Taxation (Base Maintenance and Miscellaneous Provisions) Bill

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

2 May 2005

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Thin capitalisation rules for foreign-owned banks

OVERVIEW

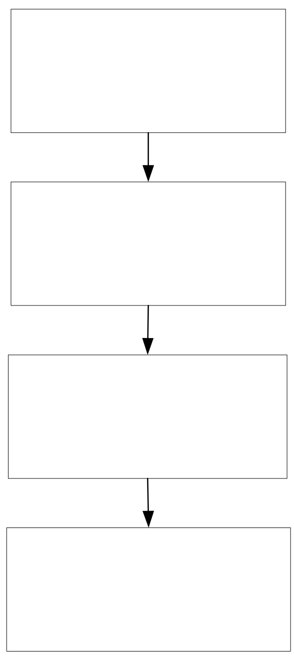
Proposed thin capitalisation rules for banks are a systemic response to the problem of excessive debt funding by banks. The fundamental objective is to measure more accurately the income associated with the New Zealand activities of banks, ensuring that excessive debt cannot be allocated to the New Zealand operations of a multinational bank.

The new thin capitalisation rules for banks compare the equity associated with the New Zealand banking business (net of certain outbound investments) with a prescribed level of required equity based on 4% of the banks' New Zealand risk-weighted exposures, and deny interest expenses where there is a deficiency. The measurement of equity is based on accounting and regulatory concepts of equity, which enables verifiability and minimises compliance costs. The objective of the new rules is not to regulate the amount of equity in New Zealand per se, but the use of equity as a benchmark for achieving an appropriate allocation of interest expenses.

Officials have worked closely with the banking industry to develop these rules. These rules will be monitored to ensure that they are operating in a way that reflects the policy intent.

Proposed thin capitalisation rules for foreign-owned banks operating in New Zealand are summarised in figure 1.

Figure 1: Thin capitalisation rules for foreign-owned banks



INCOME NOT FULLY TAX FREE

Submission
(35W – Deutsche Bank, 23 – Russell McVeagh)

In some circumstances income from an offshore investment could be subject to New Zealand tax. In that case costs incurred to earn such income should be deductible. The new thin capitalisation rules could act to deny a deduction for interest on debt funding the investment.

Comment

The submissions suggest that some interest should be deductible because the income is subject to non-resident withholding tax of 15% in New Zealand under either the conduit rules or the dividend withholding payment (DWP) rules.

Under the conduit rules the 15% non-resident withholding tax is paid in respect of the offshore assets income when the New Zealand company ultimately distributes that income to its non-resident shareholders. However, the payment of this tax can be delayed indefinitely.

Likewise, under the DWP rules the offshore income will ultimately only be subject to 15% non-resident withholding tax.

Albeit 33% is initially paid with an 18% refund when these profits are distributed to the non resident shareholders of the NZ Bank.

Given that 15% non-resident withholding tax rather than 33% income tax is paid on the offshore income it does not seem appropriate to claim a full interest deduction. Apportionment calculations would be extremely complex to take account of the different rates of tax. Consequently officials do not recommend that any interest deduction be available in respect of this income. It should also be noted that when setting the prescribed level of capital required to support the NZ business of the bank, at 4% of risk weighed exposures it was acknowledged that in some cases the offshore income could be subject to some NZ tax. Consequently if an interest apportionment was considered in the future, the 4% rate would need to be reviewed.

Recommendation

That the submission be declined.

SELECTIVE CONSULTATION CONTRARY TO GTPP

Submission
(31 – Minter Ellison Rudd Watts)

The consultation of the proposals was selective and contrary to the Generic Tax Policy Process (GTPP).

Comment

The analysis leading to the introduction of the new thin capitalisation rules for banks involved base-maintenance of a significant size which needed a more timely response than would be possible under the full GTPP. Only a small number of taxpayers were directly affected. The issues involved were extremely complex and required a more intensive technical interaction with the taxpayers directly involved. Extending the consultations to individual firms would have diverted resources from these consultations. Accordingly it was decided to keep other taxpayers informed through meetings with general bodies such as the Institute of Chartered Accountants of New Zealand and the New Zealand Law Society.

Recommendation

That the submission be noted.

IMPACT OF IFRS

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

The proposed rules should be considered in light of the effects of the new International Financial Reporting Standards (IFRS).

Comment

It anticipated that the key areas affected by IFRS will be: EQV, INTG and I. Lesser areas affected by IFRS are: REV, TXB, CEFA, NAFA, EOI, AEQ, AEQI and GFD. One difficulty in assessing the effect of IFRS is that the details of the change in standards are not yet known. The banks are likely to be in a better position to have considered and implemented the changes and are likely to raise issues themselves in the future. Officials will also monitor the IFRS changes and the need for consequential tax law changes.

Recommendation

That the submission be noted. That changes to IFRS be monitored to determine if there is any impact on the operation of the new rules.

A foreign-owned registered bank will be required to determine its "NZ banking group" under section FG 8C. This group will include all resident entities and fixed establishments (generally branches) operating in New Zealand that would be required to consolidate with the ultimate foreign parent of the registered bank for financial reporting purposes.

Section FG 8C also provides an option to exclude life insurance companies from the NZ banking group. Entities that are part of a life insurance company's group can likewise be carved out, provided they do not have a main activity that is banking, financing or leasing, and they are not holding companies of banking, financing or leasing companies.

Issue: Inadvertent exclusion of certain non-residents

Submission
(23 – Russell McVeagh)

The provision which defines taxpayers who are subject to the thin capitalisation rules (section FG 2(1)) may inadvertently exclude non-resident companies, including registered banks, to which the thin capitalisation rules were intended to apply. Section FG 2(1) should be rewritten to be consistent with the language used in the present section FG 2(1).

Comment

The proposed section currently states that a non-resident company will be subject to thin capitalisation rules only if:

- no person who is resident in New Zealand has a direct ownership interest that is equal to or greater than 50%; and
- a non-resident has a direct ownership interest that, when aggregated with the direct ownership interest of persons associated with the non-resident, is equal to or greater than 50%.

If a non-resident company is widely held, the second requirement may not be satisfied and the company will therefore not be subject to the thin capitalisation rules.

Officials agree that FG 2 (1) should be rewritten to be consistent with the language used in the present thin capitalisation rules in section FG 2(1) in order to achieve the intended effect.

Recommendation

That the submission be accepted.

Issue: Reporting bank confusion where there is more than one registered bank

Submission
(23 – Russell McVeagh)

Section FG 8D should be amended and simplified to provide more certainty in its application. It is not clear how section FG 8D is intended to apply to a banking group which includes two registered banks, one of which carries on business in New Zealand as a New Zealand-resident subsidiary, and where the other carries on business in New Zealand as the branch of a non-resident bank. The submitters note that in this example, the wording as currently stands would not classify a branch as a registered bank for the purposes of section FG 8D.

Section FG 8D should be redrafted to the effect that:

- where a banking group only includes one registered bank (including a branch), then that registered bank is the reporting bank; and
- where a banking group includes more that one registered bank (for example, two companies, two branches, or a combination) then the reporting bank of the group should be determined by way of election or by the Commissioner.

Comment

Under FG 8D, a fixed establishment will be a reporting entity only when there is no registered bank included in a New Zealand banking group. If there is both a registered bank and a fixed establishment included in a New Zealand banking group, it is clear from FG 8D that only the registered bank can be the reporting bank. The submitter is therefore correct in stating that the branch (the fixed establishment) in their example would not be the reporting entity.

This result is consistent with the policy intent, in that fixed establishments cannot be reporting entities unless there are no registered banks included in a New Zealand banking group. The election of fixed establishments would allow banking groups to elect branches which may not have interest deductions.

Officials consider that the section as currently written clearly reflects this policy intent.

Recommendation

That the submission be declined.

Issue: SOP – exclusion of non-resident life insurance business

Submission
(38W – ASB Bank Limited)

The bill should be changed so that reporting banks can elect to exclude from a NZ banking group a non-resident person or company (with a fixed establishment in NZ) whose main activity is the provision of life insurance.

Comment

There appear to be no negative issues arising from the proposal to elect to exclude from a NZ banking group a non-resident company whose main activity is the provision of life insurance. Officials agree with the submission.

Recommendation

That the submission be accepted.

EQUITY OF THE NEW ZEALAND BANKING GROUP

The NZ banking group's net equity is calculated under section FG 8G. The starting point will be the accounting values of shareholders' equity and branch equity included in the financial statements of the members of the NZ banking group, based on accounting consolidation principles.

Section FG 8G also requires a number of additional deductions from the aggregated accounting equity described above. These deductions essentially follow the prudential deductions required by the regulator (the Reserve Bank of New Zealand). The requirement to make these deductions from equity is based on the premise that the NZ banking group must have enough equity to fully fund certain assets of the group. With offshore assets for example, the effect of this is that interest deductions cannot be taken in respect of the funding for these offshore assets. This reflects the policy that where these assets generate income that is exempt from NZ tax there is no entitlement to a tax deduction in respect of the funding of these assets.

A supplementary order paper (SOP) was tabled on 15 March 2005 to require the deduction of fixed-rate shares held by the New Zealand banking group from the calculation of the groups NZ net equity.

The deduction from net equity for fixed rate shares applies to fixed rate shares that have been offered to the public on or after 1 January 2005. Fixed rate shares that have been offered to the public before 1 January 2005 are not required to be deducted from net equity until after 1 January 2010.

The SOP 337 also provides for a regulation-making power to amend the definition of equity of the NZ banking group.

Issue: Definition of New Zealand net equity

Submission

(18 – New Zealand Bankers' Association)

In some circumstances the New Zealand bank will consolidate a "Special Purpose Vehicle" (SPV) in which an equity interest is held by a third party. The resulting equity may be included in equity under GAAP, although in substance this equity reflects the interest of the third party. The equity held by the third party and the proportionate share of risk-weighted exposures needs to be reduced by the amount funded by the third party.

Comment

Officials agree that this would be the ideal approach. However, the proposal to determine the amount of a third party's equity in an SPV would significantly increase compliance costs because of the complexity of the issue. It does not currently appear to be a significant issue.

Recommendation

That the submission be declined, but that the situation be monitored.

Issue: Scope of AEQI

Submission
(31 – Minter Ellison Rudd Watts, 33W – New Zealand Law Society, 18 – New Zealand Bankers' Association, 23 – Russell McVeagh)

The scope of AEQI is too wide as it uses a very wide definition of associated person.

Comment

The definition of AEQI was intended to ensure that equity investments held by the New Zealand banking group in a carved-out life insurance group or other associates (that are not within the New Zealand banking group) would have to be equity funded within the New Zealand banking group. This is required as the carved-out life insurance group or other associate should be subject to the existing thin capitalisation rules and its equity should not be allowed to be debt funded by another New Zealand taxpayer. That is, without AEQI, the carved out life insurance group could be debt funded within the constraints of the existing thin capitalisation rules and its equity could then be debt funded in the New Zealand banking group. This outcome would not be appropriate.

It also ensured that the new rules could not be avoided by placing offshore investments in such companies outside the New Zealand banking group.

Officials agree that the provision as currently drafted is too broad and would affect certain transactions in an unintended way.

We propose to deal with this by limiting the AEQ and AEQI definition to cross holdings between the NZ banking group and the carved-out life insurance group. To effect this change we propose removing the reference to associated persons in AEQ and AEQI and replacing it with a reference to the carved-out life insurance members.

To ensure the new rules cannot be avoided by placing shares in a non-resident company into a company outside the NZ banking group, we propose certain amendments to the EOI definition. Shares in a non-resident company (subject to the exclusion for small portfolio share holdings as provided for in EOI) held by a company outside the banking group would be deducted from the NZ banking group equity where the company that holds those shares is either:

- a member of the carved-out life group (currently reflected in the legislation before FEC); or
- a company that a member of the NZ banking group has a 10% or greater direct voting interest in, and that shareholding results in conduit relief in respect of the shares in the non resident being flowed through to the NZ banking group.

The 10% direct voting interest threshold is being recommended as this shareholding could result in conduit relief in respect of any offshore assets being flowed through to the NZ banking group. Officials believe if such offshore assets were present the New Zealand banking group would be aware of its existence and therefore be able to determine the quantum of offshore assets.

Russell McVeagh submitted that securitisation vehicles could be included in the New Zealand banking group as a result of the "associated person" definition. Officials note that the proposal to limit the definitions of AEQ and AEQI would address this issue.

Recommendation

That the submission be accepted.

Issue: Grey list shares excluded from EOI

Submission
(Matter raised by officials)

The exclusion from EOI for certain shares in non-residents should be amended to better reflect the underlying policy.

Comment

Currently the bill provides an exclusion from EOI where a member of the NZ banking group holds shares in a non-resident and those shares are in a company that is resident in a grey list country, are held on revenue account and the shares are listed on a recognised exchange. Officials recommend that the exclusion is made clearer to reflect the original policy intent.

We recommend including a reference to the foreign shareholding not being a "sufficient interest" (as defined in section LF 1(2)) in the offshore company, or not being a "sufficient interest" if this were the only class of share on issue by the offshore company. Originally this exclusion was intended to cover small investment holdings by life companies held as part of their life insurance business, as a de minimis for compliance reasons. In this regard shares that are part of funding arrangements were not intended to be covered by this exclusion.

This area will need to be monitored to ensure the legislation is operating as intended.

Recommendation

That the submission be accepted.

Issue: Consistency of debt and equity treatment throughout Act

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

As a general matter, the definitions of equity of debt and equity for the proposed thin capitalisation rules should be consistent with the concepts employed elsewhere in the Act.

Comment

The thin capitalisation rules do not alter the definitions of debt and equity for other purposes of the Act. For most purposes in the Act, the distinction between debt and equity follows the legal form of the instrument. However for some provisions, the instruments that are accorded equity treatment are restricted to ensure that the provision achieves its policy intent. Similarly, the definition of New Zealand net equity has been altered significantly (with both additions and subtractions) to ensure that it achieves its policy intent of protecting the New Zealand tax base against the excessive deduction of interest. Each of the adjustments to equity calculation fulfils this criterion.

Recommendation

That the submission be declined.

Issue: Removal of fixed-rate shares from definition of net equity

Submission

(18 – New Zealand Bankers' Association, 21 – Institute of Chartered Accountants of New Zealand, 31,31A – Minter Ellison Rudd Watts, 33WA – New Zealand Law Society)

A number of submissions questioned the proposal to remove fixed-rate shares from the definition of New Zealand net equity as preference shares are equity.

Comment

The thin capitalisation rules do not alter the definitions of debt and equity for other purposes of the Act. For most purposes in the Act, the distinction between debt and equity follows the legal form of the instrument. However, for some provisions, the instruments that are accorded equity treatment are restricted in order to ensure that the provision achieves its policy intent. Similarly, the definition of New Zealand net equity has been altered significantly (with both additions and subtractions) to ensure that it achieves its policy intent of protecting the New Zealand tax base against the excessive deduction of interest. Each of the adjustments to equity calculation fulfils this criterion.

Fixed-rate shares are a case in point. Redeemable preference shares are an example of a fixed-rate share. They have many economic attributes similar to debt, and can be used flexibly as a substitute for it. However their tax treatment is quite different, which means that they can be used to circumvent the intent of the new thin capitalisation rules for banks. Interest is considered to be a cost to a business and so is deductible in the calculation of income. Tax is paid by the recipient of the interest, who must include it in income. Dividends, on the other hand, are a share of profit and so are not deductible. The dividends are income to the recipient. Double taxation is avoided in New Zealand through the imputation system which provides the recipient with an imputation credit, which can be used to offset tax payable by the shareholder. In effect, for fixed rate preference shares issued to New Zealand taxpayers, the company can be said to have withheld tax on behalf of the shareholder in relation to the imputation credit attached to the dividend paid. In the context of the new thin capitalisation rules, a bank which would otherwise have a denial of interest, particularly where the shares are held by NZ residents, could issue preference shares, avoiding the interest denial. The tax paid by the bank would give rise to imputation credits, as deductible interest would be replaced by non-deductible dividends. However this apparent increase in tax would be offset by a reduction in tax paid by the lender/shareholder who would receive an imputation credit equal to the increased tax paid by the bank. The transaction would not result in any net tax increase in New Zealand.

Recommendation

That the submission be declined.

Issue: Subsequent review of legislation

Submission
(18 – New Zealand Bankers' Association)

There should be scope for expeditious refinement to the legislation in order to deal with unintended effects of the legislation.

Comment

The new thin capitalisation rules involve a number of innovative concepts and need to be applied in complex transactions. It is almost inevitable that adjustments will need to be made to ensure that the rules achieve their policy intent without impeding legitimate business arrangements. The banking industry is concerned that waiting for an appropriate legislative vehicle could lead to extended uncertainty and the potential for disruption of transactions. Officials note this concern and refer to the regulation-making power provided for in the SOP.

It is proposed there should be authority provided through Order in Council to deal with situations where it is unclear whether an instrument should be considered equity or debt for thin capitalisation purposes.

Recommendation

That the submission be accepted.

Issue: SOP – regulatory power to amend the definition of "net equity" for thin capitalisation purposes

Submission
(18A – New Zealand Bankers' Association, 21A – Institute of Chartered Accountants of New Zealand, 31A – Minter Ellison Rudd Watts, 33WA – New Zealand Law Society)

The New Zealand Bankers' Association (NZBA) and the Institute of Chartered Accountants of New Zealand (ICANZ) consider that the scope of regulatory power is too wide. NZBA suggests that the power should be narrowed to deal with instruments where, due to particular characteristics, it is unclear whether they would constitute equity for the purposes of the thin capitalisation regime. FG 8G is currently silent as to whether the effective date of the regulations would be retrospective or prospective. NZBA submits that retrospective regulations should be used only where the affected taxpayer has agreed to the retrospective approach, or where the GTPP has been followed.

NZBA submits that officials should respect the principles of the GTPP process and consult with affected parties prior to the introduction of Orders in Council. NZBA asks that the Committee confirms that this is desirable.

ICANZ submits that regulatory changes should be properly consulted on so that, at a minimum, appropriate effective dates are determined. They also submit that the ability to exclude items from capital should not proceed.

Minter Ellison Rudd Watts and the New Zealand Law Society submit that changes to the definition of net equity should be made only after adequate consultation with the banking industry and professional taxation advisors. The submitters argue that items PSCH and NSCH should not be included in the definition of net equity. If this is not accepted, they argue that the inclusion of an amount in NSCH should not have retrospective effect, or affect instruments issued, or transactions executed, prior to the date of the law-change.

Comment

The SOP proposed that the definition of New Zealand equity could be modified by Order in Council. The proposed amendment recognised that the definition introduced new, complex concepts into the Income Tax Act which might require alteration based on experience. Concern was expressed by industry that undesirable uncertainty might be created if amendments to the definition were forced to await a suitable legislative vehicle. If a delay were to occur, legitimate business transactions and arrangements might be impeded. On the other hand, officials were concerned that instruments or arrangements might be developed which were not contemplated by the new rules and which would be contrary to the policy intent of the legislation. Again, a timely response would be needed to reduce the possibility of revenue loss. The amendment was proposed as a way of addressing these two issues.

Two concerns have been raised with respect to the proposed amendment. There is a concern that the Order in Council power is not broad enough as amendments might be required in other sections as part of the response to a particular situation or arrangement. The second, more substantive, concern is that changes as fundamental as redefining New Zealand equity would properly require Parliamentary oversight, given that they could raise policy questions or benefit from the wider discussion that would attend a legislative amendment.

Officials recommend that the regulation-making power should be limited to situations where it is unclear whether an instrument should be considered equity or debt for the purposes of thin capitalisation. This would provide clarity and certainty in a timely manner. Officials agree that changes made through an Order in Council should not be retrospective.

Officials agree that consultation with affected parties following the Generic Tax Policy Process prior to introduction of an Order in Council is desirable. This intention should be reflected in Inland Revenue's Technical Information Bulletin on the new banking legislation.

Recommendation

That the submission to limit the regulation-making power be accepted.

Issue: SOP – grandfathering

Submission
(18A – New Zealand Bankers' Association)

The grandfathering period for fixed-rate shares should be extended beyond the present five years. The grandfathering period should be the lesser of the term of the instrument, or 20 years.

Comment

The submitter argues that, as a matter of principle, companies who have issued instruments with long-dated terms prior to the introduction of new legislation should be able to grandfather those instruments over a significant period of time.

Many different types of instruments with long-dated terms can be affected when tax policies change. Officials consider that from a broader policy perspective, it is not appropriate to grandfather instruments on this basis.

In the present situation, it does not appear that companies with fixed-rate shares will be materially disadvantaged by the change and will have the ability to plan for the change over the transitional period.

Recommendation

That the submission be declined.

Issue: Calculation of New Zealand net equity

Submission
(18 – New Zealand Bankers' Association)

EQV is currently defined as being "the sum of the financial value of the shareholders' equity relating to members of the New Zealand banking group". This potentially suggests that the equity of each member is to be aggregated, with no eliminations.

Comment

The policy intention is that equity should be calculated on a consolidated basis. The legislation needs to be clear that EQV is calculated on consolidated grouping, not on aggregation.

Recommendation

That the submission be accepted.

NEW ZEALAND NET EQUITY THRESHOLD USING RISK-WEIGHTED EXPOSURES

Section FG 8H provides for the measurement of the net equity threshold based on 4% of the NZ banking group's risk-weighted exposures. Risk-weighted exposures, a regulatory concept, include the on and off-balance sheet assets of the NZ banking group adjusted for risk. Under section FG 8F, regulatory values are determined by applying the Reserve Bank of New Zealand's Capital Adequacy Framework, which sets out the methodology and rates for risk-weighting assets. Resident entities and fixed establishments that are members of the NZ banking group that do not currently risk-weight their assets for the regulator will need to carry out this risk-weighting exercise for the new thin capitalisation calculation.

Issue: Calculation of net equity threshold

Submission
(18 – New Zealand Bankers' Association)

In determining the risk-weighted exposures of the bank for the purposes of applying the 4% required equity threshold, certain items are excluded. The excluded items are defined in DEQ. The submitter argues that a hybrid debt amount which gives rise to a tax deduction should not be deducted in calculating risk-weighted exposures.

Comment

In order to make the deduction from risk-weighted exposures the item must have a regulatory value.

This item was left out because it does not have a "regulatory value" attached to it and consequently there is no way of adjusting for it.

Recommendation

That the submission be declined.

Issue: Treatment of deferred tax

Submission
(18 – New Zealand Bankers' Association)

The adjustment for future tax benefits in the definition TXB in section FG 8G(1) requires future tax benefits to be equity funded. This should refer to any net future tax benefits.

Comment

Officials agree with the submission. The required deduction should be matched to the Reserve Bank Capital Adequacy Framework deduction and therefore refer to net future tax benefits as this is the basis for the calculation of equity for the purposes of the new tax rules. Officials note that in order to reflect the Reserve Bank definition that the definition of TXB (c) in FG8G should be replaced with:

> (c) timing or temporary differences [to the extent that a net loss would have arisen in the current tax year if the items giving rise to the timing or temporary differences were deductible in the current tax year if there had been a net loss for the tax year].

Recommendation

That the submission be accepted and changes should be made to the definition of TXB to reflect the Reserve Bank definition.

Issue: Valuations where denominated in foreign currency

Submission
(23 – Russell McVeagh)

A concession similar to that in the existing FG 7 should be included. FG 7 enables taxpayers to measure any foreign currency denominated assets or debt, by reference to the forward rate on the first day of the income year for the relevant measurement date. A similar concession should be included in the thin capitalisation rules for registered banks with respect to financial arrangements and risk-weighted exposures so that taxpayers can better predict the value of their exposures and debt.

Comment

The submission does not explain why further modification is necessary. No evidence of the current approach being a practical problem has been presented.

Recommendation

That the submission be declined.

If, for any quarter (or more frequent measurement date that the bank chooses), net equity is less than the net equity threshold based on 4% of risk-weighted exposures, there will be an adjustment under section FG 8B to the reporting bank's annual total deductions for that measurement period.

The adjustment amount will be calculated under section FG 8B, using an average cost-of-funds interest rate based on the total interest expense of the NZ banking group divided by average quarterly interest-bearing debt for the group.

Issue: Clash between accounting and tax concepts

Submission

(18 – New Zealand Bankers' Association, 23 – Russell McVeagh)

New Zealand Bankers' Association (NZBA) and Russell McVeagh submit that there is a clash of tax and accounting concepts in FG 8B(3) and FG 8B(4).

Russell McVeagh submits that the "group funding debt" should be calculated only by reference to interest-bearing debt for tax purposes, not accounting purposes.

FG 8B(3) sets out the calculation for determining the "group funding debt". FID is included in this calculation of group funding debt.

Russell McVeagh submits that FID should not refer to financial arrangements for which the "consolidated financial statements" of the group would show a deduction, because this would omit instruments which are treated as debt for tax purposes, but equity for accounting purposes.

NZBA argues that some hybrid instruments will give rise to a tax deduction but the instrument will not be classified as interest-bearing debt under GAAP. They will therefore fall outside SFI which is also included in the calculation of group funding debt. Although such instruments are presumably intended to fall within FID, technically they do not because the requirement that consolidated financial statements show a deduction is not satisfied. This is because payments on the instrument will be shown as movements in equity on the statement.

NZBA and Russell McVeagh note that the definition of interest for the purposes of calculating interest expense only picks up expenditure that is classified as interest under GAAP. They submit that interest should be interest expenditure for tax purposes and not interest expenditure under GAAP. NZBA submits that the definitions should also exclude instruments that are classified as debt for accounting purposes but as equity for tax purposes, where no tax deduction has been taken.

Comment

The difficulty with the definitions of group funding debt and interest derived from tax definitions is that the NZ banking group is a fictional group, so that no tax consolidation of this group occurs. It is therefore difficult to isolate the debt and interest as defined for tax purposes of this fictional group, particularly excluding eliminations on consolidation.

Notwithstanding this, officials agree that clarification is required and that the legislation should be amended to clarify that taxpayers can adjust the group funding debt to take into account of amounts that are considered debt for tax purposes and not accounting. Furthermore the interest amount should take account of the differences between tax concepts and GAAP concepts. That is, if an amount is included as debt for the purposes of the group funding debt definition, the interest associated with that debt should be included as interest for the purposes of these new rules.

Recommendation

That the submissions be accepted.

MINOR DRAFTING ISSUES

Issue: Drafting issues raised by NZBA

Submission
(18 – New Zealand Bankers' Association)

Paragraph (c) of the definition of EQV in section FG 8G(1) refers to the provision of funds by a "parent". The term is not defined for the purposes of FG 8G.

Paragraph (c) also refers to "permanent establishment", instead of "fixed establishment" used elsewhere in the bill.

Comment

Both drafting issues should be clarified. The term "parent" should be defined for the purposes of FG 8G. Paragraph (c) should refer to fixed establishment.

Recommendation

That the submission be accepted.

Issue: Drafting issues raised by Russell McVeagh

Submission
(23 – Russell McVeagh)

The words "in New Zealand" should be inserted between "resident" and "is a potential member" in FG 8C(3). The definition of "group quarter day" in OB 1 should refer to FG 8B(6) rather than FG 8B(5).

Comment

Both drafting corrections should be made.

Recommendation

That the submission be accepted.

Issue: Use of "contribute to"

Submission
(23 – Russell McVeagh)

The words "contribute to the value of item EQV" which are used in items "UPB" and "REV" of section FG 8G(1) are too vague. The words should be replaced by "included in calculating the value of item EQV".

The words "contribute to SFI" are similarly vague. The words should be replaced by "are included in item SFI".

Comment

This is a deliberate drafting choice. We believe the change suggested does not make the intended meaning any clearer.

Recommendation

That the submission be declined.

Changes to the tax depreciation rules

OVERVIEW

The bill introduces a number of technical changes to tax depreciation rules. The changes were outlined in an officials' issues paper released in July 2004, *Repairs and maintenance to the tax depreciation rules*, and are intended to reduce compliance costs by clarifying and improving the application of various depreciation provisions. The changes are intended to:

- better align the depreciation treatment of patents with useful life by allowing a depreciation "catch up", when the patent is granted, for the period the patent was pending;
- improve the operation of the special tax depreciation rules;
- add plant variety rights and the right to use plant variety rights to the list of depreciable intangible property; and
- allow deductibility for losses on buildings where a building is destroyed or rendered useless (irreparably damaged) as the result of a "qualifying event".

Sixteen submissions were received on the tax depreciation changes. While submissions were broadly supportive of the changes in the bill, they considered that some did not go far enough. In particular, in relation to the amendment to allow deductions for losses on buildings affected by a "qualifying event", submissions commented that a deduction should be allowed for all losses on buildings. Also, in relation to the changes to the tax treatment of patents, submissions commented that a better treatment would be to allow depreciation to commence when a patent application was lodged (rather than waiting until the patent is granted and allowing a depreciation "catch up").

