that are withdrawn on or shortly before, or after an employee ceases employment, except in limited circumstances.

In some circumstances, a literal interpretation of this section conflicts with its intended application, the practical application being that the fund withdrawal tax has applied when it is the policy intent that it should not.

An amendment will enable previous employment to be counted for the "two years or more" employment test in section CL 8(2)(a) when the employer changes as part of a business restructuring, such as a company buy-out, the employees join the new employer's scheme and the existing scheme funds are transferred to the new scheme.

The contribution tests in section CL 8(2)(b) and (c), which provide that contributions in the year of ceasing employment and the two previous years should not exceed 150 percent or more of the previous year's contribution, will be relaxed. If this test is not met together with the employment test, the contributions withdrawn are subject to fund withdrawal tax. The amendment will provide that fund withdrawal tax will not be payable if the employer's contributions have begun during the year of cessation and the two previous income years, the amount of the employer's contribution is what is prescribed by the superannuation fund's documentation, and the reason for joining the fund was not to avoid the top personal tax rate.

Background

The top rate of specified superannuation contribution withholding tax for most employees is set at 33%. When the top personal tax rate was increased to 39% an avoidance opportunity was created.

The fund withdrawal tax rules were introduced to counter this avoidance opportunity. The rules aim to remove the tax benefit for those earning over $60,000 a year from substituting employer contributions to a superannuation fund for salary and wages and subsequently withdrawing the increased contribution and thus avoiding the 39% rate. The rules provide that in certain circumstances, a 5% withdrawal tax will apply to withdrawals from superannuation funds.

DEFERRED DEDUCTION RULE

(Clauses 16, 17 and 18)

Summary of proposed amendments

The recently enacted deferred deduction rule will not apply if 70 percent of an arrangement's assets consist of foreign shares held on capital account.

The criteria for defining limited recourse loans have been restated to clarify that loans from associated persons are generally excluded, and separately, arm's-length loans from New Zealand financial institutions are excluded from the definition. Two other changes ensure consistency or make the rule work as it was designed to do.

Application date

The amendments will apply from the 2004-05 income year, but will not apply to arrangements entered into before the start of the 2004-05 income year, unless:

- at the time of entering into the arrangement, the investor could have reasonably have expected that ten or more people would acquire an interest in the arrangement; and
- 70 percent or more of the allowable deductions of the investors from the arrangement for the income year arise from an interest in fixed life intangible property or software.

This is the general application date for the deferred deduction rule.

Key features

Foreign shares

Section ES 1(1)(e) is being amended to restrict the deferred deduction rule from applying to companies where 70 percent or more of the arrangement assets consist of foreign shares, if the proceeds upon any disposition of the shares is not gross income, other than under the foreign investment fund rules. Comprehensive tax rules surround such investments, and the deferred deduction rule should not impose further potential tax obligations.

Other changes

The section ES 2(3)(d) criteria for a limited recourse loan are being amended to reflect the original intent. Loans will be caught if:

- they are from an associated person who in turn has borrowed on a limited recourse basis; or

- they are not provided on an arm's-length basis; and
- they are not provided by a lender who regularly lends money and is resident or situated in New Zealand.

Section ES 1(1)(e) is being amended to ensure that the rule will not apply where either:

- limited recourse amounts constitute less than 50 percent of net arrangement assets; or
- 70 percent or more of the arrangement assets are assets of the kind listed in section ES 1(1)(e)(ii).

Sections ES 1 and ES 3 are amended to ensure that references to losses attributed by loss attributed qualifying companies are treated in the same way.

Background

The deferred deduction rule was introduced in the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003. 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.

These changes further target the rule and clarify aspects of it.

DATE OF TAXPAYER SELF-ASSESSMENT

(Clause 92)

Summary of proposed amendment

An amendment provides that the date of a taxpayer's self-assessment is the date of receipt at an office of the department. This aligns the date with current practice and removes any residual uncertainty for taxpayers and the Commissioner.

Application date

The amendment will apply from the 2004-05 income year.

Key feature

Section 92 of the Tax Administration Act 1994 is being amended to reflect current practice that the date of assessment is the date on which the taxpayer's return of income is received at an Inland Revenue office.

Background

Following the introduction of self-assessment into tax legislation in 2001, taxpayers are required to assess their taxable income and income tax liability. Self-assessment also includes an assessment of any net loss, terminal tax or refund due. Provision was made for taxpayers to be able to fix a date that would create certainty as to the date of their self-assessment. The date needed to be within a time period prescribed by the Commissioner. This period would be determined by reference to the last date on which a taxpayer is required to furnish a return of income.

