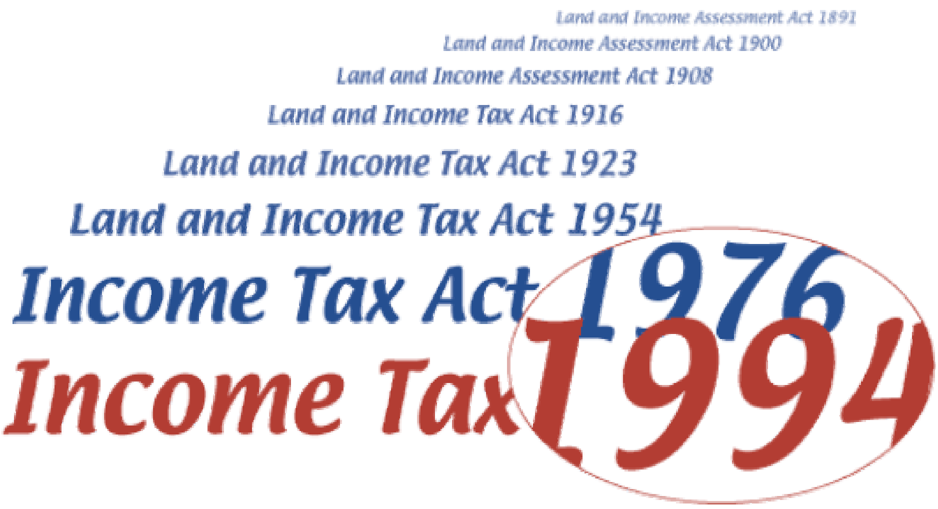
Rewriting the Income Tax Act 1994

Exposure Draft

Part I



Rewrite Project Team

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Rewriting the Income Tax Act 1994: Exposure Draft - Part I
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INTRODUCTION

This exposure draft has been prepared by the project team responsible for rewriting New Zealand's income tax legislation. It contains draft legislation for the rewrite of Part I of the Income Tax Act 2004, which relates to the permitted uses of tax losses.

Rewritten Parts A to E of the Act were enacted in May 2004, with effect from the 2005-06 tax year.

The key objective of rewriting the Act is to produce tax legislation that is clear, uses plain language and is structurally consistent. This should make it easier for taxpayers to identify and comply with their income tax obligations, ultimately saving them time and money.

We are rewriting the law as it currently stands. Changes to the law, other than minor ones in the interests of clarity or simplicity, will continue to be handled through the normal legislative programme. The presence or absence of provisions in the rewritten draft legislation in this document does not necessarily indicate any future change in tax policy.

We invite submissions on any aspect of this work.

The closing date for submissions is 30 November 2004. Submissions should be made to:

The Rewrite Project
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Electronic submissions should be sent to: policy.webmaster@ird.govt.nz.

Please note submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with the Act. If you feel any part of your submission could be properly withheld under the Act (for example, for reasons of privacy), please indicate this clearly in your submission.

COMMENTARY ON REWRITTEN PART I

This commentary on the draft legislation for rewritten Part I outlines current policy on tax losses, the structural changes proposed in the rewrite of Part I, and proposed policy changes emerging from the process.

The proposed changes to structure and policy are relatively minor, and are intended to improve the legislation. They fall into four main types:

- changes in the structural approach;
- changes to the law to improve its clarity;
- drafting changes to modernise the style and language; and
- removal of redundant material and relocations to subpart IZ.

BENEFITS OF THE PROPOSED STRUCTURE

Although current readers may be familiar with the concepts relating to the use of tax losses, the drafting of Part I in the rewrite must also take into account the needs of future readers. Future readers will come to the legislation without knowledge of how tax losses arise and the ways in which they are used. By listing all ways in which various amounts fall within the "tax loss" rules, the draft legislation assists the reader understand the scope of the loss rules without needing to search through the entire Act.

EXISTING POLICY

The policy intention of the loss rules in Part I is that the taxpayer who bears the economic burden of a "tax loss" is ultimately able to gain the benefit of those losses for tax purposes. The benefit provided for is the reduction in the income tax liability in a future tax year.

This policy is expressed in section IE 1(1) and (2) of the Income Tax Act 2004 (the 2004 Act). The section also highlights that the corporate veil for companies is set aside to ensure that there is at least a 49% continuity in shareholding in order for the benefit of the tax losses to be realised.