PATENTS

Issue: Commencement date of depreciation

Submission
(1W – Fisher & Paykel Appliances, 2W – Fisher & Paykel Healthcare, 9W – New Zealand Institute of Patent Attorneys, 13W – Industrial Research Limited, 17W – Ernst & Young, 29W – PricewaterhouseCoopers)

Costs relating to a patent application should be depreciated from the time the patent application (with a complete specification) is lodged – the date from which legal effect will be given if the patent is granted.

Comment

Submissions have commented that the proposed changes to the tax treatment of patents, in clause 21 of the bill, have no regard to the date from which patent protection actually applies and the time at which the underlying invention is used or is available for use.

When a patent is granted, protection is applied retrospectively from the date the patent application was lodged (the legal life of a patent is 20 years). The changes in the bill allow for this to be better reflected in the tax treatment by providing a deduction for depreciation for the period a patent is pending as a "catch up" when the patent is granted.

Submissions have argued that the better tax treatment is to allow depreciation from the date a patent application is lodged, instead of waiting until a patent is granted to recognise an asset (and then "catching up" depreciation). They consider that an asset arises at the date a complete patent application is lodged as, in the case of competing patents, it is the application date that determines priority and therefore the validity of a patent. The application first filed has priority legally and enables its owner to both generate revenue from commercialisation of the invention as well as prevent others from operating in the same field. Submissions also argue that, for financial reporting purposes, an asset is realised when an application is lodged.

Submissions make useful points in relation to the validity of a patent application as an asset. In particular, comment that an invention is typically only commercialised when a patent application is lodged. If an invention were to be disclosed prior to an application for a patent, a patent would not be able to be sought in respect of it as the secrecy provisions of the Patents Act 1953 would no longer be met. This would leave it open for competitors to also extract value from the invention. Also the date of filing an application in New Zealand is important as it has implications for priority given to applications filed offshore (which is where the majority of costs are incurred).

In light of these comments, officials consider that some economic benefits do arise when a patent application is lodged even though the full benefits may not arise until the application is subsequently granted. And while technically legal protection does not exist until a patent is granted, the unique nature of this type of intellectual property (the back-dating of legal life once the patent is granted) requires a different approach to be undertaken. We therefore agree with submissions and recommend that depreciation be allowed from the date a patent application is lodged.

The date a patent application is lodged should be the date an application with a complete specification (of the invention being patented) is lodged. The alternative is to allow depreciation from the date an application is lodged with a provisional specification (a complete specification is required to be filed within 12 to 15 months of a provisional specification). However, a patent's legal life is only retrospective to the date a complete specification has been lodged and we therefore consider this to be the appropriate benchmark for commencing depreciation.

We recommend that the change to allow depreciation to commence when a patent application with a complete specification is lodged should apply to such applications that are filed on or after 1 April 2005. This is different from the application date currently in the bill (in respect of the provisions which would allow a depreciation "catch up"), which applies in respect of patents granted in the 2005-06 and later income years (applications for which were filed prior to 1 April 2005). Officials do not consider that the change proposed in response to submissions would be sensible in relation to applications that have been made prior to the 2005-06 income year.

We do however recognise that moving to this new treatment (from what is currently in the bill) will disadvantage those taxpayers who would have been entitled to a depreciation "catch up" (under the provisions currently in the bill) for patent applications lodged prior to 1 April 2005 that are granted in the 2005-06 and subsequent income years. To maintain equity across taxpayers, officials consider that the provisions currently in the bill (principally clause 21) should be retained as a transitional measure for taxpayers who have lodged patent applications prior to 1 April 2005 which were granted in the 2005-06 or a subsequent income year.

It is our view that if taxpayers are able to commence depreciation in respect of patent costs from the date an application with a complete specification is lodged, then this is recognition that to all intents and purposes some of the benefits of patent protection arise (for example, the ability to commercialise), albeit indirectly. If a "patent" is effectively deemed to arise for tax depreciation purposes, we consider that a patent application should also be deemed to be a patent for the purposes of other provisions in the Income Tax Act. This would include the provision which requires any gains on the sale of patents to be returned as gross income (under section CB 26 of the Income Tax Act 2004). Under this change any gains on the sale of a patent application would become taxable.

While officials consider that treating a patent application as a patent, for the purposes of section CB 26 is the correct result if the patent application is deemed, for depreciation purposes, to be a patent, we recognise that the bill as introduced did not contain a provision to tax any gains on the sale of a patent application. Consequently, it would be unfair to apply such a provision to taxpayers who, in the interim, have filed for a patent without the knowledge that any sale of the application will give rise to a taxable event. We therefore consider that the proposed change to deem a patent application to be a patent for the purposes of section CB 26 should only apply in relation to patent applications that are lodged on or after the date of Royal assent. These changes should apply in respect of applications with provisional specifications (and not complete specifications) lodged on or after the date of Royal assent.

Recommendation

That depreciation be allowed from the date a patent application with a complete specification is lodged. This change should apply in respect of patent applications that are lodged on or after 1 April 2005. The provisions currently in the bill (clause 21), that allow a depreciation "catch-up", should apply to patent applications that were lodged prior to 1 April 2005 but are granted in the 2005-06 and subsequent years.

A patent application should be deemed a "patent" for tax purposes (with any gains on sale being taxable, as per the case with patents at present). This change should apply in respect of patent applications with provisional specifications that are lodged on or after the date of Royal assent.

Issue: Useful life of patents

Submission
(1W – Fisher & Paykel Appliances, 2W – Fisher & Paykel Healthcare, 9 – New Zealand Institute of Patent Attorneys, 13W – Industrial Research Limited)

Taxpayers should be able to depreciate patents over a timeframe that more accurately reflects the economic reality of the underlying invention. Options include depreciation over seven or 10 years, or more reliance being placed on taxpayers' financial reporting policies.

Comment

Submissions have commented that a 20-year straight-line basis for depreciating patent costs bears little resemblance to economic reality, with the tax treatment having a penal impact. Most comment that if there is significant economic value to be derived for a high-technology invention, it is likely to be extracted in its early years in the market before alternatives are offered by the competition or the technology itself is superseded. Consequently, few patents extend beyond 10 years in the current environment of fast-moving technology development and adoption.

Suggestions to better align the tax depreciation treatment of patents with commercial realities include: a depreciation rate based on a 10 or seven-year life; a 10% diminishing value rate; closer alignment with financial reporting policy; or a special tax depreciation rate for patents as an asset class (in respect of a taxpayer's portfolio of patents and patent applications). This latter proposal has been considered as part of a submission on the special tax depreciation rate rules.

The issue that arises is determining what an appropriate economic life for patents, as an asset class is, given that no single patent is likely to be similar to another. For example, it may well be that some mechanical patents become obsolete prior to expiry of legal life while others like pharmaceutical patents may be held for close to legal life. Different classes of mechanical and pharmaceutical patents may also have varying economic lives. Also, the costs of holding a patent are unlikely to be significant (just renewal fees) which may mean that taxpayers are more readily able to "carry" patents, even though they are not being used in the income earning process (for example, as a defensive ploy to prevent a competitor from extracting rents from a patented technology, product or process).

A seven or ten-year economic life, as suggested in submissions is therefore no less arbitrary than the current estimated useful life, which is based on legal life for patents. Officials recognise that the legal life of a patent is unlikely to be an accurate reflection of true economic life in all instances, but then depreciation is not meant to be a perfect reflection of how assets actually depreciate. Rather it is an approximation, and as with any approximation, there will be some assets in the class that depreciate faster and others that depreciate slower than the average.

In the case of a patent, legal life is arguably one of the better proxies available as it provides a cap on the life of a patent. Also, where a patent lapses (for example, the patent is not renewed) the tax rules allow the remaining book value to be written-off. We therefore do not consider that the approach of depreciating patents over their legal life should be changed.

Officials have serious concerns about allowing the use of financial reporting policy to derive tax depreciation rates because under the new International Financial Reporting Standards, patents will be recognised on a cost/valuation basis (as opposed to a depreciated value basis). Given the uncertainties associated with valuation for accounting, it would not be appropriate to allow tax depreciation to follow financial reporting policy.

Recommendation

That the submissions be declined.

Issue: Transitional issues

Submission
(17W – Ernst & Young)

Subject to the earlier submission on when depreciation in respect of a patent should commence, clauses 20 and 21 of the bill should be retained as transitional provisions where a patent application has been lodged before the start of the 2005-06 income year, but a patent is not granted until the 2005-06 or a later income year.

Comment

The submission comments that the provisions currently in the bill, which allow for a "catch-up" of depreciation for the period a patent is pending, should be retained for applications that were lodged prior to the 2005-06 income year (and are not granted until that or a later income year). The submission suggests that retention of clauses 20 and 21 for patent applications lodged prior to the 2005-06 income year might be appropriate in the interests of achieving taxpayer equity.

Officials have previously agreed that depreciation in respect of patent costs should commence from the date a patent application with a complete specification is lodged, with this change applying to patents lodged on or after 1 April 2005. We also recommended that clause 21 of the bill should be retained to accommodate taxpayers who have filed a patent application prior to 1 April 2005.

Recommendation

Clause 21 of the bill should be retained in respect of patent applications that are granted in the 2005-06 or a subsequent income year that were lodged prior to 1 April 2005.

Issue: Patents granted in other jurisdictions

Submission
(9 – New Zealand Institute of Patent Attorneys, 13W – Industrial Research Limited, 17W – Ernst & Young, 29W – PricewaterhouseCoopers)

The proposed changes should also cover a patent application accompanied by a complete specification that is lodged with the appropriate intellectual property office in a foreign jurisdiction.

Comment

Submissions comment that the intent of the changes should be that they apply to all patent applications lodged by New Zealand tax residents in all international jurisdictions, not just New Zealand. They comment that New Zealand will not be the only country in which patent applications are made where any sort of export or overseas commercialisation or use arising from the underlying invention is contemplated. Some argue that patents pertaining to New Zealand are likely to form just a small percentage of those held, both in number and expense, and a taxpayer may elect to lodge a patent in an overseas jurisdiction(s) and not in New Zealand due to the nature of, and likely market for, the underlying invention.

Officials agree that the proposed amendments should apply to all patents (and patent applications), not just those lodged with the Intellectual Property Office of New Zealand.

Recommendation

That the submissions be accepted

Issue: When ownership of patent applications change

Submission
(29W – PricewaterhouseCoopers)

In Clause 21, the proposed description of the required adjustment (when a patent is granted to a person who did not lodge the complete patent application) is unclear and should be clarified.

Comment

The submission comments that the use of the word "affected" in clause 21 does not describe adequately the adjustment required in circumstances where a patent is granted to a person other than the person who lodged the patent application. Officials consider that the purpose of this clause is to reduce the deduction available as a depreciation "catch-up" in the first year a patent is granted, to reflect the period the patent application was held by a person who is not the person to whom the patent was granted. We agree that there is potential for ambiguity with the current wording and consider that an amendment to clarify clause 21 should be made.

Recommendation

That the submission be accepted.

Issue: Patent renewal fees

Submission
(17W – Ernst & Young)

The legislation should state clearly that any patent renewal fees paid during the legal life of a patent are of a revenue nature and deductible in the year incurred.

Comment

The submission contends that a draft interpretation statement (IS2215) on the tax treatment of patents, issued by Inland Revenue, which takes the position that patent renewal fees (payable at the end of the 4th, 7th, 10th and 13th year of a patent) should be capitalised and depreciated is incorrect. The submission considers that such fees are not capital in nature as they do not effect the acquisition of any capital asset or provide an enduring benefit. Instead they protect the holder from losing the rights already created through the patent application process. The submission comments that this plus their recurrent nature present strong arguments for treating such fees as expenditure of a deductible, revenue nature.

We consider that this issue is outside the scope of the bill and should be dealt with as part of the formal process for providing feedback on the draft interpretation statement. The interpretation statement outlines the Commissioner's view that patent renewal fees relate to the ownership of the patent and are therefore capital in nature. The Commissioner's view is that such expenditure is not incurred to maintain a patent, in the sense of keeping it up-to-date, and nor are they simply administrative fees. The process for considering submissions on the interpretation statement is currently under way. The process will involve the re-issue of the exposure draft after feedback from the current consultation round has been considered.

Recommendation

That the submission be declined.

Issue: Drafting

Submission
(9 – New Zealand Institute of Patent Attorneys)

In clause 21(1)(a), the words "complete application" should be changed to "patent application accompanied by a complete specification".

Comment

The submission comments that there is no such thing as a complete application. The correct term is a "patent application accompanied by a complete specification". Officials agree with the recommendation.

Recommendation

That the submission be accepted.

Issue: Costs associated with obtaining a design registration

Submission
(9 – New Zealand Institute of Patent Attorneys)

Costs associated with obtaining a design registration should be depreciable intangible property under Schedule 17 of the Income Tax Act.

Comment

The submission comments that design registrations (under the Designs Act 1953) should be depreciable intangible property as the process for obtaining a design registration and the fixed lifetime protection means that design registrations are more similar in nature to patents and plant variety rights than other types of intellectual property. It also comments that such a change should encompass design registrations in all jurisdictions, not just New Zealand.

The submission raises a number of important issues in relation to the tax treatment of registered designs, which officials need more time to consider. We therefore consider this issue to be outside the scope of the current bill. However, we intend to consider the implications of including registered designs as depreciable intangible property as part of the next phase of the tax depreciation review.

Recommendation

That the submission be declined in relation to the current bill, but note that officials intend to consider this issue as part of the next phase of the tax depreciation review.

Issue: Commencement date for intellectual property rights generically

Submission
(9 – New Zealand Institute of Patent Attorneys)

Costs relating to all fixed-term intellectual property rights – patents, registered designs, utility models and plant variety rights in New Zealand and overseas – should become depreciable as the costs are incurred (over the estimated useful life of the relevant intellectual property right).

Comment

The submission comments that the rationale for allowing depreciation for patents from the date of application (as opposed to the date of grant) applies equally in the case of other types of intellectual property.

The submission attempts to deal with the issue of the tax treatment of intellectual property generally by standardising their treatment. However, different types of intellectual property have different features (for example, legal life, the type of protection offered or the commencement of that protection). The tax treatment, to an extent, attempts where possible to reflect these different features. While a simple approach to depreciating intellectual property would be desirable, we consider that it would be very difficult to have a standard treatment for the different variants of intellectual property available. Consequently, this is why there is recognition in the bill that patents, for example, need different depreciation rules.

Recommendation

That the submission be declined.

PLANT VARIETY RIGHTS

Issue: Plant variety rights granted in other jurisdictions

Submission
(4W – Zespri International Limited, 9 – New Zealand Institute of Patent Attorneys, 17W – Ernst & Young)

The proposed change to include plant variety rights (and the right to use plant variety rights) as depreciable intangible property should also apply in respect of plant variety rights secured offshore and licensing fees incurred to maintain plant variety rights offshore.

Comment

Submissions have commented that in the absence of wording changes to the proposed amendment, a New Zealand taxpayer who incurs expenditure to preserve a plant variety in an offshore jurisdiction in order to derive taxable income in New Zealand, would not be able to claim this expenditure for tax purposes. Submissions have also noted that the costs of obtaining protection offshore would normally greatly exceed the costs associated with New Zealand rights and it is therefore anomalous to restrict depreciation deductions solely to plant variety rights registered under the New Zealand legislation.

Officials agree that plant variety rights granted offshore (as well as the right to use plant variety rights secured offshore) should be included within the scope of the proposed change.

Recommendation

That the submissions be accepted.

Issue: Deductibility for plant variety development costs

Submission
(17W – Ernst & Young)

Specific provisions should be included in the Act to ensure plant variety development costs can be deducted or depreciated in the same manner as plant variety rights

Comment

The submission comments that, as well as direct plant variety rights registration costs, there can also be very substantial costs incurred over a number of years in developing the underlying plant varieties (after they have been identified as new varieties to ensure consistency of standards and quality, particularly where crops and produce are involved). The submission contends that such costs may not be deductible under the scientific research or development provisions in the Income Tax Act and therefore may be non-deductible/non-depreciable expenditure.

Costs associated with developing plant varieties are separate from the cost of obtaining protection over the relevant plant variety. They should not be included in the cost of obtaining plant variety rights. To the extent that further development costs need to be incurred in developing a plant variety, for example for commercialisation, these costs should be treated separately. These costs may, as suggested in the submission, currently be non-deductible under current rules. Officials need to work through the costs that are involved and the tax treatment of these costs at present in more detail. Therefore, we do not consider that we are in a position to recommend a change as part of the current bill. We intend to consider this issue as part of the next phase of the tax depreciation review.

Recommendation

That the submission be declined in relation to the current bill, but note that officials intend to consider this issue as part of the next phase of the tax depreciation review.

Issue: Application date of the changes

Submission
(4W – Zespri International Limited)

The proposed change should include some type of grandfathering clause to allow for amortisation of all existing plant variety rights ownership costs or, in the case of the right to use plant variety rights, the costs of acquiring those rights.

Comment

The submission comments that it seems inequitable to only apply the legislative amendment to acquisitions of plant variety rights occurring either in or post the 2005-06 income year. The submission argues it would be more equitable to include some type of grandfathering clause to allow amortisation of all existing plant variety rights ownership costs or the costs of acquiring those rights.

The changes to allow depreciation in respect of plant variety rights (and the right to use plant variety rights) are intended to be prospective and apply to new grants/acquisitions of plant variety rights. Allowing plant variety rights obtained prior to the 2005-06 income year to be depreciated would provide an economic gain to taxpayers who undertook this expenditure with the knowledge that it was not depreciable at the time. Officials therefore do not agree that allowing existing plant variety rights to be depreciated would be equitable.

Recommendation

That the submission be declined.

Issue: Application of clauses 20 and 21 to plant variety rights

Submission
(9 – New Zealand Institute of Patent Attorneys)

The proposed change to allow depreciation in respect of the period a patent is pending to be claimed along with the first depreciation deduction (in clauses 20 and 21 of the bill), should be also allowed in respect of plant variety rights.

Comment

Subject to earlier comments on when depreciation should commence for intellectual property, the submission argues that alternatively, the proposed amendments to allow a "catch-up" of depreciation for patents should be extended to also apply to plant variety rights. The submission contends that plant variety rights involve long periods from initial submission (of the application) to grant, as there is a requirement for test trials involving the growing of plants to establish that the variety is unique, stable, distinct and homogeneous.

Our understanding is that in New Zealand, on lodgement of an application for plant variety rights, provisional protection over the plant variety applies. This allows the taxpayer who developed the plant variety to undertake commercialisation with the knowledge that any infringements during this provisional protection phase are able to be actioned as and when they arise. This is distinct to the process for patents, which allows infringements during the period a patent is pending to be actioned only once the patent is granted.

In the case of plant variety rights, the rights are deemed to exist until the application is granted. If an application is subsequently not granted, the rights (during the provisional phase) are deemed never to have existed. This in itself creates some complexity over when depreciation should commence in respect of plant variety rights. The Plant Variety Rights Act 1987 also deems a plant variety to be new (and hence able to be registered) if a taxpayer has not sold that plant variety in New Zealand for a period of more than 12 months (and a longer period offshore). This contrasts with the treatment of patents where any disclosure of an invention prior to the filing of a patent application results in the loss of the ability to patent that invention.

Given these considerations, the submission argues that the best treatment is for plant variety rights (and, in effect, all intellectual property) to be depreciated from the time the relevant costs are incurred. In response to an earlier submission on this point in relation to patents, it was agreed that there is a case for allowing depreciation to commence from the date a complete specification is lodged. However, we do not consider that a similar treatment (depreciation from the date of application) should apply to plant variety rights.

Officials' reasoning for applying depreciation in respect of plant variety rights from the date of grant is on the basis that legal protection applies from this date. Given this, it is not possible to say on the date of application when plant variety rights, if granted, will expire. This is because the application phase, even though provisional protection applies, is not counted towards the ultimate legal life of 20 or 23 years (unlike a patent). This makes it difficult to consider allowing costs incurred in obtaining plant variety rights to be depreciated from the date an application for such rights is made because the period over which depreciation should be allowed is uncertain.

In our view, allowing a depreciation "catch up" for plant variety rights, when these rights are granted, has greater merit. However, the concept of a depreciation "catch up" would be different from that of patents for the reasons outlined above. Under such an approach for plant variety rights, estimated useful life would be legal life (20 or 23 years depending on the plant variety) plus the time taken for the application to be granted (the provisional protection phase). A deduction for depreciation relating to the provisional protection phase would then be allowed in the year of grant (together with the depreciation deduction for that year).

For example, assume an application for plant variety rights takes five years to be granted. Once granted, legal life will be 20 years. For tax purposes, the estimated useful life would be legal life plus the five years that the application was pending. In the year of grant a deduction equivalent to $5/25^{th}$ of the costs incurred would be allowed (for the period the application was pending) as well as $1/25^{th}$ relating to the depreciation in the year of grant. In each subsequent year, a depreciation deduction equivalent to $1/25^{th}$ of the costs would be allowed.

Recommendation

That the submission recommending applying the depreciation "catch up" provisions to plant variety rights be accepted, subject to officials' comments on how a depreciation "catch up" should work for plant variety rights.

LOSSES ON DESTRUCTION OF BUILDINGS

Issue: Losses on disposal of buildings should be wider

Submission

(5W – Christchurch City Holdings Limited, 10 – Port Companies of New Zealand, 15W – Business New Zealand, 20W – Contact Energy Limited, 21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG, 27W – Alliance Group Limited, 28W – Corporate Taxpayers Group, 29W – PricewaterhouseCoopers, 32W – The Warehouse Limited)

All losses on the disposal of a building should be tax deductible. To mitigate any risk to the tax base, a loss should be allowed where a taxpayer originally built the building and has owned since that time; or a taxpayer has owned the building for a minimum period. Targeted anti-avoidance provisions should be used to address any specific concerns.

Comment

The provisions in this bill focus on a quite narrow issue, where buildings have been irreparably damaged by an event outside the control of the taxpayer. These submissions raise much wider concerns. We acknowledge that in some cases, such as Port Companies, the concerns seem valid.

Submissions argue that all losses on disposal of a building (including a loss on sale) should be deductible. For example, submissions argue that in some sectors of the economy buildings become obsolete from a technological or marketing perspective sooner than they would from a purely functional perspective. Submissions also argue that losses are allowed in relation to other depreciable property and that buildings should be treated in an identical manner. Some contend that the current policy creates a tax bias in favour of repairing/reconfiguring/upgrading existing buildings rather than demolition and construction of new buildings, an outcome which may not be socially or economically desirable. They further state that if the submission above is not accepted, at a minimum, all losses on the destruction of a building (whether or not there is a "qualifying event") should be deductible.

We agree that there is a case to consider for allowing a general deduction for losses from the sale or disposal of buildings. However, there are two important balancing considerations:

- Although buildings may usually be expected to depreciate over time, rates of depreciation are typically low. The market value of buildings is subject to fluctuations and, as a consequence, the value of buildings can be variable. If gains are not taxed when buildings appreciate, there is an argument for not allowing deductions for losses on sale, in order to prevent over-investment in buildings. Although similar issues can arise for other assets, this is likely to be a particularly important problem for buildings because of their low depreciation rates and the volatility of estimates of the value of buildings.

- There is also a concern that the value of land improvements (including buildings) is normally calculated as the difference between the overall value of a property and unimproved value of the land. There are tax integrity issues when values are apportioned (between the land and improvements) for tax reasons, rather than their actual value. This issue has the potential to create a significant tax avoidance problem and is exacerbated by the fact that buildings move in and out of the tax base.

The submissions acknowledge what they consider officials' key concern to be – the ability to manipulate the tax rules in relation to claiming deductions on losses on buildings. They make a number of suggestions on how to manage this concern. Submissions identify a number of measures that could be implemented to address the issue of taxpayers attributing a substantial portion of the value of a property to the building to create an artificial loss, including:

- allowing a deduction for losses on buildings where the building is owned by the taxpayer who originally constructed the building; or where a taxpayer has owned the building for a minimum period (5 or 10 years); or
- requiring taxpayers to satisfy the Commissioner of the apportionment methodology used (between land and buildings) used to value buildings;
- specific anti-avoidance provisions to address any mischief that arises.

Officials have considered the suggestions for less comprehensive changes to the tax treatment of buildings, to allow losses in certain circumstances. The anti-avoidance measures raised in submissions could potentially reduce the risk of valuation manipulation. But the suggestions do not address our concern that allowing more general losses on buildings may create a tax-driven investment bias. In addition, the suggestions are not without problems.

We would be concerned that lock-in effects may occur if we allow losses for the demolition of a building and not on its sale. In these circumstances a taxpayer would have an incentive to hold a building until it was scrapped rather than selling the building shortly before scrapping. This would also be true if a taxpayer who demolished a building were able to claim deductions in the same way as could be claimed if a building were not in use. On the other hand, the status quo does have a very unattractive feature of providing incentives for taxpayers to refrain from demolishing a building merely because this forgoes a stream of depreciation deductions. And it may be true that our general concerns about allowing losses on buildings do not necessarily apply to all taxpayers all of the time – for example, port companies who are not selling port land and buildings.

The above issues demonstrate the difficulty of drawing sensible borderlines in this area. Officials would like to consider some generic policy solution rather than attempting a quick fix in this area.

Submissions have also argued that the definition in the bill relating to instances where a loss is allowed – a "qualifying event" –will create unnecessary disputes between taxpayers and Inland Revenue. For example: whether the qualifying event was of such a magnitude that it resulted in or brought about the destruction of a taxpayer's building; or whether the destruction or damage was caused by the action or inaction of the taxpayer or a related party.

Decisions about whether to allow losses on buildings irreparably damaged as the result of a qualifying event or taxpayer actions will be fact-specific. As such there is the potential for disputes between taxpayers and the department concerning the facts in each case. To mitigate some of these risks, the department will provide guidance and examples in the *Tax Information Bulletin* on the policy intent and how Inland Revenue will apply the proposed law. However, some cases will end up in court and it will be the court's role to determine questions of fact.

The changes proposed in the bill are aimed primarily at extending the provisions in the Taxation (Venture Capital and Miscellaneous Provisions) Act relating to disaster relief, to take account of more generic events that may cause a taxpayer's building to be destroyed. Officials consider that the issue of general deductibility of losses on buildings should be considered as part of the ongoing depreciation review.

Recommendation

That the submissions be declined in relation to the current bill, but note that officials are considering the issue of tax depreciation for buildings more widely as part of the ongoing tax depreciation review.

Issue: Dredging costs

Submission
(10 – Port Companies of New Zealand)

The Committee asked officials to report on whether dredging costs are currently depreciable, following the submission by the port companies of New Zealand.

Comment

The short answer is that dredging costs are not currently depreciable. The reason is that as long as capital dredging is maintained – through regular maintenance dredging – it is believed unlikely that the dredged area will be subject to a decline in value.

Economic theory suggests that tax depreciation rates should mirror how an asset declines in value. This avoids a situation whereby the tax depreciation rates artificially encourage or discourage investment in particular types of assets. This is our starting point.

We have considered whether capital dredging might reasonably be expected, in normal circumstances, to decline in value while it is in use or available for use. Capital dredging is when dredging is undertaken for the first time to remove some of the seabed in order to deepen a channel or harbour. Dredging to maintain this depth is akin to repairs and maintenance.

We considered capital dredging in the following circumstances:

- When capital dredging is maintained (and a deduction is allowed for these repairs and maintenance): It is a reasonable expectation that the capital value of the dredging will not change with maintenance. The correct result is not to allow depreciation deductions for capital dredging.
- When capital dredging is subject to deferred maintenance (and the harbour depth is not regularly maintained): It can be reasonably expected that its capital value will decline during the period of deferred maintenance, but that its value would be restored by any subsequent dredging. It is also likely that the taxpayer would argue that such dredging was akin to repairs and maintenance. Again, the correct result is not to allow depreciation deductions for capital dredging.
- When capital dredging is abandoned or sold: In principle, a deduction for any loss realised on the capital value of the dredging costs ought to be allowed. However, there may be a number of practical and avoidance considerations that lead to a different final policy response. For example, how to define abandonment.

Recommendation

Under current rules, losses from the abandonment of capital dredging costs would not be allowed. This is similar to other "black hole" expenditure and will be considered as part of the ongoing depreciation review.

Issue: Losses when a building is no longer used/required to be demolished as the result of a qualifying event

Submission
(29W – PricewaterhouseCoopers)

The definition of a "qualifying event" to be applied in determining whether a person is entitled to deduct a loss on a building needs to be amended to ensure that it applies also where a person destroys a building already damaged (or partially destroyed) by an event outside their control. Guidance should also be provided to taxpayers where an asset is partially damaged, but not destroyed, to enable taxpayers to determine whether in such a situation the asset can be considered to have been rendered useless.

Section EE 32 of the Income Tax Act 2004 should be amended to allow a deductible loss to be claimed in respect of a building owned but no longer used as a result of a "qualifying event".