However, the discretionary provision that allows the Commissioner to fix a period within which a taxpayer can elect the self-assessment date is not being used by Inland Revenue. In practice, the date of notice of assessment is being treated as the date of receipt of the return by Inland Revenue. Therefore the provision is redundant.

ASSESSMENTS IN DISPUTED CASES

(Clause 100)

Summary of proposed amendment

An amendment confirms the validity of assessments made at the direction of an authorised officer, and those that follow practice and current policy approved by the Commissioner.

Application date

The amendment will apply from the date of enactment.

Key feature

A new provision is being inserted into section 114 of the Tax Administration Act 1994 to confirm that assessments made at the direction of an authorised officer and assessments made following current policy or practice directed by the Commissioner are valid.

Background

As part of the disputes resolution process, the documents that comprise each party's arguments are forwarded to Inland Revenue's adjudication service for review. The function of the service, as described by Sir Ivor Richardson, is to consider the dispute impartially and independently of the audit function.[4] An amended assessment, if required, is then issued, based on this review.

Depending on the outcome of the Adjudication process a taxpayer's assessment may be amended by Inland Revenue. This involves the adjudication officer directing another officer (usually the investigating officer) to amend the assessment on the grounds specified by the adjudication officer.

Administratively, it is more efficient that the investigating officer makes and issues the amended notice of assessment (if required) after the adjudication unit has considered the issue, rather than the adjudicator. In general terms all officers of the department should follow current practice directed by the Commissioner when considering the issues relating to the assessment. The amendment confirms that assessments issued by one Inland Revenue officer at the direction of another remain valid. This is necessary following a draft Crown Law opinion which raised an issue as to whether the assessing officer's function could be fettered in such circumstances.

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[4] *Organisational review of the Inland Revenue Department; Report to the Minister of Revenue (and on tax policy, also to the Minister of Finance)* from the Organisational Review Committee April 1994, page 67.

WRITE-OFF – DATE OF MEASUREMENT OF NET LOSS

(Clause 116)

Summary of proposed amendment

An amendment is required to section 177C(6) of the Tax Administration Act 1994 to allow net losses to be measured as at the time the last return was filed rather than according to the taxpayer's return of income for the income year immediately before the income year in which the outstanding tax is written off.

Application date

The amendment will apply from the date of enactment.

Key features

An amendment is being made to section 177C(6) to allow net losses to be measured as at the time the last return was filed.

Background

The Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002 introduced the new taxpayer financial relief rules. Under section 177C(5), if the Commissioner writes off outstanding tax for a taxpayer who has net losses, the net losses are reduced, in whole or in part, in proportion to the amount written off. Section 177C(6) provides that the net losses are measured "according to the taxpayer's return of income for the income year immediately before the income year in which the outstanding tax is written off".

In applying the legislation, Inland Revenue is encountering two practical problems. Firstly, where there are returns outstanding the outstanding returns are then requested, which can lead to delays in finalising cases. Secondly, where a case is being considered just after a balance date but before the due date for the return, any decision made in relation to write-off has to be followed up after the return has been filed, to ensure that any losses have been properly extinguished.

The amendment will allow net losses to be measured as at the time the last return was filed.

MISCELLANEOUS TECHNICAL AMENDMENTS

A number of miscellaneous technical amendments are being made to the tax Acts. Unless otherwise indicated, the amendments will apply from the date of enactment.

Income Tax Act 1994

Removal of references to "assessable" (Clauses 6, 23 and 25)

The references to "assessable" in the headings of sections CG 25 (cases where assessable income calculation cannot be undertaken), GC 14 (income assessable to beneficiaries) and HH 3 (gross income assessable to beneficiaries) will be removed because they are redundant. This is consistent with the removal of references to "assessable" by the self-assessment amendments enacted in 2001.

Expenditure on leases of personal property (Clause 15)

Section EO 2 provides a straight line spreading rule for expenditure on leases of personal property. It is intended that finance leases be excluded from the ambit of this provision because the timing of finance lease expenditure is governed by the accrual rules. A clarifying amendment is necessary to achieve this policy intent. This amendment will apply from 1999, when the finance lease rules were implemented.