The policy has been modified over time, however, to deal with particular types of tax losses and taxpayers and to extend the application of the loss rules to various forms of tax credits and tax payments. The current structure of Part I and its relationship with subpart BC does not reflect the total picture relating to tax losses. These structural problems are described here.

PROPOSED CHANGES TO THE STRUCTURE

Relationship between section BC 4 and Part I

Under Part I, a person may use a "net loss" calculated under section BC 4 in ways other than those mentioned in section BC 4(4). This means that the structural relationship between section BC 4 and Part I does not adequately reflect the scheme and purpose of the use of tax losses.

Therefore the draft legislation proposes a clarification of the relationship between section BC 4 in the core provisions and Part I. This proposed clarification involves broadening section BC 4(4) to reflect the total uses of a "net loss".

"Standard" rule for use of "tax losses"

The draft legislation proposes in draft subpart IA a standard, core rule for the use of "tax losses". Under the concepts presented in the draft legislation, in any tax year, a person has a general pool of "tax losses". The general pool of "tax losses" for a tax year is the sum of the "net loss" for that tax year, the amount of the balance of unused "tax losses" from the prior tax year (if any) and other amounts that must be added to the pool (for example, converted imputation credits under section LB 2).

At the end of a tax year, the person must carry forward the balance of the pool of tax losses to the next tax year, unless they elect to apply all or part of the balance of this pool to a range of uses in each tax year.

As companies are a significant group of taxpayers, a clear signal is given in draft subpart IA that a company must satisfy shareholding continuity requirements in order to carry forward its tax losses. Similarly, for a company to transfer its tax losses to another company, it must satisfy the commonality of shareholding requirements.

Draft subpart IA clarifies that an adjustment to the balance of the general pool of tax losses is necessary when an assessment is made for an earlier tax year by the Commissioner of Inland Revenue under section 113 of the Tax Administration Act 1994. It may affect any number of prior tax years whenever such an assessment adjusts the amount of net loss for any of those tax years or otherwise adjusts the balance of available tax losses.

Tax-year basis

The core provisions permit a carried forward loss and other amounts treated as a "net loss" to be subtracted from net income in calculating taxable income for a tax year. Therefore the concept of "tax loss" and "loss balance" apply to all taxpayers and are generally related to a tax year. However, in some of the rules relating to companies (continuity, grouping and part-year issues) these concepts are related to balance dates of the companies, so the term "income year" is used.

Additions to the general pool of "tax losses"

There are a variety of amounts that a person must add to the general pool of "tax losses" in a tax year. This list applies to specific classes of taxpayer and consists of the following amounts (section references being to the 2004 Act):

- for a person who includes imputation credits in their annual gross income for a tax year, the amount calculated under section LB 2(3) and (3A) relating to their unused imputation credits at the end of that income year;

- for a person who has unused deductions in relation to payments of supplementary dividends at the end of a tax year, the amount determined under section LE 4(5);

- for an Australian imputation credit account company that has paid further income tax that is not creditable against an income tax liability in the future, the amount determined under section ME 9(5B);

- for a person with an unused foreign tax credit in relation to attributed controlled foreign company (CFC) income at the end of a tax year, the amount calculated under section LC 4(6);

- for a person with an unused attributed CFC net loss at the end of a tax year, the amount determined under section IE 3(5);

- for a person who has an unused foreign investment fund (FIF) net loss at the end of a tax year, the amount determined under section IE 4(6);

- for an investment fund with excess expenditure, the amount under either section DV 5(4) or the amount under section DV 7(2);

- in any tax year, for a person who has carried forward tax losses from the prior tax year that relate to certain farming and horticultural activities, the amount determined under section IE 2.

As a company must satisfy the continuity or grouping requirements for each component of a loss balance, a generic concept of "tax loss component" is used to refer to each net loss and the other amounts listed earlier that are included in a company's "loss balance".

Ring-fenced losses

The draft legislation identifies a number of classes of "net loss" that are calculated either under the core provisions or are determined under specific provisions in Parts C, D, or E:

- a "net loss" determined under section BC 4 for a loss attributing qualifying company (use determined under section HG 16);
- a partnership loss determined under section BC 4 for a special partnership (use determined under section HC 1);
- a life insurer's policyholder net loss under section EY 42(10) (use determined under subpart II);
- excess expenditure of investment funds (unit trusts, group investment funds and superannuation funds) (use determined under sections DV 5 and DV 7(1));
- an attributed CFC net loss under section DN 4(3) (use determined under section IE 3);
- a FIF net loss under sections DN 8(3) and DN 9(3) (use determined under section IE 4);
- the net loss of a mining company, a resident mining operator and a non-resident mining operator to the extent it relates to mining activities (use determined under section IH 1); and
- the net loss of a petroleum mining company to the extent it relates to mining activities before the 1990-91 tax year (use determined under sections IH 1(2) and IH 2).