Comment

The submission comments that, on occasion, a taxpayer may need to demolish a building after it has been damaged by a "qualifying event" (for example, arson, a natural event or accident). It argues that the definition of "qualifying event" should be drafted so that in such circumstances a taxpayer is entitled to claim a loss on disposal even though the actual destruction is caused by their own action.

Officials consider that this submission raises some fundamental questions about when a deduction is allowed for losses on buildings under the proposed definition of "qualifying event". The policy intent of this change is for a loss to be allowed where an unexpected event results in a taxpayer's building being irreparably damaged and rendered useless, when the damage is not caused by the actions of the person or their failure to act (or the actions or inaction of the taxpayer's agents). The unexpected event could be a natural disaster such as an earthquake, or an event like a fire. It does not include changes to regulation (for example, health and safety) that make a building obsolete and which require it to be knocked down. The event must have caused damage to the building. What is meant by "irreparably damaged" and "rendered useless" is that the building has no continuing economic value for the taxpayer.

It should be irrelevant whether the building is still standing and therefore needs to be demolished by the taxpayer or whether the taxpayer chooses not to demolish the building (but is no longer able to use it). A deduction for the loss should arise. We consider that the current definition of "qualifying event" (in clause 60 of the bill) and the amendments to section EE 41(2) of the Income Tax Act 2004 (in clause 24) are deficient in this regard and should be amended. Section EE 32 of the Income Tax Act 2004 should also be amended to mirror the loss on disposal provisions.

Officials will ensure that the *Tax Information Bulletin* announcing the changes (once they are enacted) will contain general examples of what constitutes a building being irreparably damaged and rendered useless as the result of a qualifying event.

Recommendation

That the definition of "qualifying event" in clause 60 of the bill be amended so that it means an unexpected event that results in a taxpayer's building being irreparable damaged and rendered useless, where the damage is not caused by the actions (or inaction) of the taxpayer and their agents. Amendments will also be needed to section EE 41(2) and EE 32.

Issue: Application date of changes

Submission
(5W – Christchurch City Holdings Limited, 10 – Port Companies of New Zealand, 28W – Corporate Taxpayers Group, 32W – The Warehouse Limited)

The changes should apply from the commencement of the 2004-05 income year (buildings destroyed on or after 1 April 2004) rather than the commencement of the 2005-06 income year.

Comment

Submissions have commented that there is no policy reason why a building that is destroyed by a "qualifying event" before 1 April 2005 is not tax deductible whereas a building destroyed post that date is tax deductible.

The issue that arises is providing a bright line for taxpayers so that they know that events after a certain date qualify and others don't. Submissions suggest that the line should be drawn earlier so that more events qualify. This change is meant to be prospective.

Officials do not consider there to be any exact science to picking the date for applying a change to the tax rules. 1 April 2005 is the start of the 2005-06 income year for most taxpayers and was considered the most appropriate date, given the considerations above, to apply this change from.

Recommendation

That the submission be declined.

Issue: Definition of "qualifying event"

Submission
(29W – PricewaterhouseCoopers)

The insertion of a new definition of a "qualifying event" in the Income Tax Act 2004 may result in confusion. The provisions should state clearly the purposes for which the definition is to apply.

Comment

The submission comments that the bill inserts a new definition of "qualifying event" and this may cause confusion as the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 also inserted a definition of "qualifying event".

The definition of "qualifying event" in the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 is limited to destruction caused by the February and July 2004 storms. The definition inserted by the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 also applies more widely in relation to the Income Tax Act (for example, it also applies to section MB 3B of the Income Tax Act 2004 which deals with the provisional tax rules).

The definition of "qualifying event" in the current bill is designed to widen the definition that was inserted by the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004, for the purposes of the tax depreciation rules. Ideally, the current change would have amended the definition as inserted by the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004. However, when the current bill was being introduced, the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 had not yet received Royal assent. Consequently, this was the reason for the two definitions of "qualifying event" identified in the submission.

We consider that the definition currently in the bill should extend the existing definition for "qualifying event" but only for the purposes of the tax depreciation rate rules (in section EE 41(2)). That is, the definition of "qualifying event" inserted by the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 should remain for the purposes of other provisions in the Income Tax Act 2004 (for example, section MB 3B).

Recommendation

That the definition currently in the bill should extend the definition for "qualifying event" that already exists, but only for the purposes of the tax depreciation rate rules (in section EE 41(2)).

Issue: Losses on sale of a temporary building

Submission
(22 – KPMG)

The loss on sale of a temporary building should be able to be spread back from the year of sale.

Comment

The submission comments that there may be instances where buildings have been constructed for specific purposes, and at the end of the life of the project for which the building was constructed (or acquired) the building is demolished. While a deduction on disposal of a temporary building is available, there is no income earning process against which to offset the deduction. This is analogous to the restoration cost issue for taxpayers with environmental expenditure.

The New Zealand tax rules do not allow carry-back of tax losses to past periods to offset against taxable income in those periods. This is for a variety of reasons, including the uncertainty that such rules would create for past tax assessments (including "use-of-money interest" issues) and the associated uncertainty for government revenue flows.

Recommendation

That the submission be declined.

SPECIAL TAX DEPRECIATION RATES

Issue: Special tax depreciation rates for classes of depreciable property

Submission
(17W – Ernst & Young)

The legislation should allow the Commissioner to set special or provisional tax depreciation rates for classes of depreciable property, not only for single items of depreciable property.

Comment

While welcoming the proposals to increase the Commissioner's flexibility in setting special tax depreciation rates, the submission comments that it would be more helpful for taxpayers if they were able to apply for special tax depreciation rates on a class of asset basis rather than on an item-by-item basis. The example provided is where taxpayers have a portfolio of patents and/or patent applications, and the potential cost of having to make individual special tax depreciation rate applications could be significant.

Officials do not support allowing the Commissioner to provide special tax depreciation rates in respect of a class of depreciable assets. The special tax depreciation rules are designed to deal with case-specific instances where an individual asset is expected to depreciate in a manner that is different to that envisaged when a general depreciation rate for that asset was set. The idea behind the rules is to allow taxpayers the ability to apply for a special rate where there are, for example, special circumstances that will impinge upon the use of the particular asset at some future date.

Officials consider that this is different to an instance where a taxpayer may have a set of identical assets (for example, five printing presses) and requires a special tax depreciation rate to cover the set. Each printing press is expected to be subject to the same special circumstances. Currently, the legislation would seem to require taxpayers to file a special rate application for each individual asset in the set. This is in spite of the fact that the different applications would typically be considered together (and the same special rate issued for each asset if the applications were successful). We consider that the legislation should be amended to ensure that the Commissioner can grant a special tax depreciation rate for a set of identical assets (without requiring a separate application for each asset in the set).

The class of asset (or a "pool") approach cannot, however, be readily applied in the case of special tax depreciation rates for an asset class where different assets in the class may have different factors that will affect how they depreciate. Issuing a special tax depreciation rate for a portfolio of intellectual property (as opposed to on an item-by-item basis) would be especially problematic as it would involve determining an average rate for assets that are often difficult to value (and hence susceptible to manipulation) and for which economic lives may vary significantly (for example, for different types of patents). Therefore, as a general rule, officials do not consider that the legislation should require the Commissioner to set a special tax depreciation rate for a pool of assets, such as a taxpayer's portfolio of intellectual property.

It should be noted however that provisional tax depreciation rates are allowed for classes of depreciable property. A taxpayer can apply for a provisional tax depreciation rate if there is no general rate for the particular asset or asset class (for example, where the asset is new). The key difference between a provisional and special tax depreciation rate is that in relation to the former, a general rate exists, but for a variety of reasons may not be applicable in the case of a particular taxpayer (and their use of a particular asset). In the case of the latter, no general rate exists so a new rate must be considered.

Recommendation

That the submission be declined. However, the special tax depreciation rate rules should be amended to allow taxpayers to apply for a special tax depreciation rate for a set of identical assets (without requiring a separate application for each asset in the set).

Issue: Guidelines for issue of special tax depreciation rates

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

There need to be clear guidelines available on the special tax depreciation rate setting-process which set out the documentation and evidence required.

Comment

The submission comments that such guidelines would assist taxpayers and their advisors in determining whether or not it is appropriate to proceed with an application for a special tax depreciation rate. It argues that at present, it is difficult for taxpayers to assess the likelihood of success and as a result many taxpayers decide not to proceed because of uncertainty.

It should be noted that Inland Revenue currently provides information in relation to applying for special tax depreciation rates – for example, on its website. Inland Revenue Adjudication and Rulings Field Liaison and Communication unit also fields enquiries on these applications. In relation to the proposed changes to these rules, the amendments in the bill are only the legislative side of the changes to the special tax depreciation rules. A number of administrative changes will also support the new legislation. It is the combination of the two that officials consider will allow the Commissioner greater flexibility in being able to consider special tax depreciation rate applications. Officials agree that some guidance in relation to the changes to the special tax depreciation rules are necessary and will release a *Tax Information Bulletin* on these changes once the legislation is enacted.

Recommendation

A *Tax Information Bulletin* on these changes will be released once the legislation is enacted.

Issue: The six-month deadline for issuing special tax depreciation rates

Submission
(17W – Ernst & Young, 29W – PricewaterhouseCoopers)

Where the issue of a special tax depreciation rate determination is delayed beyond the initial six-month period there should be some remedy for affected taxpayers or, alternatively, a sanction of the Commissioner for breach of the limit.

Comment

Submissions recognise that it is not always practicable for the Commissioner to complete special tax depreciation rate determinations within the six-month period currently legislated for. However they express concerns about extending this period without providing protection to affected taxpayers. One submission argues that where the issue of a special tax depreciation rate is delayed beyond the initial six-month period, then there should be a remedy for taxpayers whose tax positions may be affected. Possible remedies could be an extension to their due date for filing a return; or an express provision to require the Commissioner to amend any assessments already made.

The submission also argues that the legislation should allow the Commissioner to exercise his discretion in relation to a wide variety of matters that may be affected by the depreciation determinations.

Another submission argues that an extension to the six-month limit be restricted to circumstances in which the taxpayer agrees specifically to the extension. Where the taxpayer does not agree to the extension and the six-month limit is breached, a sanction should be imposed on the Commissioner.

The purpose of the proposed change is to provide greater certainty to both the Commissioner and the taxpayer involved where a special tax depreciation rate application is not able to be considered with the current six-month time limit. Currently, under the six-month time limit, the Commissioner must refuse a special tax depreciation rate application if he is unable to reach a view on the validity of the application within the prescribed timeframe.

Administratively, this would require taxpayers to re-file the application, at their expense, in terms of both time and money. In practice, the Commissioner considers applications outside this time-limit with the approval of taxpayers. However, there is uncertainty about the legislative validity of these determinations. The proposed change simply validates this practice in legislation. The change is not intended to provide greater flexibility to the Commissioner at the expense of the taxpayer.

Special tax depreciation rate applications are becoming increasingly complex, both in terms of the variety of assets for which special rates are being sought and the factors which taxpayers consider will affect their useful life. This is expected to become further complicated with the addition of fixed-life intangible property (for example, patents and other intellectual property) to the category of assets for which a special rate may be sought.

Equally, the Commissioner is bound by the time limit even though information necessary for processing the application may still be held by the taxpayer (and only known to them). The process of requesting and receiving this information can also add to the time taken to process an application. There is also the process of consulting with independent valuers for certain applications, which can add to the time taken. Consequently, it is likely the six-month time limit will be breached for certain applications.

It is important to note that under the proposed change it will be at the discretion of the taxpayer to elect to extend this initial deadline. Inland Revenue will endeavour to meet the six-month deadline but the proposed change is a reflection of the fact that in future it may not be as easy to meet. We do not support requiring the Commissioner to extend return filing dates for taxpayers or to suffer a sanction if a special tax depreciation rate application cannot be set within six-months. This could impose unrealistic timeframes in relation to complex special tax depreciation rate applications. It could also create incentives for taxpayers to, for example, delay the provision of important information in relation to an application to extend the time available to file their returns.

There is already scope for dealing with concerns around special tax depreciation rates issued beyond the six-month time limit, which impact on tax assessments. Officials consider that taxpayers whose tax assessments are affected by special tax depreciation rate applications that are pending, should make a request to the Commissioner, under section 113 of the Tax Administration Act 1994, for an amendment to those assessments once a special rate is granted.

Recommendation

That the submissions be declined but it be noted that mechanisms already exist for dealing with concerns around special tax depreciation rates that are issued outside the current six-month time limit, which affect past income tax assessments.

Issue: Estimated useful life under the special tax depreciation rate rules

Submission

(21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG)

Estimated useful life should be able to be changed to reflect an asset's remaining useful life. More flexibility could also be provided in the special tax depreciation rules to enable more options in relation to second-hand assets.

Comment

The submissions have commented that changes to the special tax depreciation rate rules should explicitly make it clear that estimated useful life should incorporate estimated useful life where economic life is shortened by a change in technology or regulation. Other submissions suggest that taxpayers are currently locked into depreciating second-hand assets over the estimated useful life of a new asset, and that the special tax depreciation rules should provide taxpayers with a mechanism to satisfy the Commissioner as to the appropriate treatment in relation to second-hand assets (for example, depreciation over remaining life).

The treatment of second-hand assets is a difficult issue. Under current rules, the effective life of second-hand assets is treated as if these assets were new when a taxpayer acquires them. This is sometimes referred to as the "whole of life" approach. Suppose, for example, a taxpayer acquires an asset with an estimated useful life of 20 years, 12 years after it was used. The taxpayer is required to calculate depreciation based on the assumption that the asset has a future economic life of 20 years rather than eight.

If a taxpayer acquires the 20-year asset and depreciates it on a diminishing value basis, the depreciation rate allowed is 9.5% before loading (or 11.4% after). If a subsequent purchaser, who acquires the asset second-hand after 12 years, were able to claim depreciation as though it had an economic life of eight years, this would boost the rate of depreciation to 22%. It would seem unattractive to provide incentives for taxpayers to sell and repurchase assets merely to claim higher depreciation rates. This suggests that allowing depreciation on a "whole of life" approach is attractive.

Also, if all 20-year assets had an economic life of exactly 20 years, it would be arguable that a second-hand asset acquired after 12 years should attract depreciation deductions based on an expected future life of eight, not 20 years. However, in practice the economic lives of assets vary. If some assets which have an expected useful life of 20 years when new expire within 12 years, a 12-year-old second-hand asset will have an expected future life of more than eight years, but how much more is a matter on which it is difficult to generalise.

The New Zealand tax depreciation rules are a pragmatic response to the difficult issues outlined above. They may set depreciation rates which are too low for second-hand assets but it is difficult to find a more satisfactory general approach in the absence of fundamental changes.

Special depreciation rates should be set on a basis which is consistent with the general depreciation rules. If the "whole of life" estimate of economic life is generally used for second-hand assets, then taxpayers should not be able to apply for higher special rates merely because an asset has aged. To allow this would be to encourage taxpayers to apply for special depreciation rates for any second-hand assets.

There is, however, a separate issue. At times, some event that is outside the taxpayer's control may mean that the asset's useful life will be curtailed (and the asset will not be able to be salvaged). Examples include where the regulatory environment changes so an asset is no longer able to be used lawfully (for example, environmental legislation which outlaws the use of a particular type of machine) or where the raw materials that are used as an input into the asset are expected to run out. Another example is where the rate of technological obsolescence for an asset is significantly higher than was originally envisaged. Here, uncertainty about future life is not an issue. In principle, it would appear reasonable for the Commissioner to take such factors into account when setting a special depreciation rate for a particular asset.

The above view does not require a legislative amendment. Rather, it is the view of the Commissioner on what estimated useful life should be in the context of special tax depreciation rate applications. The legislative changes aimed at widening the factors that the Commissioner can have regard to when considering special tax depreciation rate applications are designed to support this interpretation of estimated useful life.

Recommendation

That in setting special tax depreciation rates for second-hand assets' the Commissioner should normally continue to apply a "whole of life" approach. Where, however, it is evident that an asset will have a shorter economic life as a result of changes in regulation or the lack of availability of raw materials, then these factors should be able to be taken into account when setting special tax depreciation rates.

Issue: Special tax depreciation rates part way through an asset's life

Submission
(29W – PricewaterhouseCoopers)

The special tax depreciation rate rules specifically need to allow the Commissioner to grant an application for a special tax depreciation rate part way through an asset's useful life.

Comment

The submission comments that there may be instances where economic factors which determine the useful life of an asset have been changed radically part-way through an asset's life and the Commissioner has declined to issue a special tax depreciation rate that reflects these changes. These factors include outside events such as changes to the availability of a raw material that an asset processes or significant changes to the economic viability of the asset that were not anticipated when the asset was acquired and have not been factored into the standard calculation of the asset's useful life.

The submission suggests that the new rules should confirm specifically that the Commissioner has the flexibility, in the appropriate circumstances, to amend the useful life of a depreciable asset part way through its life.

The issues in relation to allowing a special tax depreciation rate part-way through an asset's economic life is similar to those discussed under the previous submission on the estimated useful life of second hand assets. That is, assume that an asset which has an estimated useful life of 20 years when new, is expected to expire within 12 years, eight years into its use. There may be a similar asset, which at year eight, is expected to have an expected future life of more than 12 years. Again, this is because the economic lives of assets vary (and can do so at different points in their life). Consequently, officials consider that allowing depreciation on a "whole of life" approach is also a pragmatic approach in these circumstances.

However, in the response to the previous submission we considered that there may be some events that are outside the taxpayer's control which may mean that an asset's useful life will be curtailed (such as availability of raw materials and regulatory changes). In those scenarios, we recognised that it would appear reasonable for the Commissioner to take such factors into account when setting special depreciation rates.

We consider that a similar approach is reasonable with respect to special tax depreciation rate applications part-way through an asset's life, as in the case of the example outlined above, this is in substance no different to a second-hand purchaser who buys the asset at year eight (and is able to show that the asset will expire within three years). To not do so would create a distortion to sell and repurchase the asset to claim higher depreciation rates.

Again, we consider that no legislative amendment is required as the above view is that of the Commissioner on what estimated useful life should be in the context of special tax depreciation rate applications made part-way through the life of an asset.

Recommendation

That in setting special tax depreciation rates for assets part-way through their useful life the Commissioner should normally continue to apply a "whole of life" approach. Where, however, it is evident part-way through the useful life of an asset, that an asset will have a shorter economic life as a result of changes in regulation or the lack of availability of raw materials, then these factors should be able to be taken into account when setting a special tax depreciation rate for a particular asset.

Issue: Special tax depreciation rates for excluded depreciable property

Submission
(29W – PricewaterhouseCoopers)

Taxpayers should be permitted to apply for a special rate in respect of "excluded depreciable property".

Comment

The submission comments that there is no policy reason why the special tax depreciation rate rules should not be accessible in respect of "excluded depreciable property" (typically, assets acquired prior to 1 April 1993, the date of introduction of the current tax depreciation rules). The submission argues that this discriminates against older assets and this exclusion should not apply in circumstances where the historic depreciation rate for the property is inappropriate or non-existent.

To be excluded depreciable property, an asset must have been held by the same taxpayer since before the introduction of the current rules. Consequently, excluded depreciable property typically comprises a number of large infrastructural assets. The depreciation rates for these assets were "grandfathered" to reflect the fact that the decision to invest in these assets was made based on the tax rules that existed at the time. Also, given the unique nature of most excluded depreciable property, it would be difficult to find comparable investment undertaken under the current rules, to act as an appropriate benchmark (against which to compare historic rates).

Recommendation

That the submission be declined.

Issues: Drafting

Submission
(29W – PricewaterhouseCoopers)

The words "and include a rate determined by the Commissioner under section 91AD, 91AE or 91AJ of the Tax Administration Act 1994" do not need to be included in section EE 12(1). [Clause 19]

In relation to section 91AE(2) of the Tax Administration Act, the words "after having regard to the factors in subsection (2)" should not be removed. [Clause 93]

Comment

The submission comments that the above drafting changes are not necessary.

In relation to Clause 19 of the bill, officials consider that this is a clarification that a depreciation deduction is allowed under the general rules, but also as the result of a special tax depreciation rate and a provisional tax depreciation rate determination or where the Commissioner opts to increase the maximum value under the pooling method for depreciation.

In relation to clause 93 of the bill, officials consider that the proposed new wording of section 91AE(2) is broader in scope and offers greater flexibility to the Commissioner in considering special tax depreciation rate applications, than the wording that it replaced.

Recommendation

That the submission be declined.

OTHER

Issue: Deductibility for resource consents that are not granted or are withdrawn

Submission
(29W – PricewaterhouseCoopers)

Sections DJ 14B of the Income Tax Act 1994 and DB 13B of the Income Tax Act 2004 do not achieve the stated policy intent of allowing a deduction for costs incurred in relation to certain applications for resource consents that are not granted or are withdrawn.

Comment

The submission comments that the above sections, as enacted in the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004, are deficient in that their wording limits their application to resource consents that are themselves depreciable property rather than including a reference to the costs of a resource consent application that otherwise forms part of depreciable property. It further comments that this is contrary to the policy intent as stated in the report-back of the Finance and Expenditure Committee on the relevant legislation – to allow a deduction where a resource consent application is refused or withdrawn, which if granted, would have formed part of the cost of other depreciable property.

The submission also comments that this provision should be further extended to provide a deduction for costs that would otherwise have been tax deductible under an industry-specific provision. Examples given include the provisions relating to expenditure to prevent or combat pollution, the cost of minerals, timber and flax, and forestry expenditure.

Officials consider that the above submission raises an important shortcoming with respect to sections DJ 14B and DB 13B. It correctly points out that the policy intent was to allow a deduction for resource consent applications, which if granted, would have been depreciable both in their own right and as part of other depreciable property. An example of the latter is a consent to construct a building or other structure which is typically included in the cost of the building or structure and depreciated accordingly. The sections as currently drafted do not allow deductions for consent costs which would have been part of the cost of other depreciable property. Officials consider that given the relatively minor remedial nature of this change, an amendment in the current bill should be included to correct this discrepancy.

The other point made in submissions is in relation to consent costs, for which a deduction is allowed under specific tax rules (as opposed to the depreciation rules). The submission recommends that consents that would typically be deductible as part of other expenditure under specific tax rules should also be within the scope of sections DJ 14B and DB 13B. Officials consider that the policy intent of the relevant sections is to allow a deduction for the cost of failed or withdrawn resource consent applications, to the extent that these costs would have been allowed as deductions (either under the depreciation rules, the general tax deductibility rules or, where applicable, specific tax rules), if the application was granted. We therefore agree with this submission.

Recommendation

That the submission be accepted.

Death and asset transfers

OVERVIEW

Clauses 11, 18, 23, 26, 27, 28, 29, 31, 32, 33, 34, 35, 36, 37, 45, 47, 48, 60(5) & (12), and 100

Provisions in this bill clarify the income tax rules on transfers of assets by introducing generic rules for the treatment of "in kind" or "in specie" distributions and gifts, including transfers of assets and liabilities upon a taxpayer's death.

The changes will apply only to assets and liabilities that are in the tax base, such as buildings for which depreciation is claimed – for example, rental properties and land or shares for which the gain is taxable. The vast majority of estates will not be affected as their assets are not in the tax base.

Under the bill:

- A disposal and acquisition of a taxpayer's assets and liabilities will be deemed to occur at market value, on the day of their death.
- "In kind" distributions of assets by companies and trusts (including estates) will be treated as dispositions and acquisitions at market value.
- Gifts will be treated in the same way as "in kind" distributions.

This means that for a number of estates, there will be two market value transactions: one at the time of the taxpayer's death, and one on the subsequent distribution of the estate to beneficiaries. However, rollover relief applies to both these transfers for estates left wholly to spouses and to forestry assets where the beneficiaries are close relatives. This allows for the transfer of assets and liabilities at the book values they have for tax purposes. For simple estates when the assets are left to charity or to close relatives only, rollover relief applies to the subsequent distribution to the beneficiaries. These exceptions continue to apply where there are specific legacies to third persons of assets that are not in the tax base.

Four submissions discussed the provisions in the bill relating to death and distributions. The submissions supported the clarification of the rules, but all sought more extensive rollover relief.

As a result we recommend that financial arrangements owned by the deceased at the date of death should be excluded from the market value rule where the deceased taxpayer was a cash basis holder and the beneficiaries are related. This will reduce compliance costs and mean that the new rules will apply to even fewer estates.

SUPPORT FOR AMENDMENTS

Clause 45

Submissions

(21 – Institute of Chartered Accountants of New Zealand, 24W – Auckland Trust Special Interest Group, 29B – PricewaterhouseCoopers)

The submission supports the introduction of legislation which clarifies the treatment of property that is within the tax base on the death of a taxpayer and the distribution by the executor/administrator of that property to the beneficiaries of the estate. *(PricewaterhouseCoopers)*

The submission supports the proposals to clarify the tax treatment of death and certain other "in kind" transfers but have a number of concerns regarding the draft legislation. The Institute explicitly offered its congratulations on bringing forward the proposals. *(Institute of Chartered Accountants of New Zealand, Auckland Trust Special Interest Group)*

Recommendation

That the submissions be noted.

ROLLOVER RELIEF

Clause 45

Submission

(21 – Institute of Chartered Accountants of New Zealand, 24W – Auckland Trust Special Interest Group)

Elective rollover relief should be available at the time of transfer, provided the property would be held by the beneficiary for the same purpose as it was held by the deceased.

Comment

The Institute of Chartered Accountants of New Zealand argues that, in addition to the limited rollover relief provided in the bill, elective rollover relief is justified because:

- Death should not accelerate the creation of a taxable event when there is no amount that has been received by any party.
- Any specific concerns about assets leaving the tax base should be addressed by specifically excluding or denying the application of rollover relief when this occurs.
- There will be cases where a taxable event takes place under the proposed rules and the taxpayer will not have the cash available to pay tax and may well have to liquidate part of the asset to do so. An asset should not need to be realised to meet a tax obligation triggered by the event of death.
- The existing taxation system, with notable exceptions such as the accrual rules, does not tax on a full accrual basis, but on the basis of derivation of income. There is no good policy reason to move from that principle.
- Death is not an opportunity for tax planning or avoidance.

Officials consider that these arguments are insufficient to justify an extension of rollover relief. Extensive rollover relief would undermine the purpose of the policy clarification because of the potential for differences in the tax circumstances of the deceased and the estate/beneficiaries. It is also appropriate to finalise a taxpayer's affairs at death, including their taxation obligations.

Under the amendments the main taxation item at date of death is likely to be depreciation. Most other tax adjustments will almost always be insignificant. If the depreciation adjustment results in taxable income this indicates that depreciation deductions prior to date of death have been overclaimed. It seems entirely appropriate that there should be a depreciation adjustment at death. (Under current law, livestock and financial arrangements are already explicitly valued at market value at death.)

An elective mechanism would mean the certainty objective would not be as well addressed.

Recommendation

That the submissions be declined.

Submissions
(22 – KPMG, 29B – PricewaterhouseCoopers)

There should only be one valuation point for transfers relating to death – the date of distribution to beneficiaries.

Comment

It is appropriate to finalise a taxpayer's affairs at death, and any exclusions to that rule need to be justified. Rollover is already proposed at death for estates left to spouses who are the only beneficiaries, and for forestry assets where the beneficiary is a close relative. Officials consider that further exclusions are unjustified.

Recommendation

That the submission be declined.

Submission
(29B – PricewaterhouseCoopers)

Rollover relief should be available, both at death and upon the transfer of assets and liabilities to beneficiaries, for all assets which pass to the spouse or de facto partner of the deceased, irrespective of whether other property in the tax base passes to other beneficiaries.

Rollover relief should be available for transfers of property to beneficiaries who are close relatives or charities, regardless of whether there are other bequests of assets that are in the tax base.

Comment

The exclusions included in the bill are carefully targeted at simple estates to reduce risk to the revenue. Officials consider that further exclusions are not justified. Further, in the limited number of estates where both the spouse and other family members are beneficiaries of assets that are in the tax base, it is likely that they will be in partnership. This would be simpler to administer if the beneficiaries have the same cost base, as proposed in the bill.

Recommendation

That the submission be declined.

Submissions
(24W – Auckland Trust Special Interest Group)

Elective rollover relief should be available for resettlement of assets between family trusts.

Elective rollover relief should be available for transfers from an estate to a family trust.

Comment

Resettlements are difficult to conceptually address. Any concessionary treatment, if it can be done, would have to be carefully restricted to ensure that it is appropriate. In contrast, the proposed market value approach offers certainty and simplicity. Thus, officials believe a market value treatment is correct for the resettlement of assets between family trusts.

Recommendation

That the submissions be declined.

Submission
(22 – KPMG)

There should be only one deemed disposal for transfers relating to death where the deceased is not resident in New Zealand at the time of death – that is, the date of death.