Further dividend withholding payment provision correction (Clause 50)

Section MG 9(5C), relating to further dividend withholding payment payable by a company, was enacted recently by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003. The reference to "income tax" in this provision is a drafting error and will be replaced by a reference to "dividend withholding payment", with the same application date as new section MG 9(5C).

Amounts of PAYE tax deductions (Clauses 58 and 60)

Section NC 6, which relates to amounts of PAYE tax deductions, refers to tax deductions fixed by an annual taxing Act. These references are redundant because the annual taxing Act is not used to fix amounts of PAYE deductions. Instead, the amounts of PAYE deductions are generally the amounts of the basic tax deductions specified in Schedule 19 of the Income Tax Act 1994. Accordingly, the annual taxing Act references in section NC 6 will be omitted, which will simplify the wording of the provision and assist in highlighting the central role played by the basic tax deductions specified in Schedule 19. Section NC 12 will be consequentially amended to remove its reference to amounts of PAYE deductions being changed by annual taxing Act.

Omitted section reference in fringe benefit tax rules (Clause 61)

Employers who use the multi-rate method for calculating their fringe benefit tax liability and cease to employ staff in the first three quarters of the income year must treat the quarter in which employment ceases as the final quarter of the year and undertake the multi-rate calculation in relation to that quarter. Section ND 12 is intended to modify the return filing and payment dates for that quarter. However, owing to the omission of a section reference, only those provisions relating to the payment of the fringe benefit liability have been modified, not the return filing date provision. Accordingly, section ND 12 will be amended by insertion of a reference to section ND 10(3). The amendment will apply with application to a fringe benefit provided or granted by an employer on or after 1 April 2000 (the application date of the multi-rate FBT rules), unless the employer has filed such a return based on application of the current law before the date of enactment and has relied upon the current law.

Dividend withholding payments by local authorities (Clause 63)

From the date of enactment, local authorities are to be exempted from their current liability, under section NH 1 of the Income Tax Act 1994, to pay 33% dividend withholding payments on dividends from foreign companies. The proposed amendment is expected to result in a small decrease in compliance and administrative costs, as local authorities will not be required to file returns.

In principle, dividend withholding payments are paid on behalf of shareholders, but local authorities have no shareholders. Local authorities are not liable to tax on any other investment income, although they do pay tax on income derived from their trading enterprises. In 2002, the legislation was amended to exempt charities from this same obligation, their liability having been due to an oversight in the original legislation.

Definition of "lessee's acquisition cost" (Clauses 20 and 65)

The drafting of the definition of "lessee's acquisition cost" in sections FC 10(8)(a) and OB 1 will be clarified by following the approach used in the definition of "lessor's disposition value" in section OB 1. In particular, it will be made clear in the definition of "lessee's acquisition cost" that the consideration is provided to the lessee under the finance lease or the hire purchase agreement.

Timing of expenditure on leases of land and buildings (Clause 65)

A drafting error at the time the finance lease rules were enacted in 1999 resulted in expenditure on leases of land and buildings being excluded inadvertently from the definition of "accrual expenditure" in section OB 1, which in turn means that such expenditure is not covered by the timing rule in section EF 1. An unintended consequence is that a taxpayer may claim an upfront deduction for the entire amount of a lease prepayment, instead of spreading the prepayment over the term of the lease as intended. Before the finance lease rules were implemented the timing of expenditure on leases of land and buildings was covered by the timing rule in section EF 1. An amendment is therefore necessary to ensure that expenditure on leases of real property continues to be covered by section EF 1. This will be achieved by including the term "operating lease" in the list of provisions to which paragraph (f) of

the definition of "lease" in section OB 1 applies. This amendment will apply from the inception of the new finance lease rules in 1999 as it could never have been intended by Parliament that expenditure on leases of land and buildings would not be subject to the timing rule in section EF 1.

Definition of "land tax" (Clause 65)

The definition of "land tax" in section OB 1 is redundant and will be repealed.

Definition of "premium" (Clause 65)

The definition of "premium" in section OB 1 was amended in 1999 as part of amendments to ensure that guarantee fees paid to non-residents are subject to an effective tax rate of 3.3% on the gross amount under section CN 4. However, some of the wording of the 1999 amendment may have inadvertently taken certain insurance premia outside the ambit of section CN 4. In particular, the addition of a reference to a premium being payable "to an insurer" may have made it more difficult to apply section CN 4 in the situation where a non-resident parent of a New Zealand company enters into a contract of insurance with a non-resident insurer to cover risks faced by the New Zealand company and the New Zealand company reimburses its non-resident parent for premiums paid on the contract of insurance. These reimbursing payments should come within the section OB 1 definition of "premium" and therefore be subject to section CN 4. The removal of the insurer reference in the definition of "premium" will facilitate this. The lists of provisions to which the insurance-related definitions apply will also be corrected.