The use of tax losses

The draft legislation sets out how all or part of the balance of the general pool of "tax losses" and "ring-fenced tax losses" may be used. However, there are restrictions on the use of any class of "net loss" in calculating the schedular income tax liability for the classes of schedular income referred to in section ID 1.

This structure is intended to provide a complete picture of permitted uses of "tax losses" and provide signposts to the relevant operative provisions. The draft legislation does not propose to consolidate into Part I loss provisions that are currently located outside Part I. Because these types of loss rules tend to be regime-based, these provisions are more sensibly situated within their body of rules as, for example, the treatment in section HG 16 of a "net loss" calculated under section BC 4 (relating to the "net loss" of a loss attributing qualifying company).

Compulsory application of balance of pool of "tax losses"

In each tax year, each person uses the balance of the general pool of "tax losses" they have in the following ways:

- Unless they elect to apply all or part of that balance to an elective use in that tax year, they must carry forward the balance of the general pool of "tax losses" from that year to the next succeeding tax year and subtract it from their net income (if any) for that subsequent year.

- If they have a "net loss" in that succeeding tax year, the carried forward "tax losses" are aggregated with that "net loss" and then used in the manner set out in (1) above.

Elective uses of the general pool of "tax losses" (all elective)

- In any tax year, any person may elect to use an amount from the general pool to pay a shortfall penalty assessed in relation to their income tax liability (Draft section IW 1).

- Trustees may elect to use an amount from the general pool to adjust the amount of a taxable distribution under section HH 3(4).

- Companies (including consolidated groups of companies) may use the pool of "tax losses" in a tax year to:

  – pay a dividend withholding payment liability; or
  – obtain a dividend withholding refund.

The amount of a "tax loss" put to an elective use is subtracted from the general pool of tax losses before determining the balance of "tax losses" that may be carried forward under the standard rule.

Provisions overriding the standard "tax loss" rule for companies

To be able to carry forward any class of "tax loss" from one tax year to the next, a company must satisfy the continuity rules in draft subpart IB. In addition, this carry-forward may be subject to rules applying to ring-fenced "tax losses.

A company in a group of companies may choose to transfer or group a class of “net loss” to another company in that group, under the conditions set out in draft subpart IC. This transfer may be further restricted by “tax loss” rules relating to:

- amalgamated and amalgamating companies;
- consolidated groups; and
- ring-fenced “tax losses”, such as those of mining companies.

Unique “tax loss” rules

Under section IH 3, a petroleum miner must carry its “net loss” for a tax year to preceding tax years to the extent that “net loss” relates to removal or restoration expenditure or deferred deductions under section EJ 12 in relation to a relinquished permit.

Ring-fenced “tax losses”

Ring-fenced “tax losses” are listed within draft subpart IA, along with signposts to their relevant operative provisions, some of which are not located in Part I. It is not proposed to relocate such provisions to Part I.

The various ring-fencing rules generally restrict the way in which a person may apply that class of “tax loss”. Generally, a ring-fenced “net loss” is not included in the general pool of “tax losses”, although there are exceptions to this for attributed CFC net losses (section IE 3(5)), FIF net losses (section IE 4(6)) and excess expenditure of an investment fund (sections DV 5(4) and DV 7(2)).

Changes in law to clarify the policy intent

Submissions are invited on the following policy clarifications.

Compulsory use of carried forward tax losses

In draft section IA 4(1), the legislation clarifies that carried forward tax losses must be subtracted from net income before other permitting other uses. This ordering rule is implied in sections IE 1(1)(a), IE 1(2), and IG 2(2)(f) of the 2004 Act.

We recognise that a specific use rule may override this general concept, a conflict which can be resolved in the drafting. This style of drafting is demonstrated in the 2004 Act in the linkages between specific deductions rules in Part D and the general permission (section DA 1) and general limitations (section DA 2), as, for example, in section DB 6(3).

Submissions

Comments are invited on the appropriateness of the proposed relationship between the compulsory and elective uses of “tax losses”, as are comments on the detail of the draft legislation.