Comment

Where the deceased is non-resident the only assets in the New Zealand tax base are those assets located in New Zealand. Further, where the deceased is non-resident, it is likely that the executors or administrators will also be non-resident.

In these circumstances, according to the submission, the distribution of the deceased's property to the executors or administrators would be at market value. However, distributions to New Zealand beneficiaries would be an undetermined value. This is not an appropriate tax treatment.

The tax treatment under the amendments is more appropriate as it offers certainty. Under the amendments, distributions to beneficiaries will generally be at market value.

Recommendation

That the submission be declined.

DE MINIMIS

Clause 45

Submission
(22 – KPMG)

A de minimis should be introduced. Estates where the value of property is below the de minimis should be excluded from the regime.

Comment

It is envisaged that the proposals will not affect the affairs of most deceased taxpayers, financial arrangements excepted. A de minimis would have little, if any practical effect.

However, there seems to be little point in requiring a typical financial arrangement (say a bank deposit) to be valued at market value where it has been issued at par and the deceased accounted for it as a cash basis holder. We therefore recommend that where the deceased was a cash basis holder and the estate also qualifies as a cash basis holder, any fixed-principal financial arrangements should be valued at face value.

Recommendation

That the submission be declined, but that an amendment be inserted to provide that where both the deceased taxpayer and the estate are cash-basis holders, fixed-principal financial arrangements will be valued at their face value, both at death and upon distribution to beneficiaries.

COST BASE FOR DEPRECIABLE PROPERTY

Clause 45

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

The cost base for depreciation for the recipient of an asset as a result of death should be clarified.

Comment

Generally, under current law (section EG 17 of the Income Tax Act 1994 [section EE 34 of the Income Tax Act 2004]) a taxpayer who acquires depreciable property from an associated person, either directly or indirectly, cannot claim more depreciation on that property than the associated person would have been able to if they had retained the property. Subject to certain exceptions, the taxpayer's depreciation base is limited to the original cost of the property incurred by the associated vendor for anti-avoidance reasons.

As death is not a planned event, where the section FI 6 rollover relief for property transferred to close relatives or charities applies, there is no concern about anti-avoidance. Therefore section EE 34 should be amended to ensure that the rollover can apply. Where the rollover does not apply, the estate should be allowed to use market value if that is considered appropriate.

Recommendation

That the submission be accepted.

USE-OF-MONEY INTEREST

Submission
(29B – PricewaterhouseCoopers)

The bill should be amended to include a discretionary power for the Commissioner to extend the period for which use-of-money interest will not apply in appropriate circumstances.

Comment

The bill already provides that use-of-money interest will not be imposed in relation to a deceased person's terminal tax liability in the year of death, provided all provisional tax instalments and terminal tax are paid by the respective dates. Further this would imply that there might also be issues with late payment penalties. After discussing this matter with the submitter, we are of the view that no further relief is warranted.

Recommendation

That the submission be declined.

APPLICATION DATE

Clause 45

Submissions
(22 – KPMG, 29B – PricewaterhouseCoopers)

Application should be deferred until 2006-07. *(KPMG)*

The new legislation should apply prospectively, and assuming the legislation is passed within the next few months, it should apply to deaths occurring on or after 1 October 2005 and distributions by executors/administrators occurring on or after 1 October 2005. *(PricewaterhouseCoopers)*

Comment

Officials agree that a prospective date would be more appropriate than the current application date of 1 April 2005, and agree that 1 October 2005 is suitable.

Recommendation

That the submissions be accepted.

PUBLICITY

Submission
(22 – KPMG)

Inland Revenue should undertake advertising/public notification of changes to the bill.

Comment

As part of the normal process for the passage of the bill, Inland Revenue will issue a *Tax Information Bulletin* on the provisions in the bill, including the death and transfers issue. A press statement was issued earlier when the policy design was completed, and publicity also surrounded the introduction of the bill.

Officials consider that no additional public notification is necessary.

Recommendation

That the submission be noted.

DRAFTING

Clause 45

Submission

(22 – KPMG)

Reference to "subsection (5)" in section FI 1(2) should be to "subsection (4)".

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Submission
(24W – Auckland Trust Special Interest Group)

Resettlements of assets from one family trust to another do not appear to be caught by the draft legislation they are effected:

- through a power of advancement contained in the trust deed;
- through a resettlement clause contained in a trust deed; and
- under the powers contained in section 41 of the Trustees Act 1956.

It seems logical that all resettlements should be subject to the new rules.

Comment

The policy intention is that these transactions should be caught by the new rules. Through oversight they are not reflected in the bill.

Recommendation

That the submission be accepted.

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

Section FI 2 (Disposal and resulting acquisition of property treated as occurring at market value) should be amended to read "A transaction to which this subsection applies is to be treated as …"

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

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

Section FI 3 (Market value of property to recipient) should be deleted.

Comment

The section usefully clarifies that the market value to the transferee should be the same as the market value of the property to the transferor. However, section FI 3 should be amalgamated with section FI 2.

Recommendation

That the submission be declined, but that sections FI 2 and FI 3 should be amalgamated.

Submission
(21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG, 24W – Auckland Trust Special Interest Group, 29B – PricewaterhouseCoopers)

Section FI 5(1) (Rollover for a spouse or de facto partner who are sole beneficiaries of the estate) should be amended to apply to both the transfer to the executor and the distribution to the spouse or de facto partner. *(Institute of Chartered Accountants of New Zealand, Auckland Trust Special Interest Group)*

The word "not" in the third line of subsection FI 5(2) should be removed. *(Auckland Trust Special Interest Group, PricewaterhouseCoopers)*

It is not clear that section FI 5 (Rollover for spouse or de facto partner who are sole beneficiaries of the estate) achieves its objective. *(KPMG)*

Consideration should be given to whether the words "a beneficiary of the deceased" in the proposed section FI 5(1)(b) are redundant and should be removed. *(PricewaterhouseCoopers)*

Comment

Section FI 5 is to be redrafted.

Recommendation

That the submissions be noted.

Submissions
(22 – KPMG, 24W – Auckland Trust Special Interest Group,
29B – PricewaterhouseCoopers)

It is not clear that the drafting of section FI 6 (Rollover for close relatives) achieves its objectives. *(KPMG)*

The current wording of section FI 6 is unnecessarily complex.
(PricewaterhouseCoopers)

The words "other than" in section FI 6(2) (Rollover for close relatives) should be replaced by "being". *(Auckland Trust Special Interest Group)*

The proposed section FI 6(1)(b) should be redrafted to apply only to property that is within the tax base. As it is currently drafted the subsection refers to all property. *(PricewaterhouseCoopers)*

Comment

Section FI 6 is to be redrafted.

Recommendation

That the submissions be noted.

Submission
(29B – PricewaterhouseCoopers)

The term "FIF' in section FI 6(1)(a)(i) should be replaced with "foreign investment fund".

Comment

FIF is a defined term in section OB 1 of the Income Tax Act 2004. It means a foreign investment fund as defined in section EX 29 (Meaning of FIF).

Recommendation

That the submission be declined.

Submission
(24W – Auckland Trust Special Interest Group)

Reference to section CW 36 in sections FI 6, (Rollover for close relatives and charities) and FI 11, FI 12 and FI 13 (Transitional provisions) should be extended to section CW 34 and CW 35.

Comment

Section FI 6 provides rollover relief for distributions to beneficiaries who are close relatives or charities. Section CW 36 refers to amounts of income derived by a deceased's executor or administrator from assets of the estate that have been left in trust for charitable purposes which, if the income had been derived by the charity directly, would have been exempt income. In order to qualify under section CW 36, income of the charity needs to be exempt from income tax under sections CW 34 and CW 35.

References to sections CW 34 and CW 35 in section FI 6 are unnecessary, because including them would not extend the scope of that section.

Similarly, sections FI 11, FI 12 and FI 13 do not need to refer to sections CW 34 and CW 35.

Recommendation

That the submission be declined.

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

In section FI 6(2)(c) (Rollover for close relatives) the words "that is practicable" be replaced by "to the maximum extent allowable under the terms of the will and in compliance with trustee law".

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Submission
(21 – Institute of Chartered Accountants of New Zealand, 24W – Auckland Trust Special Interest Group, 29B – PricewaterhouseCoopers)

Sections FI 7 (Rollover for forestry) and FI 8 (10-year rule for property purchased on capital account) should be amended to apply to transfers to executors and administrators and distributions to beneficiaries.

Comment

Officials agree with the submissions.

Recommendation

That the submissions be accepted.

Submission
(29B – PricewaterhouseCoopers)

The proposed sections FI 7 & FI 8 should be expanded to apply to property that is "timber", "standing timber" and "a right to take timber".

Comment

Officials agree with the recommendation.

Recommendation

That the submission be accepted.

Submission
(24W – Auckland Trust Special Interest Group)

Section F10 (Relationship of subpart FI to unexpired prepayments) should be rewritten to make it clear that:

- the unexpired expenditure at the date of death must be included in the tax return of the deceased person for the period up to the date of death;
- the administrator, executors or trustees of the estate can deduct the amount included in the tax return of the deceased person for the period up to the date of death;
- the administrator, executors or trustees of the estate must continue to account for the unexpired expenditure as if they and the deceased person were the same taxpayer;
- the section also applies to all other "in kind" transfers of assets.

Comment

Officials agree that some clarification of section FI 10 is appropriate.

Recommendation

That the submission be accepted.

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

Section FI 11(1) (Transitional provision relating to death occurring before the commencement of 2005-06 income year) should be amended to remove the words "that involves the disposal of property to an administrator, or executor or trustee on the death of a person". The section should simply refer to "a transaction that section FI 1(3)(d) applies to".

The same submission is made in relation to sections FI 12 and FI 13.

Comment

As section FI 1(3)(d) comes into force after the commencement of the 2005-06 income year it cannot apply to deaths occurring before the commencement of that income year. Accordingly, these changes should not be made to the proposed new sections FI 11, 12 and 13.

Recommendation

That the submission be declined.

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

In section FI 13, references to 2004-05 should be to 2005-06.

Comment

Section FI 13 has now been deleted.

Imputation credit shopping

OVERVIEW

The dividend and imputation rules are being introduced to ensure that in certain circumstances, when a company is sold, the benefits of any prepaid tax will stay with the original group that paid the tax and cannot be refunded. The changes have been designed as a revenue protection measure.

A number of submissions argued that the amendments were not necessary because the outcome being achieved was conceptually correct. Officials disagree with this and still believe that the specifically targeted proposals are necessary.

THAT THE MEASURES IN THE BILL TO COUNTER IMPUTATION CREDIT SHOPPING ARE UNNECESSARY OR INAPPROPRIATE

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG, 29W – PricewaterhouseCoopers)

That the proposed amendments are unnecessary if the government reconsiders the policy intent of the imputation rules that underpin the proposal and shifts the focus from an individual taxpayer perspective to a wider economic basis. *(Institute of Chartered Accountants of New Zealand)*

That the legislation supporting imputation credit transfer proposals should be withdrawn. Instead, legislation should be enacted that specifically allows these arrangements in the circumstances when it is clear that the imputation rules are actually giving rise to over-taxation. *(KPMG)*

That the government should not be promoting tax policy that obliges taxpayers to pay tax when they are making losses. *(KPMG)*

The government should introduce rules to allow corporates who are in loss and who have a policy of fully imputing dividends, and who can demonstrate a history of fully imputing dividends, to be able to purchase imputation credits from other fully taxable taxpayers. *(KPMG)*

Imputation credit shopping transactions appear to be within the ambit of existing anti-avoidance provisions, therefore the proposed measures are unnecessary and should be withdrawn. *(PricewaterhouseCoopers)*

Comment

To explicitly allow companies to purchase imputation credits from other companies is inconsistent with the underlying tenets of imputation.

The imputation credit shopping provisions are designed to buttress the existing provisions within the imputation rules, which include anti-avoidance rules, to ensure that imputation credits are only for the benefit of the shareholders that have borne the tax. This is an underlying principle of imputation.

While it is true that with measures to reduce compliance costs, such as the 66% continuity and notional single person rules, this may not be the outcome in every case, the imputation rules do aim to ensure that this principle is generally upheld.

Currently companies who are in a loss-making situation are only required to make payments of income tax to the extent that they have attached imputation credits to dividends paid to the shareholders. As far as the tax base is concerned, the prepayment of income tax simply offsets the reduction in tax paid by their shareholders that have received the imputation credits. The prepayment of income tax is merely the consequence of a choice, made by the loss making company, to pay imputed dividends to its shareholders.

Recommendation

That the submissions be declined

THAT THE MEASURES PREVENTING SHARE SPLITS FROM BECOMING TAXABLE BONUS ISSUES ARE INAPPROPRIATE AND SHOULD NOT PROCEED

Submission
(17W – Ernst & Young, 29 – PricewaterhouseCoopers, 21 – Institute of Chartered Accountants of New Zealand)

The provisions that prevent share splits from being taxable bonus issues would legislate against a widely accepted means of utilising imputation credits in circumstances where a cash dividend is inappropriate or otherwise not possible. The ability to attach imputation credits to a taxable bonus issue is an important feature of the imputation system. It allows imputation credits to be moved within a group of companies or provided to shareholders where there are insufficient cash reserves to pay a dividend.

Comment

Officials have some sympathy for the views expressed in these submissions. Before the imputation credit shopping transactions came to light, the taxable bonus issue appears to have been used to facilitate the movement of imputation credits up a chain of companies or used as a mechanism to pass the benefit of imputation credits to shareholders before a continuity breach.

While the outcomes may not have been inappropriate from a policy viewpoint, the original policy for share splits set out in the 1993 discussion document *Taxation of Company Law Reform* was that they were to be synonymous with non-taxable bonus issues.

As share splits have been used as a method of conveying imputation credits within imputation credit shopping transactions, it has proved necessary to revisit this situation.

Since the introduction of imputation grouping in 2003, officials no longer see it necessary that a mechanism is necessary to pass imputation credits up chains of wholly owned companies, particularly as such a mechanism is also used in the imputation credit shopping transactions.

Officials do not, however, at this juncture see any mischief in allowing the status quo to prevail with regard to the passing of imputation credits to shareholders that are not subject to the intercorporate dividend exemption.

Recommendation

That the submission be accepted with regard to taxable bonus issues that are not exempt intercorporate dividends.

ABILITY TO MAKE TAXABLE BONUS ISSUES IN EXCESS OF RESERVES CAPITALISED WHICH COULD HAVE INAPPROPRIATE OUTCOMES

Submission
(Matter raised by officials)

Although the proposed legislation is only targeted at share splits, it is still possible under existing legislation for taxpayers to elect that a taxable bonus issue has a value in excess of the reserves capitalised.

Comment

As with the previous situation, where this is used solely as a mechanism for moving imputation credits up a chain of companies or the resulting taxable bonus issue is a taxable dividend in the hands of the recipient, the outcome does not appear to be offensive from a policy point of view.

However, officials are concerned that this mechanism could become a substitute for the current mechanism of using share splits in imputation credit shopping transactions.

Our view is that the correct outcome is the same as the previous submission, and for taxable bonus issues that are exempt dividends in the hands of the shareholder the value should be restricted to the value of the reserves capitalised.

However, as this is not in the bill and there is insufficient time for the select committee to call for submissions, officials do not recommend that amendments be made at this stage.

In the event that this mechanism is used inappropriately in transactions such as the current imputation credit shopping ones, officials will recommend to the government that it seeks to also close this mechanism. In such circumstances, the appropriate application date recommended is likely to be retrospective to the 16 November 2004, for consistency with the current proposed changes.

Recommendation

That the submission be noted.

THE PROPOSED ANTI-IMPUTATION CREDIT SHOPPING RULES IN SECTIONS ME 9B AND ME 9C SHOULD ONLY APPLY WHEN THE DOMINANT PURPOSE IS TO OBTAIN AN IMPUTATION OR REFUND ADVANTAGE

Submission

(17W – Ernst & Young)

The provisions should be expressed to apply where the dominant purpose of the transfer of the leaving/joining company is to obtain an imputation advantage or to allow a refund to be paid or transferred. Such criterion would not prevent the targeting desired as a matter of policy but would ensure that other companies are not unwittingly affected by these provisions or their penal consequences and that the latter are not required to invest time and cost in determining the possible application or otherwise of the new provisions.

Comment

Officials agree that targeting of these provisions is appropriate as they do introduce additional complexity to the legislation. The current targeting is aimed at groups of companies that have accumulated losses in excess of $1 million in the previous income year. This measure was chosen because it is objective and easily measurable.

Consequently we do not support a subjective "dominant purpose" test as a possible method of targeting the provisions. Such a test is neither objective nor easily measurable and would be more difficult to administer and comply with.

Recommendation

That the submission be declined.

ANY PROPOSED FURTHER INCOME TAX PAYABLE SHOULD BE CREDITABLE TO FUTURE INCOME TAX PAYMENTS AND TO THE IMPUTATION CREDIT ACCOUNT

Submission
(17W – Ernst & Young)

There is no valid reason why such payments should not be treated as credits in the imputation credit account or as available to meet any future income-tax liabilities. As far as any targeted mischief is concerned, the position will have been effectively reversed and the companies should be in no worse position than if they were in before with regard to imputation credit account balances or prepaid tax.

Comment

It is important to note that such a payment is effectively optional as it is possible for the leaving company to elect to transfer a debit balance or a prepayment of tax to the extent the credit balance of the imputation credit account is exceeded. Officials expect that any payment of such a tax will be rare and very much the exception rather than the rule.

Officials agree that any payments of further income tax by the leaving company should create imputation credits for the leaving company. This is particularly significant as the most likely scenario for the further income tax to be paid is when a company would otherwise leave the group with a debit in its imputation credit account.

Officials, however, do not agree that it is appropriate that payments of further income tax should be creditable against future income tax liabilities of the acquiring group.

The further payment of tax is made, in the case of a debit balance in the imputation credit account, because imputation credits have been used by the leaving group's shareholders in excess of the tax paid by its shareholders. With creditability, the further payment of tax would be used by shareholders that are different from the ones that received the imputation credits.

Officials expect that it is unlikely that a further payment of tax will be made where there is an amount in the account with the Commissioner. In this case, it is appropriate that this amount be used to offset the further payment of tax as it simply represents the tax benefit received by the leaving company's shareholders before it left the original wholly owned group.

This is to be contrasted with the more general case of further income tax which is creditable against other income tax liabilities. This is appropriate as the shareholders that have had the benefit of the imputation credits have paid the further income tax and will offset it against future income tax liabilities will be materially the same.

Recommendation

That the submission be accepted with regard to the creation of imputation credits but otherwise declined.

THAT CLEAR RULES ON THE TIMING AND FORM OF ELECTIONS AVAILABLE UNDER PROPOSED ME 9B ARE REQUIRED

Submission
(21 – Institute of Chartered Accountants of New Zealand, 17W – Ernst & Young)

The proposed legislation is currently deficient in that it allows companies to elect to transfer ICA debit balances or prepaid tax to the extent a credit balance in the imputation credit account is exceeded but gives no guidance on the acceptable approach.

Comment

Officials agree that the legislation is deficient in the manner set out in the submissions. We recommend that the process be as follows:

- Furnished in "a form the Commissioner may require".
- Elections must be made by the leaving company, with the receiving company also notifying the CIR that they agree to receive the debit balance or the amount in the "account with the CIR".
- Elections should be made within 20 working days of the company leaving the group.
- Late and revised elections may be accepted at the Commissioner's discretion.

Recommendation

That the submission be accepted.

DEFINITION OF ULTIMATE OWNERS

Submission
(17W – Ernst & Young)

The definition of ultimate owners should be replaced with a simpler means of determining whether there has been a critical change of ownership and grouping – preferably by reference to sections OD 3 and 4.

Comment

Officials have some sympathy for the view expressed in the submission, as legal tests to ascertain ultimate ownership are complex regardless of the test chosen.

It may be that the test proposed in the submission is superior to the one currently in the bill but officials have had insufficient time to properly analyse the differences.

At this point officials note the submission and at a future stage may consider an amendment.

Recommendation

That the submission be declined but possibly considered at a future time.

TECHNICAL ISSUES

Submissions
(Matter raised by officials)

Further income tax within sections ME 9B and ME 9C should be renamed as unlike further income tax generally, this payment of tax is final and not creditable against other tax liabilities.

The term “account with the Commissioner” be clarified to apply only to payments of income tax and provisional tax.

Voluntary tax within the provisional tax rules be amended to include payments of tax when the taxpayer is not a provisional taxpayer rather than the proposed addition to imputation credits.

Sections ME 9B and ME 9C should also apply to consolidated imputation groups.

The restrictions to taxable bonus issues should also include subdivisions or the equivalent made under other parts of the Companies Act 1993.

Recommendation

That the submissions be accepted.

DRAFTING ISSUES

Submissions
(17W – Ernst & Young, 21 – Institute of Chartered Accountants of New Zealand, Matter raised by officials)

The imputation credit shopping measures should be clarified to ensure that they only apply to companies leaving or joining after the date of introduction. *(Ernst & Young, Institute of Chartered Accountants of New Zealand)*

The reference to debits "recorded" should be a reference to debits "arising" during the relevant period. *(Ernst & Young)*

The reference to "tax year" in sections ME 9B and ME 9C proposed to be inserted in the ITA 1994 should be changed to "year" as "tax year" is not a defined term for the purposes of the ITA 1994. *(Ernst & Young)*

Section ME 9C (1) – this should only apply where the former group has losses in excess of $1 million. *(Matter raised by officials)*

Section ME 5(2)(fb) – "credit" should be "debit" as it refers to ME 5(1)(fb) which is a debit. *(Matter raised by officials)*

Sections ME 9B(3) and ME 9C(4) – after excess tax should have inserted "or has an amount in a tax pooling account" or a similar type of expression. *(Matter raised by officials)*

Recommendation

That the submissions be accepted.

Privilege – right of non-disclosure for tax advice

OVERVIEW

Clauses 82, 83, 84 and 89

The privilege, or non-disclosure right, will protect tax advice documents from disclosure to Inland Revenue. To qualify for the privilege, a document (the tax advice document) will need to be created by the taxpayer for the main purpose of instructing a tax advisor, or by the tax advisor if the document was brought into existence for the main purpose of giving tax advice, on tax laws about the taxpayer's own affairs. In each case, the tax advisor will need to be a member of an approved advisor group.

The Commissioner of Inland Revenue will have a discretion to allow bodies to be approved as an approved advisor group. It is expected that the Institute of Chartered Accountants of New Zealand will apply. Other organisations may also apply, and approval will depend upon those organisations fulfilling the requirements of the definition of an approved advisor group, that is a group whose members have a significant function of providing tax advice, and are subject to a professional code of conduct and disciplinary processes. The professional code of conduct and disciplinary processes are considered to be important factors in countering any abuse of the privilege.

The privilege will be subject to restrictions. Certain information (tax contextual information) included in advice given to clients will have to be disclosed, such as factual information, information that supports financial statements and tax returns, and non-tax advice such as valuation, investment, and debt collection advice. This information will need to be disclosed in the form of a statutory declaration. Advice provided for the purpose of committing, or promoting or assisting the committing of an illegal or wrongful act will not be covered by the privilege.

Inland Revenue will publish detailed guidelines on how the provisions in the bill should be interpreted.

Eleven submissions were made on the clauses in the bill relating to the privilege. Seven of those explicitly supported the privilege, although two considered the legislative provisions were overly complex.

SUPPORT FOR THE AMENDMENTS

Submissions
(6W – Taylor McLachlan Limited, 15W – Business New Zealand, 17W – Ernst & Young, 23 – Russell McVeagh, 30W – Deloitte)

The amendment is supported because it addresses an inconsistency in the current law whereby taxation advice obtained from a lawyer may be protected from disclosure to Inland Revenue but the same advice if received from a tax advisor other than a lawyer would not enjoy that protection. *(Taylor McLachlan Limited, Business New Zealand, Ernst & Young, Deloitte)*

The introduction of a statutory non-disclosure right for tax advice provided by approved tax advisors is supported. In the interests of having taxpayers comply with their tax obligations, there should be no barriers to taxpayers obtaining professional advice that may inhibit the provision of confidential information regarding their affairs. The reforms in this area are therefore to be welcomed as a step that should promote voluntary compliance by taxpayers with their tax obligations. *(Russell McVeagh)*

Comment

These submissions reflect the policy intention of the amendments.

Recommendation

That the submissions be noted.

LEGAL PROFESSIONAL PRIVILEGE

Submissions
(15W – Business New Zealand, 22 – KPMG, 30W – Deloitte)

In place of the current proposals existing section 20 of the Tax Administration Act 1994 should be amended to provide a client of a tax advisor (being a member of an approved advisor group) with the same privilege (in relation to tax advice) as clients of legal practitioners. *(Deloitte)*

Statutory privilege for tax advice provided by accountants should also include factual background matters. *(Business New Zealand, KPMG)*

Comment

Legal practitioner privilege extends, for the purposes of the Revenue Acts, to any information, book or document brought into existence as a confidential communication between a legal practitioner and their client. It is broader than the privilege that is being introduced for non-lawyers as it extends to both opinion and fact.

Officials do not support extending legal professional privilege to non-lawyers because it could harm the tax base. For example, much relevant and useful documentation about taxpayers' affairs is held by accountants because of the very central and important role that accountants play in the administration of the tax system and in the conduct of their clients' business affairs. Accountants are the largest single group of tax agents and advisors and are responsible for a very large percentage of tax returns filed with Inland Revenue. If the scope of the proposed accountants' privilege is extended in the manner suggested, more information would be protected by privilege and the effect could be a significant loss of government revenue.

Recommendation

That the submissions be declined.

COMPLEXITY

Submission
(29W – PricewaterhouseCoopers, 21 – Institute of Chartered Accountants of New Zealand)

As currently drafted, the provisions are unnecessarily complex. In terms of both structure and complexity the provisions should be re-drafted so that they are similar to section 20 of the Tax Administration Act 1994 (for legal professional privilege). Consideration should be given to redrafting the provisions so that they set out general principles only, as this would achieve the same result.

Comment

It is agreed that complexity could be reduced in some areas and a number of the recommendations that follow aim to achieve this. Following section 20 would not generally assist as most of the complexity is around the provision of "tax contextual information" which is not a requirement under section 20.

Recommendation

That the submission be noted.

WHETHER STATUTORY DECLARATIONS SHOULD BE AUTOMATIC

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

Statutory declarations should not be required automatically as to do so would impose onerous compliance costs on taxpayers and their advisors.

Comment

Under the amendment as introduced, a tax contextual information statutory declaration must be provided within the same timeframe as the claim for privilege. Officials agree that a "two-step" process should instead be introduced to reduce compliance costs.

Under the two-step approach, a request for information by Inland Revenue will be accompanied by a request for a tax contextual information statutory declaration only if the Commissioner considers this is necessary for proper administration of the revenue. Guidelines will be issued to clarify the circumstances under which such a request would be made.

In other circumstances where a claim for privilege is made, unprivileged material will initially be provided, and Inland Revenue will review this material to determine whether sufficient information has been provided to finalise the investigation. If not, a tax contextual information statutory declaration will be requested at that stage.

Recommendation

That the submission be accepted.

TAX ADVISOR

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 28A – Corporate Taxpayers Group, 29W – PricewaterhouseCoopers, 30W – Deloitte)

The definition of "tax advisor" should include in-house tax advisors.

Comment

Currently, the definition of "tax advisor" does not exclude in-house advisors. Accordingly, a change in law is unnecessary.

The *Tax Information Bulletin* that is issued when the bill is enacted, and Inland Revenue guidelines will make it clear that requests for tax advice and tax advice provided by in-house advisors will qualify for the privilege.

Recommendation

That the submissions be noted.

Submissions
(6W – Taylor McLachlan Limited, 21 – Institute of Chartered Accountants of New Zealand, 28A – Corporate Taxpayers Group, 29W – PricewaterhouseCoopers, 30W – Deloitte)

The definition of "tax advisor" contained in proposed section 20B(4) should be amended so that there is no requirement that the person has a significant function of giving tax advice. Section 20B(4)(b) should be deleted. *(Institute of Chartered Accountants of New Zealand, Corporate Taxpayers Group, PricewaterhouseCoopers, Deloitte)*

The meaning of "a significant function of giving advice on the operation and effect of tax laws" should be clarified. *(Taylor McLachlan Limited)*

Comment

It should be sufficient for a tax advisor to be part of an "approved advisor group" and subject to a code of conduct and disciplinary process. Public practitioners or others that do not provide tax advice on a regular basis should be covered. Officials now recognise that the requirement to meet the significant function test would cause difficulties in practice.

Recommendation

That the submissions be accepted.

Submission
(29W – PricewaterhouseCoopers)

If the above submission is not accepted, the requirement in section 20B(4)(c) that the tax advisor be a natural person who is subject to a professional code of conduct and disciplinary process should instead be removed.

Comment

If the recommendation for the submission relating to section 20(4)(b) is accepted, this submission will not need to be addressed.