Tax Administration Act 1994

Requisition of information held by offshore entities (Clause 71)

Section 17(1C), which relates to the Commissioner's information-gathering powers, was amended recently by the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003. The amendment involved replacing "held by" with "in the knowledge, possession or control of". However, because this provision refers essentially to ownership-type interests, it will be amended to revert to references to "held by" as it is not accurate to refer to ownership interests being "in the knowledge of" a person. The use of "held by" is also consistent with the approach used in similar associated person and nominee provisions in the Income Tax Act 1994.

Secrecy of restricted information (Clause 75)

When section 81(4) of the Tax Administration Act was last amended to authorise Inland Revenue's disclosure of information to the Department of Internal Affairs and the Ministry of Health, a corresponding amendment was not made to section 87 to require the officers of the Department of Internal Affairs and the Ministry of Health to maintain the secrecy of that restricted information.

Section 87 is being amended to require the officers of the Department of Internal Affairs and the Ministry of Health to maintain the secrecy of all restricted information communicated to them. This is the same requirement that is imposed on Inland Revenue officials.

Matters that cannot be challenged (Clause 103)

Former section 40(c) of the GST Act listed certain decisions of the Commissioner under the GST Act that could not be disputed under the former objection provisions in that Act. These provisions were replaced in 1996 by the current challenge provisions in the Tax Administration Act. However, the effect of former section 40(c) of the GST Act was not replicated in section 138E of the Tax Administration Act, which lists certain matters that cannot be challenged. A remedial amendment to section 138E is therefore necessary to correct this oversight and restore the previous position.

Reduction of penalties for good behaviour (Clause 108)

Section 141FB, which allows shortfall penalty rates to be halved if a taxpayer has a past record of good behaviour, is being rewritten to improve its comprehensibility. The only significant policy change is that offences under sections 143 to 145 are now taken into account in determining whether a taxpayer has a sufficient track record of good behaviour.

Goods and Services Tax Act 1985

Change-in-use deductions (Clause 131)

Section 21E(4) facilitates the obtaining of a change-in-use deduction in respect of goods and services acquired for the principal purpose other than that of making taxable supplies which are then applied for a purpose of making taxable supplies. This provision is intended to replicate the effect of the first proviso to former section 21(5) and former section 21(6) of the GST Act. Two minor clarifying amendments will be made to section 21E(4) to ensure that the effect of the previous provisions is continued as was intended. In particular, the reference to “if” will be replaced with “to the extent that” and the reference to “sections 21 and 21I” will be replaced with “sections 21 or 21I”. The amendments will have the same application date as sections 21 and 21I, meaning they will apply to goods and services treated as being supplied on and after 10 October 2000.

Improving interface with Tax Administration Act (Clauses 120, 121, 122, 135, 138 and 139)

The general approach to tax administration provisions in the Inland Revenue Acts is that if they apply generically to a number of different taxes then such provisions should be aggregated and contained in the Tax Administration Act rather than replicated in the various other Inland Revenue Acts. Consistent with this approach, sections 50 (appropriation authority for refunds), 80 (authorising the making of regulations to extend statutory deadlines) and 81 (concerning general regulation-making powers) of the GST Act will be repealed as their functions can be performed by sections 185, 226 and 225 respectively of the Tax Administration Act. These Tax

Administration Act provisions will be consequentially amended to include references to the GST Act.

Transitional provision for supplies of imported services (Clause 140)

The transitional provision in new section 84B for supplies of imported services will be amended to refer to the time of performance of the services, with the same application date as that provision.

Determinations in relation to financial arrangements (Clauses 85, 86, 87, 88 and 89)

The determinations rules are to be amended retrospectively to allow the Commissioner to cancel a determination before issuing a replacement determination. It has become apparent that, contrary to the intent of the legislation, this is not allowed under current rules.

Sections 90(6), 90AC(6) and 90AE of the Tax Administration Act 1994 allow the Commissioner to "vary, rescind, restrict, or extend a determination" made under sections 90(1) and 90AC(1) by replacing the determination or by making a new determination. The determination does not have to be used for a financial arrangement which was entered into before the new determination was published until four years after the date of publication of the new determination.