Post-breach part-year net losses and breach of continuity of shareholding of a company

A question has been raised regarding the operation of the sections IE 1(2) and IG 2(4) of the 2004 Act in relation to the carrying forward of a “part-year net loss” attributable to the period following breach of continuity in a tax year (or corresponding income year).

The question raised is whether a company may carry forward the amount of a “post-breach part-year net loss” irrespective of the result of the calculation of the taxable income of the company for the tax year in which the breach of continuity occurred. The question is based on the argument that section IE 1(1) intends that the benefit of a “part-year net loss” is to be obtained by the same group of persons that bear the net loss.

The current rules are designed to reflect the general policy intent of allowing shareholders the benefit of losses generated by a company while they were shareholders. Although this may give rise to anomalies at times, these rules have been retained to avoid undue legislative complexity.

One such anomaly occurs when a company has a “net loss” in a part-year period after a shareholding change but when combining the before and after transfer tax positions, the company has “net income” for the entire tax year. In this situation, the company uses the net loss to offset against the pre-sale net income, thereby reducing the taxable income for the year, rather than carrying the loss forward.

Not exceeding net loss for the year

If the “post-breach part-year net loss” is less than or equal to the “net loss” of the company for the tax year, the amount added to the balance of the general pool of “tax losses” is equal to the “post-breach part year net-loss”. This ensures that the new group of shareholders is entitled to obtain the benefit of the “post-breach part-year net loss”.

Example 1 illustrates this effect.

EXAMPLE 1

Pre-breach part-year (net loss)	*Post-breach part-year (net loss)*	*(Net loss) for tax year*	*Amount to add to balance of tax losses*
(100)	(75)	(175)	(75)

Exceeding net loss for the year

The "post-breach part-year net loss" may be greater than the "net loss" of the company for the tax year. This result will arise where the company has an amount of "pre-breach part-year net income" and, in calculating its income tax liability for the tax year, has applied the "post-breach part-year net loss" against the "pre-breach part-year net income".

The amount to add to the general pool of tax losses can only be the residual amount, being the net loss for the tax year.

Example 2 illustrates this point.

EXAMPLE 2

Pre-breach part-year net income	*Post-breach part-year (net loss)*	*(Net loss) for tax year*	*Amount to add to balance of tax losses*
50	(75)	(25)	(25)

Having net income for the year

A company may have net income for the tax year, but still have a "post-breach part-year net loss". This situation arises when the "pre-breach net income" exceeds the "post-breach part-year net loss". The group of shareholders at the end of the tax year obtain the benefit of the "post-breach part-year net loss" by reducing their income tax liability for the tax year. This means that the shareholders will not be able to add any part of the "post-breach part-year net loss" to the general pool of "tax losses".

Example 3 illustrates this point.

EXAMPLE 3

Pre-breach part-year net income	*Post-breach part-year (net loss)*	*Net income for tax year*	*Amount to add to balance of tax losses*
200	(80)	120	0

Submissions

We invite comment on whether the draft legislation correctly clarifies the law in respect of the ability of a company to carry forward part or all of an amount of a "post-breach part-year net loss" of the company following a breach in continuity. Comments on the detail of the draft legislation are also welcome.

Carrying forward tax losses into year of breach

A question has been raised regarding the operation of the current sections IE 1(2) and IG 2(4) in relation to the carrying forward and grouping of tax losses against an amount of "part-year net income" attributable to the period before the breach of continuity in a tax year (or corresponding income year).

The question raised is whether a company may carry forward or apply the grouping rules to the amount of a "pre-breach part-year net income" irrespective of the result of the calculation of the taxable income of the company for the tax year in which the breach of continuity occurred. The question is based on the argument that section IE 1(1) of the 1994 Act intends that the benefit of a "part-year net loss" is to be obtained by the same group of persons that bear the net loss.

Having net income for the year

If the company has net income for the tax year in which the breach of continuity occurs, the amount of tax losses that may be carried forward from an earlier tax year to the breach year may not exceed the pre-breach net income. This amount may be increased when grouping applies (as in section IG 2(2)(b)(B) in the 1994 Act. This ensures that the pre-breach shareholders obtain the benefit of tax losses they have borne.

Examples 1 and 2 illustrate this point.