Recommendation

That the submission be declined.

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG, 29W – PricewaterhouseCoopers, 30W – Deloitte)

The bill should be amended to clarify the appropriate treatment of non-member partners in a chartered accountancy firm who are subject to the Institute's professional code of conduct in giving tax advice and are subject to the Institute's disciplinary process in giving that advice. These non-member partners should be treated as part of the approved advisor group.

Comment

Officials agree that these partners should qualify as tax advisors.

Recommendation

That the submissions be accepted.

Submission
(6W – Taylor McLachlan Limited, 17W – Ernst & Young, 21 – Institute of Chartered Accountants of New Zealand)

The bill should be amended to clarify the appropriate treatment of employees of a chartered accountancy firm from other professional disciplines that are authorised to sign tax advice for that firm. A member partner (or director) of the chartered accountancy firm should be allowed to make a statutory declaration. In such cases the advice would be covered by the Institute's ethical standards (because the member partner/director would be held responsible), although the advisor may not be a member. *(Institute of Chartered Accountants of New Zealand)*

The proposed definitions of “tax advisor” and “approved advisor group” should be amended to clarify that tax advisors providing tax advice as employees, contractors or through limited liability companies or trusts are included. *(Taylor McLachlan Limited, Ernst & Young)*

The definition of “tax advisor” should be amended to account for incorporated professional practices. *(Taylor McLachlan Ltd)*

Comment

Chartered accountancy firms employ staff from other professional disciplines (for example, lawyers and economists). In some instances more senior employees (senior managers, associates and principals) may be authorised to sign tax opinions for the chartered accountancy firm.

Under the bill the Commissioner would have discretion to allow the New Zealand Law Society to become an approved advisor group in order for an employee of the chartered accountancy firm who is a lawyer to qualify as a “tax advisor”.

The position with economists is less clear.

It is the view of officials that the ability to claim the right of non-disclosure should be limited to persons who are themselves subject to the disciplinary rules of the approved body. This would include employees who are members. However, for non-member employees this may mean that the claim and any related statutory declaration must be completed by a partner or employee who is a member of an approved group or subject to the group’s rules.

Similar considerations should apply when a chartered accountancy firm operates through a limited liability company or trust. A principal of the firm who is a member of an approved group or subject to the group’s rules will be able to claim the privilege.

Under this approach there will be no need for the definition of “tax advisor” to be amended to account for incorporated professional practices.

Recommendation

That the submissions be noted.

Submission
(3W – David Deck, Public Accountant)

The requirement that, to qualify for the privilege, a person will need to be a client of a tax advisor who is a member of a group or organisation approved by the CIR goes against section 32 of the Institute of Chartered Accountants of New Zealand Act. That Act provides that any person who is suitably qualified may act as an accountant. Another definition could be: any person that has been accepted by Inland Revenue as a tax agent.

Comment

Abuse of the privilege could lead to serious loss to the government revenue, so the reliance on an approved advisor group's code of conduct and disciplinary procedures is an important element of the privilege. Not all tax agents are subject to such measures. Officials consider, therefore, that no change should be made.

Recommendation

That the submission be declined.

Submissions
(28A – Corporate Taxpayers Group, 29W – PricewaterhouseCoopers, 30W – Deloitte)

A document should be eligible to be a "tax advice document" not only where the document is created for the main purpose of giving instructions and requesting or providing advice, but also to the extent that the document has been created for the purpose of providing instructions or requesting or providing advice on the operation and effect of tax laws. *(PricewaterhouseCoopers)*

A document should be eligible to be a "tax advice document" for a person if it was created for the purpose of giving to the person advice about the operation and effect of tax laws, as long as that purpose was not a minor or incidental purpose. *(Corporate Taxpayers Group, Deloitte)*

Comment

The policy intention is that privileged documents should be created for the main purpose of giving instructions or providing advice. If this is not the case, the document will be primarily factual and Inland Revenue should be able to access the relevant factual information. Removing the "main purpose" test would significantly widen the scope of the privilege, and could create a revenue risk for the government.

Recommendation

That the submissions be declined.

Submission
(28A – Corporate Taxpayers Group)

As long as a document is created in order to provide a record of tax advice given by the tax advisor then it should be eligible to be a tax advice document for the purposes of section 20B(2)(a)(ii).

Comment

Officials agree that records of advice should be eligible for the privilege and the legislation should be clarified accordingly.

Recommendation

That the submission be accepted.

Submission
(28A – Corporate Taxpayers Group)

A document that is created in order to record the research and analysis for the purpose of the tax advice given by the tax advisor should be eligible to be a tax advice document for the purposes of section 20B(2)(a)(ii).

Comment

Under existing protocols access to this type of information would be requested only after Inland Revenue had attempted to obtain the information required from the taxpayer. However, officials agree that research papers for the purpose of giving the advice should be covered by the new non-disclosure right.

Recommendation

That the submission be accepted.

Submission
(6W – Taylor McLachlan Ltd, 17W – Ernst & Young)

The legislation should also clarify that documents may be included as "tax advice documents" where they are created wholly or partly by employees or contractors of approved tax advisors who may not be individually bound by a professional code of conduct or disciplinary process because, for instance, they have not yet been admitted as members of a relevant professional society or institute.

Comment

In order to qualify for the privilege, a document must be a "tax advice document", that is, it must be prepared by a "tax advisor" who is a member of an approved advisor group. Under the bill, therefore, a document that contains tax advice but is prepared by an employee who is not a member of an approved advisor group would not be eligible for the privilege.

This is not the intended outcome. Where an employee does not satisfy the definition of tax advisor, a partner of the firm could be expected to be able to claim the privilege and make the tax contextual information statutory declaration on the employee's behalf. The definition of "tax advice document" should be amended so that tax advice prepared by employees who are not members of an approved advisor group can qualify for the privilege.

Recommendation

That the submission be accepted.

TAX ADVICE DOCUMENTS GIVEN TO OTHER PERSONS

Submissions
(6W – Taylor McLachlan Limited, 28A – Corporate Taxpayers Group, 30W – Deloitte)

A document should be eligible to be a "tax advice document" for a person if the advice about the operation and effect of tax laws is given to the person or to another person pursuant to instructions from the first person. *(Corporate Taxpayers Group)*

A document should be eligible to be a "tax advice document" for a person if the advice is about the operation and effect of tax laws, irrespective of whether the advice is given to the person or to persons associated or unassociated with the person. *(Corporate Taxpayers Group)*

The proposed sections do not appear to provide protection to tax advice given to an agent of the taxpayer in relation to the taxpayer's taxation affairs. Provision should be made for protection of tax advice documents provided to agents of the taxpayer. *(Taylor McLachlan Limited)*

The definition of a tax advice document should include one or more associated persons in the category of persons who have the right to non-disclosure of tax advice. In practice, a document may record tax advice for one or more members of a group of companies. Members of a group of companies should have the same rights as "a person" otherwise each member of the group will need to replicate the expense of giving a separate instruction to the tax advisor. *(Deloitte)*

Comment

The policy intention is that the privilege should apply to confidential communications. It is not appropriate that the privilege should apply to documents that the taxpayer has allowed to be disseminated widely. Officials consider that the provisions in the bill need to be clarified on the issue of confidentiality, and a recommendation to this effect is made below under the heading *Third Parties.*

However, we consider that the privilege should apply where the document has been provided to a taxpayer's agent or an associated person of the taxpayer. Therefore, the privilege should not apply if the document is provided to unassociated parties.

Recommendation

That the submission be accepted in part. The privilege should apply if a document is provided to an agent or associated person of the taxpayer.

TAX CONTEXTUAL INFORMATION

Submissions
(22 – KPMG, 28A – Corporate Taxpayers Group, 30W – Deloitte)

Delete the definition in new section 20F(3) (tax contextual information) and replace the definition to include reference to material facts or assumptions relating to a transaction which has taken place. *(Deloitte)*

Section 20F(3)(a) and (b) (requirements to disclose a fact, assumption or transaction step relating to a transaction that has occurred or been postulated) should be deleted. *(Corporate Taxpayers Group, KPMG)*

Comment

The policy intention is that tax contextual information should include transaction steps and assumptions which are included in the communication to support the actual transaction entered into by the taxpayer, or a similar transaction, being investigated by Inland Revenue. The intention is to access the factual information that formed the basis of the advice.

In some cases the advisor may not be aware if the transaction advised on is implemented, or if it was, exactly how it was implemented.

Accepting the submission could, therefore, undermine Inland Revenue's entitlement to factual information and is not recommended.

Recommendation

That the submissions be declined.

Submission
(28A – Corporate Taxpayers Group)

If the above submission is not accepted, the legislation should be clarified so that tax contextual information is limited to such information that is stated in the tax advice document.

Comment

The policy intention is that tax contextual information should be limited to that contained in a document. This will be clarified in guidelines. Officials consider that no change to the legislation is required.

Recommendation

That the submission be noted.

Submissions
(21 – Institute of Chartered Accountants of New Zealand)

Section 20F(3)(a) and (b) should be amended so that assumptions and transaction steps postulated by the person creating the tax advice document are not always "tax contextual information". The tax advisor should be entitled to use professional judgement about whether facts or assumptions postulated in creating tax advice are relevant as "tax contextual information".

Comment

There is no valid policy reason for the factual content of communications between taxpayers and their advisors to be confidential because taxpayers have an obligation to provide factual information to Inland Revenue.

Further, the definition of "tax contextual information" must cater for a variety of situations in which Inland Revenue will be seeking factual information about actual transactions. One such situation could be where a tax advisor provided advice on an anticipated transaction, but was no longer acting for the taxpayer at the time the transaction took place, and has no real knowledge of how the advice was implemented. Without information about how the advice was implemented, it could be difficult for the tax advisor to reach a professional judgement about the facts and assumptions that are relevant.

Recommendation

That the submission be declined.

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG,
29W – PricewaterhouseCoopers)

The disclosure requirements, as currently drafted, are unduly restrictive. The provisions should be amended to clarify that tax contextual information does not need to be provided verbatim, but may be based on the understanding of the tax advisor.
(Institute of Chartered Accountants of New Zealand, PricewaterhouseCoopers)

Section 20F(4) is unclear to exactly what is being sworn. *(KPMG)*

Comment

Verbatim recording of factual information is not required. It is the tax advisor's understanding of a transaction that should be required. The legislation will be amended to clarify this, but will not preclude the advisor providing verbatim extracts if, in their view, this is the best representation of the tax contextual information.

This will clarify the application of section 20F(4).

Recommendation

That the submissions be accepted.

Submission
(22 – KPMG)

A tax advisor should not be barred from making a statutory declaration or, if they are, it should not be because of a conviction under the offence provisions in section 20F(5). These exclusions create a very powerful opportunity for the Commissioner to threaten prosecution under any one of those provisions, knowing what effect that would have on a tax advisor.

By imposing such a sanction the taxpayer will be barred from claiming privilege if their tax advisor is barred from making the statutory declaration.

Comment

Officials consider that this sanction is necessary to address any serious abuse of the privilege.

Taking prosecution action is likely to be a last resort for Inland Revenue. Generally, to gain access to information that was withheld but which Inland Revenue considered was not privileged, a court order for the production of relevant information under section 17A of the Tax Administration Act 1994 would be sought. The bill allows the District Court to determine whether or not the information is privileged.

Further, there is no requirement in the law for the tax advisor who prepared the tax advice to be the same tax advisor who prepares the statutory declaration. Therefore if the tax advisor who prepared the tax advice is barred from making a statutory declaration the taxpayer would not lose their right to the privilege. Another tax advisor could make the statutory declaration.

Recommendation

That the submission be declined.

Submission
(30W – Deloitte)

The time limits (in section 20F(2)) to disclose tax contextual information should be periods of at least 28 days, giving the Commissioner discretion to extend such periods on the written request of the information-holder.

Comment

The draft legislation specifies a number of time limits, depending upon the provision under which information is requested. The Commissioner has discretion to extend the time limit where appropriate. Officials consider no change is warranted.

Recommendation

That the submission be declined.

Submission
(6W – Taylor McLachlan Limited)

The requirements of proposed section 20F(2)(a) (time limit for disclosure of tax contextual information where the Commissioner accesses premises to obtain information or removes and copies documents) are impractical. We consider that a set period of five working days from the time the Commissioner requests disclosure should be allowed to provide the information required to support a claim that a document is a tax-advice document, with the Commissioner retaining the discretion to allow a later date.

Comment

The proposed two-step process will generally not apply to these requests, because the Commissioner will have discretion to request an earlier tax contextual information statutory declaration where it is necessary for the proper administration of the revenue. In the limited circumstances where the Commissioner finds it necessary to access premises to obtain information, production of the tax contextual information should occur within a tight timeframe.

However, the provision gives suitable flexibility for the Commissioner to agree a later date for obtaining the information. Officials consider that no change is warranted.

Recommendation

That the submission be declined.

ILLEGAL OR WRONGFUL ACTS

Submissions
(21 – Institute of Chartered Accountants of New Zealand,
29W – PricewaterhouseCoopers)

Section 20B(2)(b) dealing with documents created in relation to illegal or wrongful acts should be the same as the equivalent provision for legal privilege in section 20(1)(c) of the Tax Administration Act 1994.

Comment

Section 20(1)(c) provides that legal professional privilege does not apply to a communication that is brought into existence for the purpose of committing or furthering some illegal or wrongful act. The bill is wider than this because the exclusion also applies to promoting or assisting such an act.

The privilege for non-lawyers differs from legal professional privilege. Accordingly, consistency with legal privilege is not a reason for change. Promoting or assisting an illegal or wrongful act is a justifiable basis for denying the non-disclosure right.

Recommendation

That the submission be declined.

PROCESS FOR CLAIMING PRIVILEGE

Submission
(22 – KPMG)

Documents should enjoy privilege without the necessity to make a claim for the privilege with the antecedent requirements (such as providing a brief description of the document).

Comment

The requirement to make a claim for privilege is important in ensuring the integrity of claims. It allows Inland Revenue to identify all information that is withheld, to request the tax contextual information if required, and in less frequent cases to contest the claim.

Officials also consider the application process for the privilege has other important implications, such as for the security of the privileged documents. We consider that no changes should be made.

Recommendation

That the submission be declined.

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 28A – Corporate Taxpayers Group, 29W – PricewaterhouseCoopers, 30W – Deloitte)

Sections 20D(2) and (3), which require certain information to be provided with a claim for the privilege, should be deleted because such requirements are better dealt with in guidelines. *(Institute of Chartered Accountants of New Zealand, PricewaterhouseCoopers)*

Sections 20D(2)(a) and 20D(3)(a), which provide that a brief description of the tax-advice document should accompany a claim for privilege, should be deleted. *(Corporate Taxpayers Group, Deloitte)*

Comment

The legislation should prescribe minimum standards to ensure that the document for which privilege is claimed is identifiable. Guidelines will be published on how the provisions should be interpreted.

Recommendation

That the submissions be declined.

Submission
(28A – Corporate Taxpayers Group, 30W – Deloitte)

Section 20D(3)(d), which provides that the areas of law the tax advisor was intending to advise on must be disclosed, should be deleted.

Comment

Officials consider that paragraph (d) should be retained so Inland Revenue is made aware of whether the document for which privilege is claimed is within the ambit of the issues under consideration. However, we now consider that the term "areas of law" is too wide, and suggest that the reference should be changed to the relevant statute and revenue type.

Recommendation

That the reference to "areas of law" should be changed to "the relevant statute and revenue type".

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

If the submissions that section 20D(2) and 20D(3) be deleted is not accepted then consideration should be given to simplifying the procedure for claiming privilege.

Comment

The introduction of a "two-step process" for providing tax contextual information (discussed above) will simplify the procedure for claiming privilege. Guidelines will also be issued to clarify the process.

Recommendation

That the submission be noted.

Submission
(22 – KPMG)

There should be no timeframe within which a claim for privilege should be filed.

Comment

Without timeframes for claiming privilege, extensive delays could occur in the tax-assessment process.

Recommendation

That the submission be declined.

Submission
(28A – Corporate Taxpayers Group)

The time limit stipulated in section 20D(4)(a) for disclosing information under section 16 or 16B should be a minimum of at least 28 days.

Comment

The Commissioner has discretion to extend the time limit for these types of requests where appropriate. Officials consider no change is warranted.

Recommendation

That the submission be declined.

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG, 28A – Corporate Taxpayers Group, 29W – PricewaterhouseCoopers, 30W – Deloitte)

There should be no need for confirmation from the client that the tax advisor is authorised to act on their behalf nor for the tax advisor to swear a statutory declaration that they are authorised to act. *(KPMG, Corporate Taxpayers Group)*

The requirement that a claim for privilege be accompanied by a written confirmation and statutory declaration that the tax advisor is authorised to act on behalf of the person may restrict the person's ability to claim the right of non-disclosure where the person is required to claim privilege immediately or at short notice. *(PricewaterhouseCoopers)*

A tax advisor who is a member of an approved advisor group is already subject to a code of conduct. A statutory declaration that they are authorised to act on behalf of the taxpayer and requirements for confirmation from the client or a statutory declaration will not provide further assurances. *(PricewaterhouseCoopers)*

Section 20D(5), which states that when privilege is claimed the tax advisor must supply written confirmation of the tax advisor's authority to act for the taxpayer and produce a statutory declaration to that effect, should be deleted. *(Institute of Chartered Accountants of New Zealand)*

In section 20D(5)(b) "statutory declaration" should be deleted and replaced with "written confirmation". *(Deloitte)*

Comment

A tax advisor who is a member of an approved advisor group will be subject to a code of conduct. Officials now consider that the tax advisor should not be required to provide a statutory declaration or written confirmation from the taxpayer to this effect.

However, in order to provide certainty, the tax advisor should provide their own written acknowledgement that they are authorised to act.

Recommendation

That the submission be accepted in part. A statutory declaration or written confirmation from the taxpayer that the tax advisor is authorised to act should not be required, but the tax advisor should be required to provide their own written confirmation that they are authorised to act.

Submission
(29W – PricewaterhouseCoopers)

If the above submission is not accepted, the requirement for a statutory declaration should not be automatic.

Comment

If the recommendation for the submissions relating to the authority for the tax advisor to act on behalf of the taxpayer is accepted, this submission will also be addressed.

Recommendation

That the submission be noted.

Submission
(28A – Corporate Taxpayers Group)

The requirement in section 20F(4) that a disclosure of tax contextual information must be in the form of a statutory declaration is unnecessary.

Comment

Officials consider that the tax contextual information statutory declaration is an important element of the new privilege, as it protects the integrity of the privilege. We consider that no change should be made.

Recommendation

That the submission be declined.

Submission
(29W – PricewaterhouseCoopers)

The provision (section 20C(4)) should clarify what is meant by a "secure place".

Comment

This term will be clarified in guidelines.

Recommendation

That the submission be noted.

Submissions
(29W – PricewaterhouseCoopers, 30W – Deloitte)

The provisions should be drafted to ensure that the tax advisor who created the document need not be the same tax advisor who later claims privilege on behalf of the taxpayer.

Comment

Section 20D(1) simply requires that a claim that a document is a tax-advice document must be made by the taxpayer, or a tax advisor who is authorised to act on behalf of the taxpayer. There is no requirement that the tax advisor who claims the privilege must be the same one that provided the advice. No change is required.

Recommendation

That the submissions be declined.

THIRD PARTIES

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 30W – Deloitte)

Section 20B(1) needs to be clarified to ensure that it applies to third parties holding a document (for example, banks and insurance companies).

Comment

The policy intention is that the privilege should apply to tax advice documents that are confidential. In some instances the fact that documents are held by third parties may mean that they are not confidential. The issue of documents held by third parties will be clarified in guidelines.

Recommendation

That the submissions be noted.

Officials' recommendation

That the provisions in the bill should be clarified by providing that the privilege should apply only to documents that are confidential. The meaning of "confidential" should be determined in accordance with case law, particularly that relating to legal professional privilege.

Submission
(29W – PricewaterhouseCoopers)

If a document held by a third party is required to be disclosed as a result of a request by Inland Revenue directly to the information holder, the provisions should be amended to allow a degree of flexibility in relation to the claim procedure. Alternatively, we suggest a simplification of the claim procedure, including elimination of the written confirmation and statutory declaration requirements.

Comment

If a document is held by a third party, this will be taken into account in setting the date by which the information will be required.. This will provide any required flexibility to the claim process.

Recommendation

That the submission be declined.

DEFINITION OF "DOCUMENT"

Submissions

(21 – Institute of Chartered Accountants of New Zealand, 28A – Corporate Taxpayers Group, 29W – PricewaterhouseCoopers, 30W – Deloitte)

A definition of "document" should be included in section 20B to ensure that coverage of non-disclosure rules is wide enough to include electronic material and information provided by other media.

Comment

Officials agree with this submission.

Recommendation

That the submissions be accepted.

INLAND REVENUE REQUESTS FOR INFORMATION

Submission
(28A – Corporate Taxpayers Group)

Requests for tax opinions (and related information) from external and in-house tax advisors should be made only in exceptional circumstances, and this should be legislatively addressed.

Comment

Inland Revenue proposes to issue guidelines covering accountants' privilege once the bill is enacted. These will include guidance on requests for tax opinions. It is expected that the guidelines will provide for the Commissioner to make requests for information from tax advisors in limited circumstances only, and that this type of request will need to be approved by a senior officer.

This is consistent with Inland Revenue's current policy, which is set out in a statement entitled *Commissioner's Policy on Access to Advice and Other Work-Papers Prepared by Accountants*. Currently, access to the opinion content of advice work–papers is sought only when the information provided by the taxpayer does not lead to a complete description of a specific transaction under review. Requests for access to the opinion content of advice work-papers is not made as a matter of course, and only after careful consideration by a senior officer.

This practice is well understood and officials do not, therefore, consider it needs to be codified in legislation.

Recommendation

That the submission be declined.

INLAND REVENUE GUIDELINES

Submission
(29W – PricewaterhouseCoopers)

Inland Revenue should publish guidelines to be available on enactment of the bill to clarify the extent of the new rules' application.

Comment

Officials agree with this submission.

Recommendation

That the submission be accepted.

DISCLOSURE OF INFORMATION TO APPROVED ADVISOR GROUPS

Submission
(22 – KPMG)

The ability to advise an approved advisor group of something that the Commissioner considers to be a breach of a member's responsibilities under sections 20B to 20F goes too far in the context of these proposals. Not only does this differ from the rules for legal privilege, but:

- what happens if the Commissioner gets it wrong and makes a complaint that later transpires was ill-founded, or overstated?;
- in what circumstances does the Commissioner intend to use this provision? The law as drafted simply refers to a breach of a member's responsibilities under sections 20B to 20F, but what is a breach of a member's responsibilities;?
- what exactly is the Commissioner asking or expecting the approved advisor group to do?

Comment

The fact that tax advisors are required to operate under an approved advisor group's code of conduct and disciplinary procedures is an important element of the privilege. If a tax advisor is not abiding by the rules of the privilege, this would be an issue that Inland Revenue would want to bring to the notice of the approved advisor group. The Institute of Chartered Accountants of New Zealand has also indicated that it would like this type of issue to be brought to its attention.

An example of when Inland Revenue may decide to notify the approved advisor group could be where a tax advisor provided a statutory declaration about a transaction and when information provided was subsequently determined by the District Court to be significantly inadequate.

Once the matter has been referred to the approved advisor group, it would be up to the group to decide on an appropriate action relative to their code of conduct and disciplinary procedures.

Clarification of this and any other circumstances in which the Commissioner's discretion would be applied should be included in the guidelines.

Recommendation

That the submission be declined.

DRAFTING

Submission
(22 – KPMG)

The rules need a ground-up redraft to better reflect their intent and objectives as announced by the Minister of Revenue, and also to remove the overly cumbersome requirements placed on taxpayers and non-legal tax advisors seeking to claim privilege.

Comment

The legislation reflects the government's intent and objectives, save for the changes recommended above. Officials consider that a major redrafting exercise is unnecessary.

Recommendation

That the submission be declined.

Submissions
(21 – Institute of Chartered Accountants of New Zealand,
29W – PricewaterhouseCoopers)

The word "by" at the beginning of section 20B(2)(a)(ii) be deleted.

Comment

Officials agree with this submission.

Recommendation

That the submission be accepted.

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 28A – Corporate Taxpayers Group, 29W – PricewaterhouseCoopers, 30W – Deloitte)

The reference to "subsection (6)(a)(ii) and (iii)" in section 20B(4)(c) needs to be a reference to "subsections (5)(a)(ii) and (iii)".

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Submission
(30W – Deloitte)

In section 20F(3)(f) the words "relating to" are too vague and should be deleted.

Comment

Under the current policy statement relating to Inland Revenue's access to advice papers, Inland Revenue has full access to all relevant accounting and tax-return work papers. Consistent with this, it is appropriate that the words "relating to" remain.

Recommendation

That the submission be declined.

Submission
(29W – PricewaterhouseCoopers)

Section 20C(3)(d) should be amended to insert the word "not" after "an approved advisor group informs the Commissioner that a tax advisor is …."

Without the word "not", the subsection could be read as providing that a document will cease to be treated as a tax advice document when the approved advisor group informs the Commissioner that the tax advisor is a member of that group.

Comment

Officials agree with this change.

Recommendation

That the submission be accepted.

Submission
(28A – Corporate Taxpayers Group, 30W – Deloitte)

In the definition of "tax advisor" in section 20B(4) the use of the word "part" (of an approved advisor group) is inappropriate and should be replaced by "a member".

Comment

Officials agree.

Recommendation

That the submission be accepted.

Submission
(30W – Deloitte)

There could be confusion in the use of the word "created" in section 20D(2)(c) and (3)(e).

Comment

This issue will be clarified in guidelines.

Recommendation

That the submission be noted.

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 28A – Corporate Taxpayers Group)

Redraft section 20B(3), which provides a definition of "tax-advice document".

The amendments suggested are:

> A document is a tax-advice document for a person if –
>
> (a) the document is eligible under subsection (2) to be a tax advice document for the person; and
> (b) ~~the person makes~~ a claim *is made*~~,~~ under section 20D, that the document is a tax advice document; and
> (c) ~~the person satisfies~~ the requirements of sections 20E and 20F *are satisfied* for the document.

(Institute of Chartered Accountants of New Zealand)

Section 20B(3)(b) should be amended to reflect the fact that a tax advisor can make a claim under section 20D that the document is a tax advice document. *(Corporate Taxpayers Group)*

Comment

Officials consider that the suggested changes will not change the interpretation of section 20B(3). Therefore, the changes are unnecessary.

Recommendation

That the submissions be declined.

Submission
(29W – PricewaterhouseCoopers)

Section 20C(4) (that a tax-advice document must be kept in a secure place) should not distinguish between a tax advisor who is accepted by the Commissioner as being a member of an approved advisor group and a tax advisor who is a member of an approved advisor group. The reference to acceptance by the Commissioner should be deleted.

Comment

Officials agree.

Recommendation

That the submission be accepted.

Tax deductions for business environmental expenditure

OVERVIEW

Clauses 4, 10, 13-17, 30, 68, 86 and 95

The proposed changes to the income tax legislation will introduce new rules for business environmental expenditure (expenditure to avoid, remedy or mitigate the discharge of contaminants).

Section DB 37 of the Income Tax Act 2004 (section DJ 10 of the 1994 Act) will be clarified and expanded by:

- specifying categories of qualifying environmental expenditure and default amortisation rates;
- giving the Commissioner the power to issue amortisation rates for other categories of environmental expenditure;
- removing the current distinction between industrial and non-industrial waste; and
- introducing a matching mechanism so that site restoration and monitoring costs can be matched against prior business income.

These changes are being made to ensure that all business operating costs, including those for dealing with environmental issues, are taken into consideration in calculating taxable income, and that the timing of such deductions is appropriate.

Eleven submissions were made on the proposed changes to the income tax treatment of business environmental expenditure. Seven submissions supported the changes to the income tax treatment of business environmental expenditure. One submission supported the removal of the distinction between industrial and non-industrial waste but did not support the other proposed changes. There were a number of submissions making recommendations on various technical aspects of the proposals.

REVISION OF SECTION DB 37

Submission
(26W – Waste Industry)

The proposed changes to section DB 37 should be withdrawn (other than the removal of the word industrial) as they will create additional compliance costs for taxpayers.

Comment

The waste industry considers that the proposed changes to section DB 37 will result in increased compliance costs for taxpayers compared with the simple pooled approach in the current rules.

Officials agree that in changing to a more accurate deduction period taxpayers may incur additional compliance costs. However, the new rules will ensure that a broader category of environmental expenditure is deductible, provide for faster deductions in some cases and ensure a more accurate measurement of income consistent with the treatment of other capital expenditure.