EXAMPLE 1

Pre-breach prior year balance of tax losses	*Pre-breach part-year net income*	*Net income (net loss) for year*	*Amount of "tax loss" from prior year to carry forward to pre-breach period*	*Taxable income (net loss) of company*
(100)	100	50	(50)	0

EXAMPLE 2

Pre-breach prior year balance of tax losses	*Pre-breach part-year net income*	*Net income (net loss) for year*	*Amount of "tax loss" from prior year to carry forward to pre-breach period*	*Taxable income (net loss) of company*
(100)	100	200	(100)	100

Having net loss for the year

If the company has a "net loss" for the tax year in which a breach of continuity occurs, the company may not carry forward any part of the prior year's balance of tax losses to the year of breach. This applies irrespective of whether the company has an amount of "pre-breach part-year net income".

Example 3 illustrates this point.

EXAMPLE 3

Pre-breach prior year balance of tax losses	*Pre-breach part-year net income (net loss)*	*Net income (net loss) for year*	*Amount of "tax loss" to carry forward from pre-breach year*	*Taxable income of company*
(100)	100	(50)	0	0

Submissions

We invite comment on whether the draft legislation correctly clarifies the law in respect of the ability of a company to carry forward part or all of an amount of a loss balance to deduct from the "part-year net income" of the loss company or another group company before a breach in continuity (or commonality in the case of grouping). Comments on the detail of the draft legislation are also welcome.

Relationship of Part I with provisions having general effect

The proposed structure for tax losses contains a prescriptive basis for carrying forward and applying those losses.

A question arises, however, as to how these prescriptive rules may be affected by amended assessments. Under section 113 of the Tax Administration Act 1994, the Commissioner may issue an assessment that amends a tax position. Such an amended assessment may affect the quantum of net loss for a tax year, the compulsory and elective uses of tax losses and the balance of tax losses at a tax year.

Examples of provisions that may lead to an amended assessment could include, among others, sections FB 2 (apportionment of income partly derived in New Zealand and elsewhere) and GD 13 (transfer pricing rule).

The current law does not explicitly address the effect of an amended assessment on the amount of tax losses that arise, and correspondingly, their uses. In line with the objectives of the Rewrite, it is proposed that the "tax loss" rules provide for adjustments to the amounts of tax losses and their uses, to give full consequential effect to a Commissioner's assessment.

For example, if the net loss is reduced in one tax year, this should affect the loss balance carried forward and have a consequential effect on the amount used in subsequent tax years. We propose to make this explicit in the legislation.

Submissions

We invite comment on whether the proposed provision is an appropriate reflection of current practice. Comments on the detail of the draft legislation are also welcome.

Ordering rule

Under current law, it is not clear whether amounts converted to available net losses (for example, converted imputation credits) and a limited number of ring-fenced net losses (for example, excess expenditure of investment funds) are to be applied on the first-in first-out basis provided for in section IE 1(3).

We propose to rationalise the ordering rule by having the same rule apply to all types of tax losses, whether generally available or ring-fenced. We consider that having a single ordering rule provides clarity for readers, thereby meeting a key objective of the Rewrite.

Submissions

All aspects of the suggested rationalisation are offered for comment. We are particularly concerned about whether the proposed ordering rule may affect positions taken by taxpayers. Comments on the detail of the draft legislation are also welcome.

Spread back of certain petroleum mining expenditure

Section IH 3 of the 2004 Act applies to a petroleum miner that has a net loss for a tax year and in that year has:

- expenditure incurred on removal or restoration operations under section DT 16; or
- deferred deductions allocated to that tax year or corresponding income year under section EJ 12.

Section IH 3 has two intended effects for the tax year in which the petroleum miner has a net loss. It

- reduces the net loss for that year by the amount of these two types of deduction; and
- provides a spread-back rule to earlier tax years for the amount of reduction in the net loss for the current tax year.

Draft sections IS 5 addresses the limit on the net loss and draft section EJ 12B (located within the spreading rules relating to petroleum mining) places the spread-back rule in Part E, as this is an allocation rule.

However, it seems possible for a different approach to this issue to be adopted. The practical effect of the current law is to ensure these two types of deductions cannot give rise to a petroleum miner having a net loss for the tax year. Adopting this approach could lead to section IS 5 would be omitted and section EJ 12B being drafted to limit the amount of deduction allocated to the current tax year under section DT 16 and EJ 12 to ensure the petroleum miner could not have a net loss for that year.

Submissions

We invite comment on whether the draft legislation correctly clarifies the law in respect of the limitation on the net loss and the allocation rule. We also invite comment on whether the policy intent would be better reflected as an allocation rule that overrides the effect of section DT 16 and EJ 12, with the loss rule omitted.

DRAFTING CHANGES TO MODERNISE THE STYLE AND LANGUAGE

The main drafting changes relate to:

- distinguishing the current year concept of "net loss" as one of the types of tax losses that may be used under Part I;
- rationalising the part-year rules and placing them in one subpart for application to continuity, grouping, consolidation, and amalgamation; and
- ordering the subparts containing the various loss provisions from the most generally applicable to the more specific.

Submissions

Comments on the detail of the draft legislation are welcome.

REMOVAL OF REDUNDANT MATERIAL AND RELOCATION TO SUBPART IZ

Sections IH 4(1) and IH 5

Sections IH 4(1) and IH 5, relating to specified mineral mining, provide for a reduction in the value of tax losses. These provisions are historic in nature and relate to the period before 1986, when specified mineral miners were entitled to a concessionary tax rate, being two-thirds of the company tax rate.

At that time a specified mineral miner was taxed on income from mining at 33%, rather than to the corporate tax rate of 48%. At the same time, a specified mineral miner could also derive non-mining income. The loss provisions now located in sections IH 4(1) and IH 5 were designed to ensure that mining losses were adjusted to reflect the concessional nature of the tax rate on net income from mining. This was also the case for the provisions reducing the value of mining expenditure being used to deduct from non-mining income (now set out in section DU 7 of the 2004 Act).

The concessionary tax rate for specified mineral miners was repealed with effect from 1 October 1986. Since that date, income from mining has been taxed at the same rate as income from other sources. Even so, the "tax loss" provisions in sections IH 4(1) and IH 5 and the deduction adjustment in section DU 7 were retained, although the policy for having done so is not clear.

These provisions are redundant. From a policy perspective, there does not seem to be any reason to retain rules that do not reflect that mining and non-mining income of a specified mineral miner are taxed at the same basic rate.

Therefore we propose to omit sections IH 4(1) and IH 5.

Submissions

We invite comment on the appropriateness of this proposal.

Section IG 1(4)

Section IG 1(4) is a provision that was enacted before the current core provisions and ensures that special provisions in the Act relating to certain taxpayer companies (such as mining and life insurance) are still applicable in determining the income of those companies.

One of the objectives of rewriting the Act is to consolidate and clarify its scheme. This objective was largely accomplished with the enactment of the 1994 Act and then the Taxation (Core Provisions) Act 1996, which clarified that the scheme of the Act is based on a global gross concept rather than a schedular approach. Schedular groups of rules were divided into their income, deduction and timing components, and this was further clarified through the enactment of the 2004 Act.

As a result, section BB 2 requires every company (whether in a group of companies or not) to calculate its income tax liability for a tax year, and satisfy that tax liability on the basis of the scheme set out in subpart BC. It no longer seems appropriate to retain section IG 1(4) because it is an historic provision relating to a now redundant schedular approach to taxation of different types of companies.

Therefore we propose to omit section IG 1(4).

Submissions

We invite comment on the appropriateness of this proposal.

Relocations to subpart IZ

It is proposed to move current sections IE 2, IH 1(2), and IH 2 to subpart IZ.

Section IE 2

Section IE 2 regulates the use of carried forward tax losses (specified activity net losses) a person has from investing in or operating various types of agricultural, aquacultural, horticultural and land leasing activities. The last of the rules leading to increases in the amount of specified activity net losses were repealed at the end of the 1990-91 tax year.

In general terms, this rule restricts to $10,000 the amount of these tax losses that a person can subtract from their net income for a tax year under section BC 5. Because these losses are finite, and it has been over ten years since these types of losses could arise, this provision is moving toward the end of its useful life. Therefore it is proposed to relocate the provision to subpart IZ.

References to losses for 1981-2 and 1991-2 tax years

It is proposed to move these references to Part IZ, but retain their effect within the loss grouping rules through a linkage. As these losses will terminate over time, it is more appropriate to draft the grouping provisions on the basis of losses that will arise from the application date of the legislation. This is consistent with the approach taken in rewriting Parts C, D, and E of the Act, for example, the depreciation rules in sections EZ 8 to EZ 26 that apply to terminating depreciation rules.

Sections IH 1(2) and IH 2

Sections IH 1(2) and IH 2 are ring-fencing rules relating to the carry-forward and use of tax losses of petroleum mining companies to the licence area in which the "tax loss" arose. These provisions relate to now repealed petroleum mining rules.

Under the current petroleum mining rules, there is no such restriction on the use of net losses from petroleum mining, and we therefore propose that these provisions be relocated to subpart IZ.

Submissions

We invite comment on the appropriateness of these relocations.