The new rules have also been designed to minimise any increase in compliance costs. A default deduction rate has been provided for those taxpayers who do not want to incur the cost of applying for a category-specific deduction rate. The record-keeping obligations for costs required to be spread over a longer period are consistent with the timing of other obligations associated with resource consents. Finally, if the legislation is enacted, Inland Revenue will publish a *Tax Information Bulletin* article (including examples) to assist taxpayers in applying the new business environmental expenditure rules.

Recommendation

That the submission be declined.

FORMAT OF DEDUCTION

Submissions

(21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG, 26W – Waste Industries, 29W – PricewaterhouseCoopers)

The format of the proposed tax deduction for business environmental expenditure should be amended to:

- remove the 35-year period for amortising certain types of environmental expenditure;
- remove the claw back in section CB 24B;
- change the formula in proposed section DB 37(2)(a) to rate x cost rather than rate x diminished value; and
- allow a wash-up deduction where a taxpayer ceases business and a full deduction has not been allowed for the expenditure by the time of cessation.

Comment

Period of deduction

Three submissions questioned the appropriateness of the default deduction rate (the lesser of the period of the applicable resource consent, or 35 years).

The current business expenditure rules allow an arbitrary five-year deduction for a narrow category of expenditure. The proposed rules will broaden the categories of deductible expenditure. In particular, deductions will now clearly be available for dealing with any type of waste, for site restoration expenditure and for environmental costs which do not involve construction (such as riparian planting). The changes also introduce a more accurate deduction period consistent with the approach taken for other capital expenditure.

In designing the new rules, the aim has been to ensure that the period of deduction is appropriate. Three of the four categories of environmental expenditure (feasibility and testing, monitoring and site restoration) will now be immediately deductible. The final category, involving creation of an environmental improvement, will have a default amortisation rate of the lesser 35 years or the length of the applicable resource consent. However, taxpayers are able to apply to the Commissioner of Inland Revenue for a shorter category specific amortisation rate. In order to ensure that Inland Revenue is well placed to offer such rates should the legislation be enacted, a process to review and process applications has already been developed.

Officials consider that in many cases the changes will result in a shorter deduction period. For example, over 80% of the environmental costs incurred by the waste industry should have a shorter deduction period under the proposed rules. Certain environmental costs will have a longer deduction period. However, as a result of using a rate based on actual life, the proposed treatment will result in a better measurement of taxable income.

Claw back

Proposed section CB 24B contains a claw-back mechanism which will apply to taxpayers who have obtained an environmental expenditure tax deduction based on the period of a resource consent. Where that resource consent is extended or renewed, the taxpayer will derive taxable income equivalent to the difference between the tax deductions claimed and those calculated using the extended resource consent period.

A number of parties have submitted that the claw back is a new concept in tax legislation, unnecessary in practice and should be removed.

Officials recommended the inclusion of the claw back because of concerns that taxpayers could manipulate the period of their resource consent in order to obtain a faster tax deduction (as the default deduction rate is the lesser of 35 years or the period of the applicable resource consent).

Officials have discussed the issue further with submitters. While officials appreciate that there are often significant costs involved in applying for resource consents, and that for commercial certainty a taxpayer would generally apply for the longest consent possible, officials still consider that an anti-avoidance provision is required. However, officials have taken account of the concerns raised by submitters with respect to the cash flow and compliance cost implications of the claw back calculation. Officials therefore propose that the claw back mechanism be replaced by a specific anti-avoidance measure with a much narrower scope.

Taxpayers who have claimed a tax deduction based on the period of a resource consent and then substantially altered the period or who have renewed that consent for the purpose of obtaining a faster tax deduction would be required to calculate tax deductions based on the default rate of 35 years. Any difference between the deductions claimed to date and tax deductions based on the default rate of 35 years would be clawed back as taxable income in the year that the consent is altered.

Taxpayers altering or renewing their resource consent for normal commercial reasons should not be affected by the specific anti-avoidance provision.

Straight line versus diminishing value deduction

The policy objective behind the proposed amendments to section DB 37 is to accurately measure taxable income by allowing a deduction for business environmental expenditure over the estimated life of the expenditure. The method for spreading the deduction is not important as the rate will be adjusted accordingly.

The tax depreciation regime allows a taxpayer to choose between a diminishing value and a straight-line deprecation deduction. For those categories of deductible capital expenditure outside the standard tax depreciation regime, a straight-line rate is usually adopted.

Officials agree that amending section DB 37 to provide for a straight line deduction will ensure consistency with other capital expenditure amortisation provisions.

Wash-up calculation

PricewaterhouseCoopers has submitted that the proposed tax deduction under section DB 37 be amended to allow a wash-up deduction where a taxpayer ceases business and a full deduction has not been allowed for the expenditure by the time of cessation.

Proposed section DB 37 allows a deduction for business environmental expenditure spread over the estimated life of that expenditure. However, section DB 37(2), which sets out the amount of the deduction allowed, already provides for the situation where the operations of the business cease and there is still unamortised expenditure.

Recommendations

That the submission on removing the 35-year period for amortising certain types of environmental expenditure be rejected.

That the submission on removing the claw-back mechanism be accepted and that instead, a specific anti-avoidance provision be included as part of the proposed environmental expenditure rules.

That the submission recommending a straight line deduction be accepted.

The submission requesting a wash-up calculation should be rejected, as this is already allowed for in proposed section DB 37(2)(b).

DEFINITION OF DEDUCTIBLE BUSINESS ENVIRONMENTAL EXPENDITURE

Submissions

(8W – Ports of Auckland, 14W – Lyttleton Port Company Limited, 19 – Environment Waikato, 21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG, 26W – Waste Industry, 29W – PricewaterhouseCoopers)

Proposed schedule 6B which sets out the definition of deductible business environmental expenditure should be amended to:

- allow a deduction for environmental dredging costs;
- allow a deduction for the cost of land in circumstances where the future use of that land is restricted as a result of incurring environmental expenditure;
- ensure a tax deduction is available (for fencing, planting and alternative water sources) where any agricultural land is retired for the purposes of reducing pollution;
- remove the distinction between riparian and screen planting and allow a tax deduction for both types of expenditure when incurred;
- replace the words "before a choice between options, of locations and methods…" in paragraph 1, part A with "before a commitment is made to an option";
- replace the words "expenditure on the construction of an improvement to land…" in paragraph 2, part A with the words "expenditure in the construction on land"; and
- define "expenditure" to include those items anticipated to fall within the ambit of parts A and B of the schedule.

Comment

Submissions have put forward a number of changes to proposed schedule 6B. This is the schedule which sets out the categories of deductible environmental expenditure. Each of the proposed changes is discussed below.

Dredging

Part C of the proposed schedule sets out the types of expenditure which will not be deductible as business environmental expenditure under proposed section DB 37. This includes expenditure related to dredging.

The exclusion for dredging was included because officials were concerned that taxpayers might be able to claim a tax deduction for capital dredging costs unrelated to avoiding, remedying or mitigating the detrimental effects of a discharge of contaminants.

Following the submissions on this point, officials have considered the issue further.

Dredging is the removal of sediment, sand, silt, mud, gravel or other materials from the bottom of a water body. Dredging is regularly carried out by port operators to maintain or deepen the depth of shipping channels and berths, but may also be carried out to remove contaminants from the seabed.

Dredging can be split in to three main categories:

- maintenance;
- capital; and
- environmental dredging.

Maintenance dredging is undertaken to maintain or restore a shipping channel or berth to its established depth. This is necessary because over time the build-up of silt and other materials reduces the effective depth of channels and berths. This expenditure is deductible under ordinary tax rules as a regular business cost.

Capital dredging is intended to deepen a shipping channel or berth beyond its established depth to increase the capacity of the channel or berth. For example, deepening a shipping channel may allow the channel to be used in a wider variety of tide conditions or by larger ships. This expenditure is capital in nature and is not tax deductible.

Environmental dredging refers to circumstances where dredging is required to prevent, combat or mitigate the impact of a spill of contaminated waste or materials. It is often significantly different to routine dredging and can involve the use of specialised or modified equipment to ensure the contaminants removed are not re-suspended in the water during removal. A significant international environmental dredging industry has developed to deal with this specialised task.

In certain situations environmental dredging may qualify as a regular business expense and therefore be deductible under the general deductibility provisions. However, there may be cases where there is more of a capital element to the expenditure and a deduction may not be available under the general deductibility provisions. However, where the expenditure has been incurred for the principal purpose of remedying a discharge of contaminants, officials agree that a tax deduction should be available. Inevitably the removal of contaminants from the seabed may slightly increase the depth of the original seabed. However, this is incidental to the main purpose of the expenditure and should not mean that a deduction is denied outright.

Restriction on future uses of land

A number of parties submitted that section DB 37 should be extended to cover a deduction for the cost of land used for the treatment of waste or where the future use of the land is restricted as a result of incurring environmental expenditure.

Under ordinary tax rules a deduction is not given for the cost of land because:

- it does not normally decline in value;
- any gain in relation to land (unless held on revenue account) is not taxable; and
- there is a perceived risk of manipulation.

However, land can decrease in value as a result of contamination. Therefore, as a proxy, a tax deduction is now proposed for site restoration. Rather than a deduction for incurring a loss on land, expenditure in rectifying that loss will be deductible.

A deduction for site restoration will not always equate to the loss in land value suffered from contamination but in the majority of situations it provides a practical solution. However, for taxpayers whose business is the acquisition and use of land for the purpose of constructing and operating a landfill, no matter how much is spent on site restoration, the loss in value will be complete. Officials therefore support a deduction for a loss in land value in these circumstances.

Officials recommend that the deduction be granted by putting the land on revenue account (this would need to be done in such a way that deductions were still available under DB 37). A deduction would then be available on sale of the site. This methodology would also provide for the ability to tax any gain on the value of the land should this ever result. Taxpayers should be required to elect that land is held on revenue account within one year of the legislation being enacted or from date of purchase thereafter.

In order to ensure a consistent treatment, all of a taxpayer's landfill sites and those of any associated parties would need to be treated on a consistent basis. Officials also consider that a deduction should not be available for losses generated from related-party transactions.

Officials also recommend that part C of schedule 6B be amended to make it clear that no deduction is permitted for the cost of land, other than in the situation described above.

Retirement of land

In broadening the categories of tax deductible environmental expenditure, officials have worked closely with Ministry for the Environment to ensure that the proposed rules are broad enough to cover alternative solutions to environmental issues – for example, riparian planting and the use of wetlands as natural filters.

In its submission in support of the proposed amendments to the tax treatment of business environmental expenditure, Environment Waikato has sought clarification that tax deductions will be available for any agricultural land that is retired for the purposes of reducing pollution. The types of expenses incurred in retiring land include fencing, planting and installing alternative water supplies.

For taxpayers carrying on a farming business, expenditure incurred on fencing, planting and installing alternative water supplies (such as troughs and pipes) should already be tax deductible or amortisable:

- via a tax depreciation deduction for assets such as fences, pipes and tanks;
- under section DP 1 for the cost of planting a commercial forest;
- under section DO 2 for farmers who plant and maintain trees for purposes of preventing or combating erosion or providing shelter; and
- under section DO 3 (up to $7,500 per year) for farmers who incur costs in planting and maintaining trees.

As the costs associated with retiring agricultural land for environmental purposes should already be deductible, officials do not consider that any amendments are required to schedule 6B.

Riparian versus screen planting

The waste management industry has submitted that there should be no distinction between riparian and screen planting and that both types of expenditure should be 100% tax deductible when incurred.

The cost of riparian planting[1] is considered to be preventative environmental expenditure. Similarly, screen planting[2] is seen as preventative environmental expenditure.

As such, both categories of expenditure have a default deduction period of the lesser of 35 years or the length of the applicable resource consent. Where this is not appropriate taxpayers are able to apply for a special amortisation rate which would allow for a deduction over a shorter period.

Therefore, there is no disparity in the tax treatment afforded to these two types of expenditure. Both categories of expenditure have been classified as environmental improvement expenditure because they result in some future benefit (such as the reducing visual impact of the improvement or reducing the amount of contaminants entering the water). They are not in the nature of site restoration expenditure (which involves removing historic contamination). Therefore, officials disagree with the submission that riparian and screen planting should be immediately deductible using a 100% amortisation rate.

Definition of environmental testing and feasibility expenditure

A number of submitters have suggested that the words “before a choice between options, of locations and methods…” in paragraph 1 of part A should be replaced with “before a commitment is made to an option”.

[1] The planting of trees or shrubs adjacent to a body of water in order to reduce the amount of contaminants in surface runoff and shallow ground water.
[2] The planting of trees to reduce the visual impact of an environmental improvement such as a landfill.

Paragraph 1 relates to environmental testing and feasibility expenditure. Inland Revenue's position of the deductibility of general feasibility expenditure is set out in the draft interpretation statement – IS2783.

Expenditure may be denied a deduction on the basis that it was incurred with a view to bringing into existence an enduring benefit or in relation to the profit-making structure of the business. In these circumstances, the critical issue is whether a decision has been made to commit to a particular proposal – for example, to acquire or develop a particular asset. Once a decision has been made to proceed with a particular course of action, any expenditure incurred after that time will be treated as relating to the underlying capital project and thereby to the profit-making structure of the business and will not be tax deductible.

The wording "before a choice between options, of locations and methods…" was used in paragraph 1 to ensure consistency with the general tests for deductible feasibility expenditure.

Submitters consider that these words are unnecessarily vague and that it may be difficult in certain circumstances to determine exactly when a "choice between options, of locations and methods" is made. They also consider that the preferred wording "before a final decision or commitment is made" is consistent with the wording used in proposed section DB 37(4)(b)(ii).

Officials' key concern with the wording in paragraph 1 is that it is consistent with the general test for tax-deductible feasibility expenditure. In order to increase taxpayer certainty, officials consider that the wording ("decision has been made to commit" to a location or method for an activity) from the draft interpretation statement should be adopted. This will increase taxpayer certainty, thereby addressing submitters concerns, as there is specific Inland Revenue commentary on the meaning of this phrase. If the amending legislation is enacted, Inland Revenue will also publish a *Tax Information Bulletin* article on the changes. This will include examples illustrating how the definition of environmental feasibility and testing expenditure should be interpreted.

Definition of environmental construction expenditure

Paragraph 2 of part A deals with expenditure incurred in the construction of an improvement to avoid or mitigate the effects of a future discharge of contaminants.

A number of submitters have suggested that the words "expenditure on the construction of an improvement to land…" in paragraph 2 should be replaced by "expenditure in the construction on land". The suggested wording would be more consistent with that used in section DJ 10, which has been the subject of judicial interpretation.[3] Adopting, as closely as possible, the wording from the current provision would increase taxpayer certainty by ensuring that existing commentary and guidance remains applicable.

[3] *Waste Management Ltd v C of IR* (1994) 16 NZTC 11,092, *Waste Management NZ Limited v C of IR* CA 55 /94.

Definition of expenditure

The waste management industry has submitted that "expenditure" be defined to include those items anticipated to fall within the ambit of schedule 6B parts A and B.

Schedule 6B sets out those categories of tax deductible environmental expenditure. The term "expenditure" is not defined for the purposes of the section.[4] Therefore, in determining the meaning of this term it is necessary to apply the rules of statutory interpretation.

Section 5(1) of the Interpretation Act 1999 states that the "meaning of an enactment must be ascertained from its text and in light of its purposes". Such an approach must be adopted unless the enactment provides otherwise or the context of the enactment requires otherwise (section 4(1) of the Interpretation Act 1999).

CIR v Alcan New Zealand Limited (1994) 16 NZTC 11,175 is the leading case on the principles of statutory interpretation. In Alcan, the Court of Appeal said it was fundamental that "words be given their ordinary meaning". The court stated that there must be a strong reason before words can be given some other meaning which they are capable of bearing in a particular context. If words are capable of more than one meaning, and the object of the legislation is clear, then the words must be given "such fair, large and liberal construction" as will best ensure the attainment of the object of the Act.

Given these principles and the significant amount of case law on the meaning of the term expenditure,[5] officials do not consider that it is necessary to include a definition as part of the proposed changes. It is clear that if an amount meets the conditions in section DB 37 and is listed in Parts A or B of the proposed schedule 6B, that a tax deduction will be available.

Recommendations

That the submission in relation to tax deductions for environmental dredging be accepted. Officials recommend that part C of schedule 6B be amended to exempt dredging other than environmental dredging. Environmental dredging could be defined as dredging principally incurred to avoid, remedy or mitigate the discharge of contaminants.

That the submissions requesting a tax deduction for a loss on land be accepted for business taxpayers who acquire and use land for the purposes of constructing a landfill footprint. Officials also recommend that part C of schedule 6B be amended to make it clear that no deduction is permitted for the cost of land, other than in relation to landfills. Losses should also not be available in respect of related-party transactions, and associated parties should be required to adopt the same tax treatment.

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[4] There is a definition of expenditure in section OB 1. However, this is only defined for the purposes of section DD 2(7) (Limitation rule) and section DW 1(2) (Airport operators).

[5] NZTBR *Case 7*, *M of NR v Wrights' Canadian Ropes Limited* [1947] AC 109, *C of IR v Banks* (1978) 3 NZTC 61, 236, *Case E48* (1982) 5 NZTC 59,285.

That the submission on amendments to cater for retiring agricultural land be rejected as these costs are already tax deductible under other provisions of the tax legislation.

That the submission that riparian and screen planting should be immediately deductible using a 100% amortisation rate should be rejected.

That the submission requesting amendment of the definition of environmental feasibility expenditure should be accepted but that the wording in paragraph 1 of part A should be amended to be consistent with Inland Revenue's draft interpretation statement on feasibility expenditure.

That the submission requesting amendment of the definition of environmental construction expenditure should be accepted.

The submission that "expenditure" be defined for the purposes of the environmental tax rules should be rejected.

Tax deduction for dealing with by-products

Officials also recommend that part B of schedule 6B should be amended to ensure that a deduction is available for dealing with by-products that would constitute a contaminant if discharged into the environment.

In carrying on their business, taxpayers may create by-products which could constitute a contaminant if discharged into the environment. In order to prevent this and to ensure compliance with environmental legislation and local government regulations, taxpayers can either deal with these by-products as and when they occur, or if that is not feasible, store the by-products until they are able to deal with them.

Regular expenditure incurred in dealing with by-products while a business is operating should fall within the general deductibility provisions. Similarly, capital expenditure incurred to construct depreciable assets for storing by-products (such as tanks) should receive a depreciation deduction. However, an issue over tax deductibility does arise where taxpayers store by-products until the cessation of a business and then incur expenditure to deal with these.

It is our view that such costs fall within site restoration expenditure and should receive the same treatment. However, the definition of remediation expenditure relies on the words "discharge of a contaminant". If stored and dealt with correctly, such by-products will never constitute a contaminant.

Officials therefore recommend that part B of the proposed schedule 6B should be amended to ensure that a deduction is available for dealing with by-products that would constitute a contaminant if discharged into the environment.

LINKS TO OTHER ENVIRONMENTAL LEGISLATION AND PROJECTS

Submission
(19 – Environment Waikato)

There should be a fully integrated review of legislation relating to environmental contamination and a tax deduction should only be available for restoration expenditure when the restoration has been carried out to a suitable standard.

Comment

Environmental review

While there are links between the current proposals and the regulation of contamination generally, the issues being addressed through these changes are tax-specific. The current tax rules for environmental expenditure are narrow, uncertain and do not lead to a correct measurement of taxable income. These tax issues would not differ under any other form of environmental regulation. Therefore, officials consider that the current proposals should proceed and that any general review of environmental regulation is outside the scope of the current bill.

Restoration to a suitable standard

While Environment Waikato supports the extension of the existing environmental expenditure provision, it has submitted that a deduction for remediation of contaminated land should be available only when remediation works have been carried out to a suitable standard. The submission refers to the Ministry for the Environment's guidelines for assessment and management of contaminated land.

Site restoration and remediation is regulated by the Resource Management Act 1991 and other environmental legislation. It is not the purpose of the Income Tax Act 2004 to regulate environmental activities. As such, officials do not agree with the submission that tax deductions should only be available if the relevant environmental standards are met.

However, while the issues being addressed by these proposals are tax-related, it is still desirable for the tax legislation in this area to be consistent with environmental regulation. To ensure this is the case, Inland Revenue officials have worked closely with the Ministry for the Environment and local government representatives.

To obtain a tax deduction for environmental expenditure, taxpayers will need to meet the normal self-assessment obligations for obtaining and documenting a tax deduction. This will include maintaining evidence that they have incurred site restoration expenditure. Compliance with environmental standards would be part of this process. This will be stressed in the *Tax Information Bulletin* article which will follow enactment of any amending legislation.

Recommendation

That the submission be declined.

LINKS TO THE DEPRECIATION REGIME

Submissions
(22 – KPMG, 25 – Foodstuffs (South Island) Limited, 26W – Waste Industry, 29W – PricewaterhouseCoopers)

The relationship between section DB 37 and the tax depreciation regime should be clarified to:

- allow "tied assets" to be amortised at the rate applicable to the environmental improvement to which they relate;
- mean that additional expenditure on a depreciable asset incurred because of site restoration should qualify for immediate deduction; and
- allow cell[6] construction costs to be amortised over the life of the cell, as determined pursuant to a special depreciation determination issued by the Commissioner.

Comment

Tied assets

The waste management industry and KPMG have both submitted that section DB 37 should be amended to ensure that the write-off period for depreciable assets that are "tied"[7] to a landfill operation (such as roads and buildings) should be no longer than the period of the remaining resource consent period granted. In addition, if the landfill were to close earlier, the remaining tax book value of those tied assets should be written off in the year of closure.

Both the current and proposed sections dealing with environmental expenditure are drafted as sections of last resort. This means that a deduction is only available under these provisions if it is not available under any other provision in the income tax legislation (for example, tax depreciation or as regular business expenditure). Therefore, depreciable assets which form part of a landfill (or other environmental expenditure) operation are tax deductible under the tax depreciation regime and not the environmental expenditure section.

This meets the general policy objective of treating all capital expenditure consistently for tax purposes and ideally under the same (depreciation) regime. It is only in exceptional circumstances where the nature of the expenditure does not permit inclusion in the depreciation regime that a tax deduction will be available elsewhere.

Therefore, officials recommend that the submission regarding the inclusion of tax deductions for tied depreciable assets under section DB 37 be rejected. Instead, the issue of tied assets is being dealt with as part of the depreciation review.

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[6] Landfills are often constructed in parts, called "cells".
[7] When the economic life of an asset is inextricably linked to the life of an income-earning process that is significantly shorter than the estimated useful life of the asset.

Changes are already included within the current bill to improve the tax treatment of tied assets (refer to clauses 93 and 94 of the Taxation (Base Maintenance and Miscellaneous Provisions) Bill). Taxpayers with tied assets can currently apply to Inland Revenue for a special (and generally faster) tax depreciation rate. However, a key requirement when applying for a special tax depreciation rate is that taxpayers be able to provide sufficient information to the Commissioner in support of an application. This includes identifying the actual economic life of an asset with a very high degree of certainty. If the actual economic life of an asset cannot be clearly ascertained, a special tax depreciation rate will generally not be allowed.

Under the changes included in the Taxation (Base Maintenance and Miscellaneous Provisions) Bill, the requirement on the Commissioner to have a very high degree of certainty is to be relaxed to make it easier for taxpayers to obtain a special tax depreciation rate. This should make it easier for taxpayers to obtain a tax depreciation rate for tied assets to reflect actual economic life.

Expenditure on depreciable assets as part of site restoration

Similarly, officials do not support the submissions that section DB 37(4)(a) be amended to clarify that additional expenditure on a depreciable asset incurred because of site restoration should qualify for immediate deduction.

As noted above, section DB 37 has been drafted as a section of last resort consistent with the current provision and policy that where possible deductions for capital expenditure should be handled under the depreciation regime. Therefore, where expenditure is incurred on a depreciable asset (even as part of a site restoration project) then the appropriate place for a tax deduction is through the tax depreciation regime.

Where a project involves both the construction of a depreciable asset and site restoration it will be a matter of the particular facts and the taxpayers records as to which expenditure was incurred on site restoration (deductible under section DB 37) and which was incurred on the depreciable asset (deductible as tax depreciation).

Deduction for cell construction costs

KPMG and the waste management industry have submitted that all cell construction costs should be amortised over the life of the cell, as determined by CIR determination.

Proposed section DB 37 allows a deduction for business environmental expenditure over the estimated life of that expenditure. Feasibility, monitoring and restoration costs are all immediately deductible. Environmental “construction” expenditure has a default estimated life of the lesser of 35 years or the applicable resource consent period. However, where this is not appropriate, taxpayers are able to apply for a category-specific rate issued by the Commissioner.

From discussions with the waste management industry, officials understand that cell construction costs are likely to meet the criteria for a special rate. However, as noted above, a deduction under proposed section DB 37 is only available for costs that fall outside the other sections of the income tax legislation. Therefore, any depreciable assets which form part of an environmental improvement will continue to be deductible under the tax depreciation regime. However, taxpayers will be able to apply for a special depreciation rate to match the write-off period for other cell construction costs where these constitute tied assets (as discussed above).

Recommendations

That the submissions regarding the inclusion of tax deductions for tied depreciable assets be rejected as the issue of tied assets is being dealt with as part of the depreciation review.

That the submissions that additional expenditure on a depreciable asset incurred because of site restoration should qualify for a deduction under DB 37 be rejected.

That the submission with respect to including depreciable assets as part of the proposed section DB 37 deduction be declined.

DRAFTING

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 25 – Foodstuffs (South Island) Limited, 26W – Waste Industry, 29W – PricewaterhouseCoopers)

There are a number of drafting references and formulas that need to corrected, including:

- the formula proposed in section DB 37(2);
- the reference to section DB 37(3)(c) in section 91AL(1) of the Tax Administration Act 1994;
- the lack of reference to aftercare costs in section DB 37(4)(a);
- the formula in section DB 37(6); and
- the reference to section CB 24B(6) contained in the section OB 1 definition of diminished value.

Comment

DB 37(2)

It has been submitted that the formula in proposed section DB 37(2) needs to be corrected in relation to the definition of diminished value.

As discussed above, officials support the submission to move from a diminishing value to straight line deduction for business environmental expenditure. In doing so, the above issues will also be addressed.

DB 37(3)(c)

This is a drafting error and officials agree that the reference in section 91AL(1) of the Tax Administration Act 1994 should be to section DB 37(4)(c).

DB 37(4)(a)

This is a drafting error and officials agree that the reference in section DB 37(4)(a) should be amended to include aftercare costs in part B of schedule 6B. A 100% rate of deduction should apply to expenditure specified in paragraph 1 of part A and part B of schedule 6B, provided it is not excluded expenditure as set out in part C of the schedule.

DB 37(6)

Submitters' concerns with the assumed life formula in proposed section DB 37(6) related to its appropriateness for a diminished value deduction. As discussed above, officials support the submission to move from a diminishing value to a straight line deduction for business environmental expenditure. In doing so, the above issue will also be addressed.

Diminished value definition

It has been submitted that the section reference in the section OB 1 definition of diminished value is incorrect.

As discussed above, officials support the submission to move from a diminishing value to straight line deduction for business environmental expenditure. In doing so the above issues will also be addressed.

Recommendation

That the submissions be accepted. Issues relating to the diminished value formula and definition will be resolved as the result of accepting other submissions on these points.

NEED FOR THE ENVIRONMENTAL RESTORATION ACCOUNT

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG, 26W – Waste Industry)

A payment should not be required to the environmental restoration account (ERA) before a tax deduction is allowed.

Comment

Deduction for accounting restoration provision

A number of parties have submitted that a tax deduction for site restoration should be available without the need to make a payment to an ERA. In general this would mean allowing a tax deduction for the level of a taxpayer's accounting restoration provision. While allowing a deduction for an accounting restoration provision would ensure matching of income and deductions, it would also open up the tax rules to manipulation through over-estimation and would contradict the established taxation treatment of accounting provisions. It would also introduce a mismatch between the tax treatment of those making and those receiving payments for restoration expenditure as the income tax legislation does not tax recipients on estimated income.

While there are a small number of exceptions to the general policy position that accounting provisions are not tax deductible, these tend to be very industry-specific and do not have the across-the-board application of business environmental costs.

Therefore, officials do not support the submission that a deduction should be available for a taxpayer's accounting restoration provision. A tax deduction based on payments to an ERA (while still linked to the level of the accounting provision) solves the issue of matching income and expenditure while ensuring consistency with the general policy on provisions and providing protection for Inland Revenue against excess tax deductions for environmental expenditure. It also has the added benefit of setting aside a pool of money specifically dedicated to restoration of the environment.

In addition, the ERA is a voluntary fund. Where taxpayers' accounting provisions meet the incurred test they will still be able to claim a tax deduction based on the level of the accounting provision (as is the position under the current law). The ERA proposals do not alter this position but merely provide a solution for those taxpayers who are unable to meet the incurred test.

Recommendation

That the submissions should be rejected.

DESIGN OF THE ERA

Submissions

(16 – Federated Farmers, 21 – Institute of Chartered Accountants of New Zealand, 29W – PricewaterhouseCoopers)

The design of the ERA should be amended to:

- cater for taxpayers with more than one site;
- allow taxpayers in a loss or tax-neutral position to benefit from the proposal;
- allow surplus funds, that cannot be matched by restoration expenditure because the restoration has been completed, to be withdrawn;
- allow more than one payment and more than one refund in an income year;
- accommodate amalgamating companies which made or received more than one payment during the year;
- treat income from refunds as being derived in the year that the taxpayer receives the refund rather than the year of application;
- make the transfer criteria in section EK 15(3) easier to satisfy; and
- remove the time bar waiver in section EK 17.

Comment

Catering for taxpayers with multiple sites

A number of taxpayers have submitted that the ERA proposals should be amended to cater for those taxpayers who have multiple sites. Taxpayers with multiple sites could be in a position to obtain a refund on one site while making payments on another site.

Officials disagree with this view. The ERA is closely linked to a taxpayer's accounting provision. Therefore, if a taxpayer's accounting provision caters for more than one site on a net basis it is correct that the ERA operates on the same basis.

Catering for taxpayers in a tax loss/neutral position

At present taxpayers must be in a taxpaying position at the time they make payments to the ERA to benefit from the tax deductions obtained. It has been submitted that the ERA proposals should be amended to allow taxpayers in a tax-loss or tax-neutral position to benefit from the proposals.

Officials do not agree with this view. The ERA proposals are a response to requests for tax deductions for accounting restoration provisions. Taxpayers in a tax-loss or tax-neutral position would be unable to benefit from a tax deduction for the level of their accounting provision. The ERA proposals are therefore consistent with the treatment taxpayers originally requested.

The ERA proposals also allow taxpayers to make deposits to the ERA over a long period and (other than the spreading provision) for any amount up to the level of their accounting provision. This provides considerable flexibility and limits the likelihood that a taxpayer would be in a tax-loss position when making deposits.

Withdrawal of surplus funds

Federated Farmers has submitted that taxpayers should be able to withdraw surplus funds that cannot be matched by restoration expenditure because restoration has been completed.

Officials agree that this should be the case. The level of the ERA is driven by a taxpayer's accounting restoration provision. Where the balance in a taxpayer's ERA exceeds 33% of their accounting restoration provision, the Commissioner is required to refund the balance. If a taxpayer had completed site restoration then presumably their accounting restoration provision would be nil. Any balance left in the ERA would therefore be refunded.

Multiple refunds and payments

Officials had originally recommended that ERA refunds and payments be limited to one per year because of concerns regarding potential manipulation of the account, resulting in unintended policy outcomes. Officials were also keen to keep compliance and administration costs low by streamlining the account. However, a number of parties have submitted that only allowing one payment or one refund per income year is too restrictive and does not cater for a change in taxpayer circumstances.

Officials acknowledge these concerns and would be willing to support a change to allow multiple payments and refunds. However, to reduce the risk of unintended policy outcomes, officials recommend that a purpose provision is introduced to make it clear that an ERA is only to be used by businesses for the purpose of matching business income with environmental expenditure.

Amendments to EK 20

Proposed section EK 20 provides for the transfer of an environmental restoration account from an amalgamating company to an amalgamated company where the amalgamating company ceases to exist in an income year.

A number of parties have submitted that the provision requires amendment to provide for the situation where both companies have either made payments to, or received refunds (including transfers) from their respective accounts during the income year.

Officials agree that the provision should allow for multiple payments or refunds in the period prior to amalgamation.

Derivation of income

PricewaterhouseCoopers has submitted that income resulting from a refund from the ERA (proposed section EK 13) should be derived in the year that the taxpayer receives the refund rather than the year that the Commissioner receives the application for the refund.

The general principle for derivation of income is that an amount is derived even if it has not actually been received. However, there are exceptions to this rule – for example, compensation for loss of trading stock and loss of depreciable property.

Officials agree that deeming income to be derived once a refund is received will increase taxpayer certainty and therefore we support the submission.

Transfer criteria

The design of the ERA provides for the transfer of balances in the account to another taxpayer where the restoration liability has also been transferred – for example, where contaminated land has been sold to another taxpayer.

PricewaterhouseCoopers has submitted that there may be situations where it will be difficult for a taxpayer to satisfy the transfer conditions in proposed section EK 15(3) and that the wording of section EK 15 should be reconsidered.

Under section EK 15(3), a taxpayer is able to treat a transfer as a payment to their ERA provided that the restoration obligation has been transferred to that person and the person would have been entitled to make an equivalent payment to the ERA.

The ability to make a payment to an ERA is restricted by certain requirements (such as no multiple payments and the maximum payment amount).

As previously discussed, officials support the submission to allow multiple payments. Therefore, this restriction will no longer apply.

The maximum payment restriction is included as part of the ERA to ensure that tax deductions mirror the accounting treatment of restoration expenditure. However, after considering the issues in the submission, officials recommend that proposed section EK 15 be amended to clarify that taxpayers will only be able to apply for a transfer from their ERA where they have transferred the restoration liability to another taxpayer. The transferee will be able to treat a transfer as a payment up to the level of their maximum account balance. Where the transfer causes the transferee's ERA to exceed the maximum account balance (as at the end of the income year) the Commissioner will be required to transfer the excess amount back to the transferor (effective as at the date of the original transfer).

Time bar

Proposed section EK 17 gives the Commissioner the power to alter an assessment at any time, despite the time bar, in order to allow a deduction for a payment or transfer, treat a refund as income, or transfer the balance of the fund on death, bankruptcy or liquidation.

While this power is consistent with that available to the Commissioner under the IES regime, officials agree that the Commissioner should be able to achieve all of the above actions without the need to waive the time bar.

Recommendations

That the submission with respect to multiple sites be rejected.

That the submission on catering for taxpayers in a tax-loss or tax-neutral position be rejected.

Officials agree with the submission on excess funds but consider that no amendment is required to deal with this issue.

Officials support the submissions on multiple payments and refunds but recommend that a purpose provision is introduced to make it clear that an ERA is to be used only by businesses for the purpose of matching of business income and environmental expenditure.

Officials agree with the submissions on accommodating amalgamating companies which made or received more than one payment during the year.

Officials support the submission to treat income from refunds as being derived in the year that the taxpayer receives the refund rather than the year of application.

That the submission requesting clarification of the transfer provisions be accepted.

That the time bar submission be accepted.

INTEREST RULES

Submissions

(15W – Business NZ, 16 – Federated Farmers, 21 – Institute of Chartered Accountants of New Zealand, 26W – Waste Industry, 28W – Corporate Taxpayers Group, 29W – PricewaterhouseCoopers)

The ERA interest rules should be amended to:

- revise the interest rate upwards to make it more commercially aligned, at least to the use-of-money interest (UOMI) rate for tax overpayments;
- ensure consistency with the existing UOMI rules;
- make interest payable from the date of payment by the taxpayer;
- give taxpayers the option of having interest paid directly to them rather than automatically credited to the ERA; and
- clarify when interest is deemed to be derived by the holder of an ERA.

Comment

Interest rate

Taxpayers have requested a deduction for estimated site restoration expenditure. While officials agree that some form of deduction should be granted in order to correctly measure business income, it must be borne in mind that any deduction is likely to be claimed long before any money is actually spent on restoration.

If officials granted a deduction for estimated expenditure and also allowed taxpayers a refund of the associated tax, taxpayers would be able to invest this cash at interest until such time as site restoration expenditure is actually incurred. The position is the same as if the government retains the cash but pays a market rate of interest on the account. The government should not be paying interest to reflect time value of money as taxpayers incur no such cost.

While the theoretically correct answer is nil interest on ERA deposits, officials recommended that a small amount of interest (3% p.a.) be paid on deposits in order to compensate taxpayers for the compliance cost associated with maintaining an ERA. This is equivalent to the interest rate paid on the income equalisation scheme.

Officials do not agree with the submission that a market value of interest should be paid on deposits.

Consistency with the UOMI rules

Several parties have submitted that the interest rules applying to the ERA should be consistent with the UOMI rules. Officials agree that it is important that a consistent rationale should be applied by Inland Revenue with respect to interest. However, due to the specific nature of the ERA it is not appropriate to adopt the UOMI interest rules. For example, as discussed above, it is not appropriate to pay a market interest rate. Officials therefore do not agree with submissions that the UOMI rules be adopted for the purposes of the ERA.

Date of commencement

Under the proposed ERA interest rules, interest on deposits commences from the date that a deposit is acknowledged as received.

A number of parties have submitted that this should be the date of payment.

Under the UOMI regime, interest is calculated from the day after the tax is paid. Officials would he happy to accept a similar approach for the ERA.

Interest paid directly to taxpayers

The interest rules in proposed section EK 6 are based on those for the IES. IES interest included in any refund is gross income of the taxpayer. However, resident withholding tax (RWT) is deducted at the time that the interest is credited.

A similar approach could be adopted for the ERA. However, ERAs have the added complication that any refund (including any interest) forms part of a taxpayer's gross income at the grossed-up rate. Crediting interest to the ERA also raises questions about how the maximum deposit amount should be calculated (inclusive or exclusive of the interest) and the impact of transferring balances in the fund (whether accumulated interest is included in the transfer) to other taxpayers.

To avoid complications with the treatment of interest paid on ERA deposits, officials recommend that interest is paid directly to the taxpayer rather than being credited to the ERA.[8] The interest would form part of gross income (and be subject to the normal non-resident withholding tax (NRWT) and RWT rules at the date that it is paid).

The Corporate Taxpayers Group has submitted that taxpayers should have the option of having interest paid directly to them rather than being credited to the ERA. Due to complications which arise with having interest credited to the ERA, officials support this submission.

Date interest income derived

The waste management industry has submitted that the proposed legislation should clarify when interest paid on ERA deposits is taxable.

[8] Care will need to be taken in the drafting to avoid issues with circularity.

As discussed above, to avoid complications with the treatment of interest paid on ERA deposits, officials are supporting a submission to have interest paid directly to taxpayers on 31 March each year (or the date that the last refund is made form the ERA) rather than being credited to the account. The interest would form part of gross income (and be subject to the normal NRWT and RWT rules) at the date that it is paid. This is consistent with the UOMI regime.

Recommendations

That the submission to pay interest of more than 3% be rejected.

That the submissions regarding adoption of the UOMI rules should be rejected.

That the submissions calling for a change to the commencement date for interest should be accepted.

That the submission regarding the payment of interest directly to taxpayers be accepted.

That the submissions regarding clarification of interest derivation be accepted. This issue can be addressed as part of a change to annual payment of interest rather than crediting of interest to the ERA.

TRANSITIONAL ISSUES

Submissions
(21 – Institute of Chartered Accountants of New Zealand,
29W – PricewaterhouseCoopers)

The transitional spreading provisions should be extended to cater for those taxpayers who may be closing a site before the expiration of the five year period.

Comment

Under the ERA proposals taxpayers will be allowed to make payments into the ERA in respect of historic restoration liabilities. This is consistent with the objective of encouraging site restoration. However, in allowing this, the cost of the changes to the government rises significantly. In order to spread this cost, taxpayers will not be able to obtain an immediate deduction for these historic restoration liabilities but are required to spread the deduction over the first five years of the regime.

While this spreading mechanism may possible disadvantage any taxpayer who ceases operations during the five year period, officials consider that it is necessary to spread the estimated $100 million cost of the proposals. The alternative would be to deny all deductions for historic site restoration liabilities. The spreading mechanism is also only a transitional measure and after the initial five year period taxpayers will be able to claim full deductions up to the level of their accounting restoration provision.

Recommendation

That the submission be rejected.

DRAFTING

Submissions
(21 – Institute of Chartered Accountants of New Zealand, 26W – Waste Industry, 29W – PricewaterhouseCoopers)

There are a number of drafting references which need to corrected or clarified, including:

- the reference in proposed section EK 4(3)(c) to section EK 7;
- the lack of reference to transfers pursuant to section EK 16 in proposed sections EK 4(6)(a) and EK 8(1);
- the reference to section EK 15(3) in section EK 8(4);
- the lack of reference to other forms of ERA transfer in section EK 12 (subsections (2)(b),(2)(a)(iii) and (8)) and the words "for the environmental restoration account" in section EK 12(8); and
- clarification that section CB 24B sets out the gross up calculation for proposed section EK 13.

Comment

EK 4(3)(c)

Officials agree that this is a drafting error and the reference should be to interest paid under section EK 6. However, if interest is no longer credited to the ERA (as discussed above) then this reference will not be required.

EK 4(6)(a) and EK 8(1)

It has been submitted that proposed sections EK 4(6)(a) and EK 8(1) should also refer to transfers pursuant to section 16. Officials agree that this is a drafting error and support the submission.

EK 8(4)

It has been submitted that proposed section EK 8(4) should be amended to refer to section EK 15(3) and that transfers under sections EK 16 and EK 20 should be treated as a transfer. Officials agree that this is a drafting error and that the correct reference is to section EK 15(3). Officials also agree that transfers to a persons ERA under section EK 16 and EK 20 should also be treated as payments.

EK 12

It has been submitted that the wording of section EK 12(b) should be clarified by expanding the reference to transfers to include those transfers possible under sections EK 16 and EK 20. Officials agree with this submission.

Likewise officials agree that proposed sections EK 12(2)(a)(iii) and EK 12(8) should also refer to transfers under sections EK 16 and 20. PricewaterhouseCoopers have also submitted that the words "for the environmental restoration account" should be removed from section EK 12(8) as they are unnecessary. Officials agree that the term "maximum account balance" is adequately defined in section EK 24 and that the words "for the environmental restoration account" could be removed.

EK 13

A number of parties submitted that for clarity the proposed section EK 13 should expressly state that the amount of the refund should be calculated pursuant to section CB 24B. Officials agree that this would increase taxpayer certainty and support the submission.

Recommendation

Officials agree that all the submissions should be accepted subject to a decision on whether interest will continue to be credited to the ERA.

REMOVAL OF THE WORD INDUSTRIAL

Submission
(29W – PricewaterhouseCoopers)

That all taxpayers should be able to take advantage of the retrospective application of the proposed amended wording of section DJ 10 of the Income Tax Act 1994.

Comment

In setting categories of business environmental expenditure and deduction rates, the aim was to ensure tax deductions were available for all environmental expenditure (no matter what the source of the waste). Officials did not want to create incentives for taxpayers to select one environmental solution over another.

The bill therefore includes a proposal to amend section DJ 10 to remove the word "industrial" so that a tax deduction is available for dealing with all forms of waste. This change is retrospective (to 1994) to protect taxpayers who have taken a wide interpretation of the term "industrial waste" (either in filing their tax returns or in raising a dispute with Inland Revenue). Taxpayers who have not taken a wide interpretation of the legislation are not able to take advantage of the retrospective change (in order to protect the tax base from opportunists).

Officials consulted on the proposed application date to ensure that those taxpayers who had taken a position on the definition of industrial waste would be able to take advantage of the retrospective change. Officials are not aware of any taxpayer who took a position with respect to the definition of industrial waste or who would not be able to take advantage of the retrospective change.

Recommendation

That the submission should be declined.

Other policy matters

TAX EXEMPTION FOR PETROLEUM EXPLORATION AND DEVELOPMENT

Issue: Extending the exemption to include income from related activities

Clauses 8 and 66

Submission
(11 – The Petroleum Exploration and Production Association of New Zealand, 12W – Ernst & Young for Swire Pacific Offshore Holdings Limited, 15W – Business New Zealand, 21 – Institute of Chartered Accountants of New Zealand, 29W – PricewaterhouseCoopers)

The main thrust of the submissions is that additional activities should be included in the exemption because those activities form an integral part of the exploration and development of oil and gas. That the "183-day rule" causes persons who offer these services to leave New Zealand to avoid paying tax and that this causes significant compliance costs. In particular, that:

- the exemption be extended to apply to income derived by support and supply vessels for offshore drilling rigs;
- the exemption be extended to include suppliers of various related services;
- other types of survey of the earth's crust should be exempted; and
- the exemption should also be extended to owners of the seismic survey vessels that are exempt, not just the operator.

Comment

The aim of the amendment is to remove a barrier in the tax system that caused offshore drilling rigs and seismic ships to enter and leave New Zealand for tax reasons. The concern was that the "183 day rule" was leading to a churning of rigs and seismic ships. The high mobilisation and demobilisation costs meant that the effect of churning was delaying or discouraging efficient exploration activities.

It is important to note that the policy is not intended to give a blanket exemption to any activity that relates to gas exploration. If such an exemption was proposed it would be difficult to defend against calls for tax concessions for other sectors of the economy. The exemption has been deliberately targeted at specific activities where general principles of taxation were posing a huge barrier to particular exploration activity.

Support and supply vessels

The industry is primarily concerned that the exemption advanced to offshore drilling rigs be extended to support and supply vessels. In short, their argument is that these vessels are integral to the operation of the drilling rigs. Typically an offshore drilling rig cannot operate without the services of two supply and support vessels before, during, and after the drilling of the well. These support and supply vessels are needed to supply services and to be on hand in case of an emergency.

The main difficulty in recommending an extension of the exemption to support and supply vessels is that continuing to tax these vessels will not have a material (adverse) impact on the amount of drilling that takes place in New Zealand during the period of the incentives package. While these vessels may churn in response to tax, the costs of mobilising and demobilising are simply not of the same order as those costs associated with the churning of drilling rigs. At most, the absence of an exemption would create some logistical complexity and possibly some increased costs in relation to the execution of a drilling programme.

In addition, while we accept the industry's view that the prospect of a New Zealand firm becoming substantially involved in this activity is fairly remote – at least in the next few years, it can't be ruled out altogether. We understand local firms have undertaken some work on drilling rig platforms in the past. If this is the case, the existence of an exemption would make a New Zealand supplier of services – even of just some services such as delivery of food and supplies – uncompetitive. Yet extending the exemption to include New Zealand residents would create significant efficiency and equity concerns for all New Zealanders.

Finally, there will always be tax complexity and potential leakage around legislating and administering tax exemptions. These lead to increased compliance and administrative costs as well as risk to the tax base. Consequently, it is preferable to keep tax exemptions to an absolute minimum.

Ancillary services

Submissions sought extension of the exemption to all services that are ancillary to offshore petroleum exploration. The same arguments mentioned above in relation to supply and support services apply. That is, there is no case that is analogous to the problem of the churning of the rigs referred to above. Extending the exemption would create serious boundary problems for the administration of the tax system. Moreover, wider application of the exemption would raise competitive neutrality issues vis-à-vis resident providers of services.

Other types of surveying

One submission argued that the exemption should be amended to exempt the income derived by surveyors using any survey method to identify and develop petroleum deposits. While it is possible to use other surveying methods, seismic surveying is the primary exploration tool used in offshore exploration and is regarded as most effective method available. As with the other submissions, it is necessary to make distinctions to ensure that the exemption is properly targeted and not framed in too broad a fashion.

Owners of drilling rigs

The aim of the reform is to remove a tax barrier to entities that actually perform the drilling rig/seismic operations – regardless of whether they own or lease the equipment they use. There is no basis for extending the exemption to offshore owners of drilling rigs that lease their equipment to operators.

Recommendation

That the submissions be declined.

Issue: Exemption should be automatically given

Clauses 8 and 66

Submission
(15W – Business New Zealand, 21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG)

That the exemption be automatically given, rather than being applied for. That it be clarified whether a certificate of exemption from non-resident contractors' withholding tax should be applied for when income derived by the non-resident is exempt from tax.

Comment

The submission raises the question whether the entities covered by the exemption should have to apply for a certificate of exemption from Non-resident Contractors' Withholding Tax (NRCWT). The NRCWT regime requires a New Zealand employer who makes a contract payment to a non-resident contractor to withhold tax from that payment. In situations where the non-resident contractor does not have to pay tax, because of the operation of a double tax agreement or otherwise, the non-resident contractor can apply to the Commissioner of Inland Revenue for a certificate of exemption.

Where a certificate of exemption is obtained, payments can be made to the non-resident contractor without any NRCWT being withheld. The submissions request a special rule removing this requirement for entities covered by the exemption. However, the reason for the certificate of exemption procedure is that it provides the Inland Revenue with important information needed to ensure the integrity of the tax system. In other situations where entities are not subject to income tax – for example, because of a double tax agreement exemption, they are still liable under the NRCWT rules and a certificate of exemption must be applied for. There would seem to be no reason why this requirement should be removed for entities covered by the present exemption.

The KPMG submission makes the point that it would appear to be ultra vires the regulation making power to require a person to apply for an exemption certificate when the income they derive would be exempt income under the Income Tax Act. They make this submission on the basis that the withholding regulations derive their authority from the regulation-making powers in the PAYE rules, specifically section NC 21. The PAYE rules are expressed to apply "For the purpose of enabling the collection of income tax …". Because no income tax is payable, the argument is that the regulations cannot apply.

However, the regulation-making power in section NC 21 is very wide. It allows the regulations to be made to declare payments as withholding payments for the purposes of the PAYE rules. These include a contract payment to a non-resident contractor. This treatment is not affected by whether or not the payments are exempt in the hands of the recipient. In addition, the PAYE rules provide, specifically in section NC 1, that the rules will apply notwithstanding anything in the Income Tax Act, other than part KD. An application for a certificate of exemption is therefore still required, even though the income is exempt income under the Act. Entities who qualify for the exemption should therefore still apply for a certificate of exemption.

Recommendation

That the submission be declined.

Issue: Note that because the amendment is retrospective Inland Revenue should amend affected assessments

Clauses 8 and 66

Submission
(29W – PricewaterhouseCoopers)

That the Committee note an expectation that the Commissioner will amend the assessments of taxpayers affected by the exemption to reflect the retrospective application of the amendment.

Comment

Because the exemption is retrospective to 1 January 2004 taxpayers eligible for the exemption may have filed their tax returns for the 2004 and 2005 income years based on the current law, that is, before the bill is enacted. Officials agree that the assessments of taxpayers affected by the exemption will need amending.

Recommendation

That the submission be noted.

Issue: Application date in the Explanatory Note to the bill is erroneous

Clauses 8 and 66

Submission
(29W – PricewaterhouseCoopers)

The submission contends that the application date in the Explanatory Note to the bill is erroneous. The application date is currently 25 August 2004 but should refer to 1 January 2004.

Comment

Officials agree that the application date in the Explanatory Note to the bill is incorrect. It should refer to 1 January 2004.

Recommendation

That the submission be accepted.

Issue: Whether the exemption should apply to New Zealand-residents

Clauses 8 and 66

Submission
(29W – PricewaterhouseCoopers)

That the exemption not be restricted to non-residents, but also apply to New Zealand residents.

Comment

The exemption, as currently framed, applies only to non-residents. The reason for targeting only non-residents is that only non-residents currently provide the types of services covered by the exemption. In addition, non-residents are generally more sensitive to New Zealand taxes than residents because of their inherent mobility. It is also important to maintain a distinction between residents and non-residents because exempting residents may raise competitive-neutrality issues with other residents performing similar or substitutable services.

Moreover, to open the exemption to resident companies could give rise to resident companies gaining access to income-sheltering opportunities. We do not know at the outset precisely what form these could take, but it does, in general terms, pose a risk to the tax base. The exemption should therefore remain restricted to non-resident companies.

Recommendation

That the submission be declined.

Issue: It is not clear when exploration and development starts and finishes

Clauses 8 and 66

Submission
(29W – PricewaterhouseCoopers)

That the amendment lacks clarity as to when exploration and development activities commence and cease.

Comment

The terms exploration and development are not technical terms of art, but they are terms which have a widely recognised meaning in the industry. However, it is possible for a myriad of situations to arise and whether a well is a development well or not can only be decided on a case-by-case basis. It is not possible to exhaustively define what these terms mean.

Recommendation

That the submission be declined.

Issue: Reference to the earth's crust is confusing

Clauses 8 and 66

Submission
(29W – PricewaterhouseCoopers)

That the reference to the earth's crust should be removed as it causes confusion.

Comment

Officials agree that the reference to the earth's crust may be confusing because it is not clear what the crust of the earth represents. The crust may represent different depths in different offshore permit areas. Therefore, the reference to the earth's crust should be removed.

Recommendation

That the submission be accepted.

Issue: Residual issues relating to New Zealand-sourced income

Clause 9 and 65

Submission

(22 – KPMG)

The amendment to exclude the foreign-sourced income from the income of the Cook Island National Superannuation Fund (the Fund) is appreciated. However, the amendment still leaves some residual issues relating to the treatment of New Zealand-sourced income. Preference is that the Fund be deemed not to be resident in New Zealand.

Comment

The Cook Island National Superannuation Fund is a compulsory national superannuation fund established under Cook Island legislation. Under current New Zealand tax law, the current governance structure is likely to result in the Fund being treated as a unit trust and therefore a company for tax purposes. Due to the administration, management and investment functions of the Fund being carried out in New Zealand by the Public Trust, as trustee for the Fund, it is likely that the centre of management of the Fund is in New Zealand, meaning the Fund will be resident in New Zealand. The fund is therefore likely to be a New Zealand-resident company for tax purposes and subject to New Zealand tax on its worldwide income at the rate of 33%.

If it were not for the Public Trust being the trustee of the Fund, the Fund would be treated as a non-resident for New Zealand tax purposes and therefore taxable only on its New Zealand sourced income. The proposed amendment exempts its foreign-sourced income from income tax which means that the Fund will be subject to tax on its New Zealand sourced income.

The submitter has expressed a preference that the Fund be deemed not to be resident in New Zealand for tax purposes. By being treated as a non-resident, the Fund would be able to receive interest on which approved issuer levy or non-resident withholding tax has been paid.

The policy intent of the proposed amendment is to ensure that the Fund is treated for tax purposes in a manner similar to that of a non-resident.

Officials accept that the proposed amendment does not achieve the policy intent because the Fund can not receive interest on which approved issue levy or non-resident withholding tax has been paid.

Recommendation

That the Fund be treated for tax purposes in a manner similar to that of a non-resident.

TAX RECOVERY PROVISION: APPLICATION TO CIVIL PENALTIES AND INTEREST

Issue: Amendment should not be made

Clause 49

Submission
(29W – PricewaterhouseCoopers)

The proposed amendment to section HK 11 should not be made. The amendment extends the scope of the section and no policy justification for the extension has been provided.

The submission notes that the Income Tax Act 1994, the Income Tax Act 1976 and the Land and Income Tax Act 1954 all included provisions with similar effect to section HK 11 of the Income Tax Act 2004. The new penalties and use-of-money interest rules were introduced in 1996 with application from the 1997-98 income year. Given that the application of section HK 11 was not extended at the time the penalties and interest rules were introduced, it is difficult to accept the contention that the amendment is "in line with the policy intent of the tax recovery provision".

Comment

Officials do not agree with the submission's view that the proposed amendment is not in line with the policy intent of the tax recovery provision. The tax recovery provision in its current form was enacted in 1992 as section 276 of the Income Tax Act 1976, with application from the 1992-93 income year. Section 276(5)(d) referred to the "proportion of any additional tax or other impost arising under this Act for late payment, which comprises part of the tax liability". Section 421 of the Income Tax Act 1976 stated that penal tax "shall for all purposes be deemed to be tax of the same nature as the deficient tax". These references were carried through to the Income Tax Act 1994 until they were replaced by the new penalties and interest rules which were enacted in 1996.

Current section HK 11(4)(d) refers to the "proportion of any late payment penalty or interest arising under this Act or the Tax Administration Act 1994 for late payment, which comprises part of the tax liability". Section 156A(1) of the Tax Administration Act 1994 provides that "for all purposes relating to the recovery of an unpaid civil penalty by the Commissioner, the civil penalty is deemed to be a tax of the same type as the tax in respect of which the penalty is imposed".

Therefore, there are significant statutory references which indicate a legislative intent to apply the tax recovery provisions in section HK 11 to civil penalties and use-of-money interest. However, there is some uncertainty that the current law achieves this policy intent. A clarifying amendment is therefore desirable to remove this uncertainty.

Recommendation

That the submission be declined.

Issue: Consideration of overall level of penalties

Clause 49

Submission
(22 – KPMG)

There is a need for further thought to be given to the overall level of penalties – in particular, their counterproductive nature in inducing taxpayer compliance. It is premature to effectively elevate penalties to the status of tax without further consideration being given to the broader issue of penalties and their overly-harsh impact on some taxpayers.

Comment

It is outside the scope of this amendment to consider a wider review of the penalty rules. Officials note that the current penalty rules that were originally enacted in 1996 have been subject to several reviews, including by the Committee of Experts in 1998, and the Finance and Expenditure Committee in 1999. The penalty rules were also the subject of a further discussion document in 2001 as part of a post-implementation review by the government. Substantial amendments have been made to these rules since their enactment in 1996.

The amendment proposed to be made to section HK 11 to ensure that it applies to civil penalties and use-of-money interest is of a clarifying nature only. It is the policy intent of section HK 11 that it should apply to allow Inland Revenue to collect unpaid civil penalties and use-of-money interest imposed on companies from their directors and shareholders if the requirements of that provision are satisfied.

This clarifying amendment is quite discrete and should not be dependent on a wider review of the penalty rules themselves.

Recommendation

That the submission be declined.

Issue: Application date of proposed amendment

Clause 49

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

The change to section HK 11 should come into force on the date that it receives the Royal assent and apply to arrangements entered into after that date. The amendments should therefore not apply to arrangements entered into before the legislation is enacted.

Comment

The proposed amendments to section HK 11 are currently stated as coming into force on 1 April 2005. Given that officials consider the amendment to be of a clarifying nature only it is probably more appropriate for the amendment to come into force on the date of enactment (that is, the date of Royal assent). Officials agree with the submission to this extent.

However, officials do not agree that the amendments to HK 11 should apply only to arrangements entered into after the date of enactment. Such an approach would not be consistent with the clarifying nature of this amendment, which should simply apply from the date of enactment.

Recommendation

That the submission be accepted to the extent that the amendments to section HK 11 should come into force on the date on which the bill is enacted.

EXCESS IMPUTATION CREDITS OF INDIVIDUALS

Issue: Treatment of excess imputation credits of individuals

Clause 51

Submission

(21 – Institute of Chartered Accountants of New Zealand,
29W – PricewaterhouseCoopers)

The rule should be changed to enable the refund of excess imputation credits to individuals. PricewaterhouseCoopers submit that, if this is rejected, consideration should be given to refunding excess imputation credits if they are less than say, $2,000.

Comment

The submitters acknowledge that the proposed rule would remedy a mismatch between the benefit that "individual" taxpayers receive from excess imputation credits and the amount of tax paid when the credits were created.

The "carry-forward" proposal is designed to prevent the acquisition of disproportionate losses but also to be consistent with the overall framework of the imputation system. Although refunding imputation credits would remedy the problem of disproportionate losses, it would be a fundamental change to the current system and is therefore outside the scope of the bill.

Recommendation

That the submission be declined.

Issue: Extinguishing of carried-forward imputation credits

Clause 104

Submission

(21 – Institute of Chartered Accountants of New Zealand,
29W – PricewaterhouseCoopers)

When writing-off an amount of irrecoverable outstanding tax, the Commissioner should not have the degree of discretion provided in clause 104 to determine the order in which any net losses or carried-forward imputation credits of the taxpayer are extinguished. The Institute of Chartered Accountants of New Zealand submits that there should be a specific and certain rule. PricewaterhouseCoopers submit that there should be a default apportionment, and that the Commissioner should be required to ask the taxpayer for their preferred apportionment between net losses and carried-forward imputation credits.

Comment

Whether net losses or carried-forward excess imputation credits are extinguished first when an amount of outstanding tax is written off will not generally have a significant impact on taxpayers. A simple rule with no discretion is likely to have lower compliance and administration costs than a rule that provides a choice.

Under the core provisions of the Income Tax Act, available net losses are used before tax credits that are available in the same tax year. It would be consistent and simpler if this pattern were continued under section 177C of the Tax Administration Act.

Recommendation

That the proposed rule be changed so that, when writing off an amount of irrecoverable outstanding tax, the Commissioner must extinguish any net loss before extinguishing any carried-forward excess imputation credits.

Issue: Numbering of provision on use of imputation credits

Clause 51

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

Since subparagraph (iv) of section LB 2(3) of the Income Tax Act 2004 will be omitted by the bill, the current subparagraph (iiia) should be renumbered as (iv).

Comment

Renumbering current subparagraph (iiia) as subparagraph (iv) would risk creating unnecessary confusion between the new and old subparagraph (iv). This would be contrary to standard drafting practice.

Recommendation

That the submission be declined.

PUBLICATION OF TAX OFFENDERS' NAMES

Clause 103

Submission
(15W – Business New Zealand)

Business New Zealand fully supports the proposal that the Commissioner does not publish the names of serious tax offenders.

Comment

While the proposed amendment will repeal the current name publication provisions, some benefits are still seen in publishing the names of tax offenders. These benefits are greatest in cases where a court has imposed a sanction. As such, the Commissioner will, when appropriate, seek publicity after court-imposed sanctions.

Recommendation

That the submission be noted.

Issue: Support objective

Clause 106

Submission

(7W – Deloitte on behalf of the New Zealand Fire Service)

The submission supports the proposed amendment, which is to provide certainty that GST is payable on the Fire Service levy (the levy) and confirm the New Zealand Fire Service's past treatment of the levy.

Recommendation

That the submission be noted.

Issue: Scope of the proposed amendment

Clause 106

Submission

(7W – Deloitte on behalf of the New Zealand Fire Service)

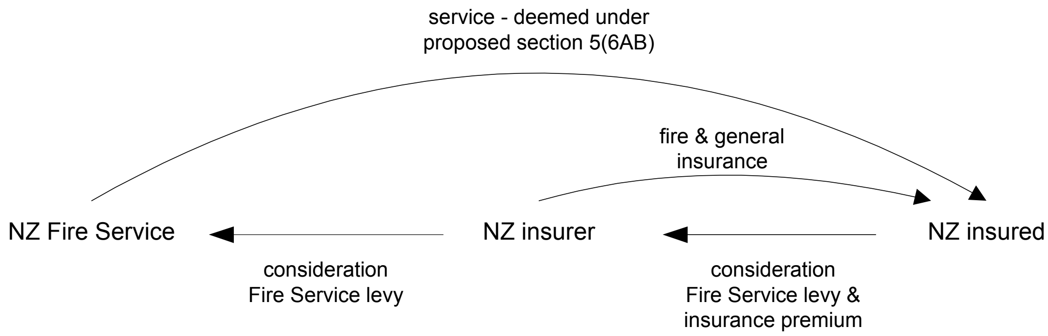
As currently drafted, the proposed section 5(6AB) confirms the application of GST to the levy but does not specify who is the recipient of the services that are deemed to be supplied under the proposed amendment. As such, the submission notes that it is possible to reach several different conclusions as to the application of the proposed amendment.

The Fire Service Act 1975 treats the amount of a levy that an insurer must pay to the New Zealand Fire Service as a debt due by the insured to the insurer. The treatment of these amounts should be better reflected in the GST Act by specifying that GST applies to payments from the insured to the insurer as well as the payments from the insurer to the New Zealand Fire Service. This clarification could be achieved by inserting a new subsection to ensure that the debt due by the insured is treated as subject to GST (with offsetting input tax credits).

Comment

Officials consider that section 5(6AB) does not affect insurers, because they are acting as collection agents for the New Zealand Fire Service. The purpose of section 5(6AB) is to clarify the application of GST to amounts collected under the levy by the New Zealand Fire Service under the Fire Service Act. This is achieved by deeming the payment of the levy to be consideration for the supply of goods and services by the New Zealand Fire Service. As such, section 5(6AB) does not have an effect on insurers' GST returns as they are neither required to charge GST on the levy (this is the responsibility of the New Zealand Fire Service under the amendment) nor able to claim input tax credits as they pass the levy directly on to insured persons. The amendment suggested the submission is not required.

Under the Fire Service Act the levy is not legally imposed on the insured, but on the insurer offering the fire and general insurance. The imposition of the levy under the Fire Service Act therefore establishes a payment mechanism but does not attempt to define who receives the services. Proposed section 5(6AB) is consistent with this treatment. Its application is illustrated below.



In the illustration the insurer is treated as a collection agent for the New Zealand Fire Service as envisaged under the Fire Services Act. The GST consequences of this treatment are as follows:

- the insurer will not be able to deduct the GST charged by the New Zealand Fire Service on the levy;
- instead, the insurer will pass on the GST inclusive amount to the insured person – typically this is shown as a separate line item on the insurers invoice to the insured;
- if the insured person is registered for GST, they will be able to deduct input tax in the usual manner.

In the event of the insured defaulting on paying the levy, the GST Act provides the insurer with an avenue of GST relief under existing section 26(1A).

The proposed treatment should not disturb existing practices by insurers. Officials note that an earlier guide on the application of GST prepared by the GST co-ordinating office in 1986 was clear that GST on the levy, like the levy itself, is collected by the insurer as agent. The guide notes that:

> "[t]he gross levy, inclusive of GST, should be paid over to the Fire Services Commission, and it will be Commission's responsibility to account for the tax in its own GST return. The levy should be excluded from the insurer's GST return."[9]

[9] See *The fire and general insurance industry*, page 18; The GST Co-ordinating office, April 1986.

Officials also note that the analysis is consistent with New Zealand's generally accepted accounting practice. Both Financial Reporting Standard 35 (FRS 35) and the New Zealand equivalent to International Reporting Standard 4 (NZ IFRS 4) require that levies, such as fire service levies, not be included in the amounts recognised as income as the insurer is acting simply as a collector.[10]

We therefore do not consider that it is necessary to clarify the GST treatment of the levy between the insurer and the insured as suggested in this submission. Nevertheless the existing practices could be confirmed in the legislation by specifying that the services are received by the insured.

Recommendation

That the submission be declined but that proposed section 5(6AB) be redrafted to specify that the services are received by the insured.

Issue: Treatment of penalties and interest

Clause 106

Submission
(7W – Deloitte on behalf of the New Zealand Fire Service)

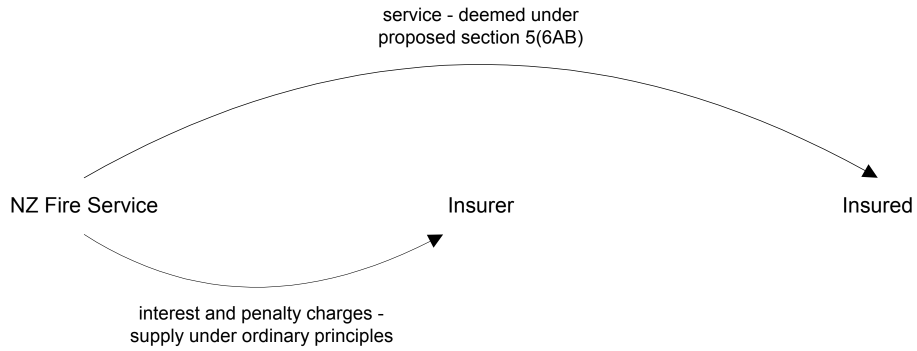
The treatment of penalties and interest imposed under the Fire Service Act should be specifically clarified in the legislation as consideration for exempt supplies.

Comment

Section 2 of the Fire Service Act includes in the definition of "levy" interest and penalties. This in effect ensures that penalties and interest are collectable in the event of an insurer not paying the appropriate amount to the New Zealand Fire Service. Interest and penalties imposed by the New Zealand Fire Service are not directly passed on to the insured.

This compares to the proposed treatment of the levy itself which, following the recommendation on page 176 under the heading "Issue: Scope of the proposed amendment", is deemed to be supplied to the insured (proposed section 5(6AB)).

[10] See *FRS 35: Financial Reporting of Insurance Activities*, paragraph 5.3, July 1999, Institute of Chartered Accountants of New Zealand; *NZ IFRS 4 Insurance Contracts*, paragraph 4.2.3 page 103, 2004, Institute of Chartered Accountants of New Zealand.



While both the levy and interest are treated under the Fire Service Act as the same payment, the elements are designed to achieve different objectives. The levy is imposed in the event of an insured person taking out fire insurance and represents consideration in return for the activities provided by the New Zealand Fire Service. The imposition of penalties and interest, on the other hand, is meant to ensure the correct and prompt payment of the funds collected by the insurer on behalf of the New Zealand Fire Service. The payments are therefore for different supplies by the New Zealand Fire Service.

This difference is reflected in the proposed amendment as it excludes "penalty or default interest" from being deemed to be a supply to the insured under section 5(6AB). Excluding "penalty or default interest" from section 5(6AB) does not, however, preclude the existence of a supply by the New Zealand Fire Service to insurers under ordinary GST principles.

Penalty interest or a charge in the nature of interest imposed under statute has, since 10 October 2000, been treated as consideration for an exempt supply under section 14(3)(a)(ii) of the GST Act. This was the result of an amendment made to the GST Act by the Taxation (Relief, Refunds and Miscellaneous Provisions) Act 2002 which sought to provide parity in exempting from GST the penalty interest for both supplies made under contract and supplies made as a result of an enactment. The purpose of section 14(3) is to ensure that charges that compensate for the time value of money, like other comparable supplies that are exempt from GST – such as financial services – remain outside the GST base. We note that the New Zealand Fire Service currently treats penalty interest as an exempt supply.

Penalty charges under the Fire Service Act are not, however, specifically included within the scope of section 14(3)(a)(ii). As noted above, the purpose of section 14(3) is to remove payments which compensate for the time value of money from the scope of the GST base. However, penalty charges can be used to recover costs in addition to the time value of money – for example, administrative costs. To specifically exempt non-interest penalty charges imposed by the New Zealand Fire Service would extend the scope of section 14(3) and potentially exempt supplies that should otherwise be subject to GST. This outcome would not be consistent with the original policy intent and potentially create inconsistencies between penalties charged under contract or an enactment with those imposed under the Fire Service Act.

Officials note, however, that proposed section 5(6AB) as presently drafted is unclear. We recommend that penalties imposed under the Fire Service Act be excluded from the scope of proposed section 5(6AB). This change should allow the New Zealand Fire Service to determine the GST treatment of penalties imposed on insurers according to the application (or not) of the exemption for penalty interest under section 14(3)(a)(ii) and/or ordinary principles.

Recommendation

That the submission be declined. Clause 106 should, however, be amended to remove penalty charges, in addition to interest penalties, from the ambit of proposed section 5(6AB).

Issue: Deduction of input tax

Clause 106

Submission

(7W – Deloitte on behalf of the New Zealand Fire Service)

The deduction of input tax for GST charged on the levy needs clarification. The drafting of the proposed amendment leaves open the question whether insurers are able to deduct input tax for GST paid on the levy. The amendment does not clearly specify who receives the services which are deemed to have been supplied when the levy is imposed. Without reference to a recipient, GST-registered persons that pay the levy may not be entitled to deduct that GST as "input tax".

Comment

Following the recommendation on page 176 under the heading "Issue: Scope of the proposed amendment", clause 106 should be redrafted to specify that the insured is the recipient of the services deemed to be supplied under proposed section 5(6AB). This should overcome the problem identified and allow GST-registered insured persons to deduct input tax in the usual manner for any GST paid in connection with the levy. As insurers are treated as agents (see comment on page 176) and the recommendation on page 178 will clarify this, no further change is required to allow insurers to deduct input tax.

Recommendation

That the submission be declined.

Issue: Zero-rating levies paid by non-residents

Clause 106

Submission
(7W – Deloitte on behalf of the New Zealand Fire Service)

The GST Act should be clarified as to whether it is possible to zero-rate the Fire Service levy if it is charged to non-resident insurers.

Comment

Following the recommendation on page 176 under the heading "Issue: Scope of the proposed amendment", proposed section 5(6AB) should specify that the insured is the recipient of the services deemed to be supplied for the levy. This removes arguments that non-resident insurers are the recipient of the services supplied by the New Zealand Fire Service. Instead, if a non-resident insurer agrees to insure property in New Zealand the non-resident should, like a New Zealand-resident insurer, pass the GST-inclusive value directly to the insured. As noted in the submission, the imposition of the levy is determined by reference to the location of the insured's property. Therefore, liability for the levy arises when there is a connection to property in New Zealand. For the purposes of the GST zero-rating rules, services that are directly connected with property in New Zealand cannot be zero-rated as they are considered to be consumed in New Zealand.

Recommendation

That the submission be declined. Officials are planning to clarify the application of GST to statutory levies to ensure that such levies are properly included in the GST base. This will also cover the relationship of the zero-rating rules to statutory levies. This work is included in the tax policy work programme.

Issue: Scope of the amendment is incorrect

Clause 110

Submission

(15 – Business New Zealand, 21 – Institute of Chartered Accountants of New Zealand, 22 – KPMG, 28W – Corporate Taxpayers Group)

The submission contends that the scope of the amendment should be reconsidered because the current law does not raise a serious problem. The reasons cited are that the amendment is out of line with similar Australian provisions, and will cause additional business costs to businesses investing into New Zealand. This could result in entities choosing not to come to New Zealand, in favour of Australia as a more favourable destination. The KPMG submission considers the position in the European Union.

Comment

The first point raised by the submitters is that the current legislation does not raise a serious problem. However, experience suggests otherwise. For example, a non-resident company organises a conference in New Zealand for its agents. The company did not carry on any other activity in New Zealand and did not make any supplies in New Zealand except for supplies of entertainment and accommodation to their agents. The agents were not charged for this supply.

However, the non-resident company still registered for GST and claimed a refund of tax on the inputs of an entertainment and accommodation nature it incurred while its agents attended the conference in New Zealand. The legislation, as it currently stands, allows this refund. Although the supplies are made for nil consideration, they still qualify as taxable supplies in terms of the legislation.

The non-resident company in this situation is essentially the same as a final consumer, because it does not carry on any commercial activity in New Zealand. The company can register for GST in New Zealand because it carries on a taxable activity somewhere in the world. There is no requirement that it must carry on a taxable activity in New Zealand. There is therefore a real problem that is not remedied by the current legislation. That is, a company that acts like a final consumer is able to claim a refund of GST. The amendment will ensure that this is remedied.

The argument that the amendment could cause entities to go to Australia or elsewhere, because it imposes additional business costs, is not necessarily correct. Persons generally do not select where they go solely for tax reasons. It is more likely that decisions to come to New Zealand are determined by reasons other than their GST treatment. For example, New Zealand levies GST on goods purchased in New Zealand by tourists even when those goods will be consumed outside the country, thereby imposing an extra cost on tourists. This cost is refunded in many other countries. However, this does not seem to have any adverse impact on our tourist industry. Whether tourists come to New Zealand is clearly driven by other reasons.

Recommendation

That the submission be declined.

Issue: The amendment is not required because provisions already exist to deal with the perceived mischief

Clause 110

Submission
(17W – Ernst & Young, 29W – PricewaterhouseCoopers, 33W – New Zealand Law Society)

The submission states that the proposed amendments are unnecessary to combat the supposed abuse, as there are already existing provisions which will allow any input tax credits claimed in illegitimate circumstances by non-residents to be disallowed.

Comment

The main thrust of the submission is that there is already adequate legislative authority to prevent the problem the amendment is aimed at. The argument is that the input tax credit could be denied because the goods and services were not acquired for the principal purpose of making taxable supplies.

Taxable supplies are defined to be those supplies charged with tax pursuant to section 8 of the Goods and Services Tax Act 1985. Section 8 imposes tax at the rate of 12.5% on the supply in New Zealand of goods or services by reference to the value of that supply. Section 10 of the Act defines the value of supply. In section 10(19) it states that where any supply is made for no consideration, the value of that supply is nil.

The argument the submitters make is that, because the supply is for nil consideration, and the tax to be charged in relation to that consideration is nil, no taxable supplies have been made. (A registered person can only claim an input tax credit for its purchases of goods and services if it acquired them for the principal purpose of making a taxable supply.)

However, this argument is incorrect. Even though the tax that is payable as a result of applying 12.5% to nil consideration is nil, this does not mean that the supply is not a taxable supply. The supply has been charged with tax at 12.5%, and that is the requirement for a taxable supply, not that some positive amount of tax should be payable as a result of the application of section 8. There is no requirement in the Goods and Services Tax Act 1985 for consideration to be charged on supplies between unassociated persons. Supplies made for nil consideration may therefore qualify as taxable supplies, and an input tax credit is therefore allowed under the current law. The problem the amendment is aimed at therefore does exist and is not addressed under the current law.

The submitters also raise the point that the general anti-avoidance provisions could be used to deny an input tax credit. However, whether a particular situation amounts to avoidance has to be considered on a case-by-case basis. A more certain approach is needed to ensure that input tax credits are not available in this situation.

Recommendation

That the submission be declined.

Issue: The proposed amendment will result in commercial uncertainty for multi-national groups with New Zealand operations

Clause 110

Submission
(17W – Ernst & Young)

The submission states that commercial uncertainty will be introduced by the proposed amendments for multi-national groups with New Zealand operations.

Comment

The submission contends that the amendment will create significant uncertainty for non-residents who are registering for GST for legitimate reasons. It will therefore become a determining factor when non-residents are considering how to structure their operations, resulting in the possible hindrance of commercial transactions.

It is also submitted that the Commissioner's intended guidelines on how the discretion will be applied will not solve this issue. This is so because the Commissioner's guidelines are not binding, and this would leave it uncertain how the discretion should be applied.

However, officials consider that guidelines will clarify and make sufficiently certain the application of the Commissioner's discretion. This is an accepted way of setting out detail that is not appropriate for inclusion in the legislation and has worked well in other situations. A recent example is the Inland Revenue guidelines on the application of the zero rating of business-to-business supplies of financial services. The point raised by the submission in relation to grouping should be adequately dealt with by the guidelines to be published.

Some guidelines have already been provided in the commentary to the bill by way of example. This guidance states the proposed discretion will not be exercised in the case of a non-resident registering in advance of starting business operations in New Zealand.

Recommendation

That the submission be declined.

RWT ON DIVIDENDS PAID TO NEW ZEALAND INVESTORS IN OFFSHORE UNIT TRUSTS

Clauses 2, 52B, 57B to 57E, 60, 84B, 85 and 87

Overview

In December last year legislation was enacted[11] that resulted in distributions from certain unit trusts previously treated as "non-taxable bonus issues" for New Zealand tax purposes being treated as dividends and taxed accordingly. This new legislation affects distributions from offshore unit trusts.

As a consequence, individual investors in offshore unit trusts will derive a dividend, from which no foreign or New Zealand tax will have been withheld. These investors will have a New Zealand income tax liability and will be required to file an income tax return.

The resident withholding tax (RWT) rules should allow fund managers to withhold tax on behalf of investors. The RWT rules require the deduction of withholding tax from interest and dividends paid to New Zealand residents. RWT is deducted at source at the time the interest or dividend income is paid, thus eliminating the need in many cases to file an income tax return as the correct amount of tax will have been withheld.

The income tax legislation does not currently allow New Zealand fund managers, who are not agents, to elect to be subject to the RWT rules in relation to investments in offshore unit trusts by New Zealand residents. In many cases, the rules prevent a taxpayer helping another to meet their tax obligations.

The proposed amendments will make it easier for individuals to accurately meet their tax obligations, while lowering compliance and administration costs. A key advantage of the proposal is that it is voluntary. The decision to offer the withholding facility is a matter for each fund manager to consider.

It is proposed to amend the resident withholding tax rules to allow:

- New Zealand fund managers to elect to offer a withholding tax facility (to be a RWT "proxy");
- the correct marginal tax rate to be nominated where an investor elects to use the withholding tax facility; and
- the requirement that the investor files an annual income tax return to be removed.

[11] Taxation (Venture Capital and Miscellaneous Provisions) Act 2004.

Issue: Application date

Submission
(29WA – PricewaterhouseCoopers, 36W – New Zealand Funds Management Limited, Matter raised by officials)

A number of clauses do not have an application date. The application date for all the amendments allowing persons to be a RWT proxy, should be 21 December 2004, including consequential amendments to the Tax Administration Act 1994.

Comment

Officials agree that the application date for all the amendments should be 21 December. This was the date the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 was assented to and that was the offshore unit trust dividend amendment effective from. The application date is retrospective to ensure that taxpayers are not adversely affected by the timing difference between the enactment of the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 and the enactment of the Taxation (Base Maintenance and Miscellaneous Provisions) Bill currently before the Finance and Expenditure Committee.

Officials also note that the amendments amend the Income Tax Act 2004 which comes into force on 1 April 2005. However, the amendments apply from 21 December 2004, and therefore the Income Tax Act 1994 should also be amended.

Recommendation

That the submission be accepted.

Issue: Type of recipient

Submission
(37W – Investment Savings and Insurance Association of New Zealand,
29WA – PricewaterhouseCoopers, 36W – New Zealand Funds Management Limited)

One of the conditions for the RWT proxy rules to apply is that the recipient is a natural person. There is no policy reason why the recipient cannot be a trustee of a qualifying trust.

Comment

The proposed amendment allows a person to elect to be a RWT proxy for a payer of resident withholding income. One of the conditions to be a proxy is that the recipient is a natural person.

Officials acknowledge that some unit holders will be trustees, as well as natural persons. There is no reason why trustees of qualifying trusts should not also be recipients.

Recommendation

That the submission be accepted.

Issue: Type of dividend subject to proxy treatment

Submission
(36W – New Zealand Funds Management Limited, 37W – Investment Savings and Insurance Association, 29WA – PricewaterhouseCoopers, 34W – ING (NZ) Limited)

A RWT proxy should be entitled to treat all dividends distributed by the payer as resident withholding income. The RWT proxy rules should not be limited to taxable bonus issues.

Comment

As currently worded, the amendments allow a RWT proxy to pay resident withholding tax in respect of taxable bonus issues only.

Officials agree that the ability for a RWT proxy to pay resident withholding tax should not be limited to taxable bonus issues. Therefore, the proxy will be able to pay resident withholding tax in respect of all dividends.

Officials also note that it should be clarified that an RWT proxy pays resident withholding tax based on the recipient receiving the net amount of the dividend (that is, the post-tax amount).

Recommendation

That the submission be accepted.

Issue: Taxable bonus issues not "dividends" for purposes of RWT proxy rules

Submission

(29WA – PricewaterhouseCoopers, 36W – New Zealand Funds Management))

The Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 makes certain income and property of Australian unit trusts taxable. The amendments as contained in the supplementary order paper may create difficulties of interpretation in respect of the ability of a resident withholding tax proxy to pay RWT on certain distributions.

There is concern that the bonus issue is not taxable because it is excluded from the definition of "dividend" (although taxable under the revised definition of "taxable bonus issue"), and therefore may not constitute "resident withholding income" for the purposes of the RWT proxy rules.

Comment

Extending the RWT proxy rules to apply to all dividends, as recommended above, addresses this concern.

Recommendation

Note that this submission is addressed by the previous recommendation.

Other amendments proposed by officials

OFFSHORE UNIT TRUST – CONSEQUENTIAL AMENDMENTS TO THE INCOME TAX ACT 2004

Submission

(Matter raised by officials)

The Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 introduced various changes in relation to the taxation of offshore unit trusts by amending the Income Tax Act 1994. Various consequential amendments were required to the Income Tax Act 2004. However, one consequential amendment was not made because of oversight. The submission requests that the consequential amendment be made to the Income Tax Act 2004 and apply from the same date as the original amendments – that is, 21 December 2004.

Comment

The consequential amendment relates to section CF 3(2)(c)(ii) in the Income Tax Act 1994. No equivalent provision currently appears in the Income Tax Act 2004, and therefore should be included.

Recommendation

That the submission be accepted.

SHORTFALL PENALTY FOR EMPLOYERS OF NON-RESIDENT CONTRACTORS

Submission

(Matter raised by officials)

The new shortfall penalty currently found in section 141AA of the Tax Administration Act 1994 should be included in the definition of a shortfall penalty. It should also be included in the listed sections to which section 141K of the Act can apply to ensure that the penalty can be increased where there is obstruction. These amendments should apply from the same date as the original amendments, that is, from 1 April 2005.

Comment

The Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 introduced a new shortfall penalty for certain situations.

The new penalty contains two errors. The first is that the new penalty is not included in the definition of "shortfall penalty" in section 3(1) of the Act. The definition of a "shortfall penalty" should be amended to include a reference to section 141AA.

The second is that reference to the penalty was not included in section 141K(1). Section 141K provides that a penalty can be increased by the Commissioner where the taxpayer obstructs the Commissioner in determining the correct tax position in respect of the taxpayer's tax liabilities. There is no reason why the Commissioner should not also have this power in relation to the shortfall penalty imposed by section 141AA.

Recommendation

That the submission be accepted.

MINOR DRAFTING CHANGES

Issue: Allocation deficit debit rules for life insurance companies

Submission
(Matter raised by officials)

The definitions of "policyholder DWP ratio" and "reduced deficit debit" in new section MG 8B of the Income Tax Act 2004 should be amended to correct some minor drafting errors with application from the 2005-06 income year.

Comment

The Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 amended the allocation deficit debit rules for life insurance companies to prevent the inappropriate results that could arise under the previous rules.

New section MG 8B of the Income Tax Act 2004 contains the definitions for the new allocation deficit debit rules. Two of these definitions contain minor drafting errors which should be corrected.

First, in the definition of "policyholder DWP ratio", the reference to "dividend withholding payment credit account" should be replaced with "dividend withholding payment account".

Secondly, in the definition of "reduced deficit debit", the reference to "imputation credit account" should be replaced with "dividend withholding payment account".

These changes were made at the Finance and Expenditure Committee stage of the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 to the corresponding provisions in the Income Tax Act 1994, but were not carried through to the Income Tax Act 2004 as they should have been.

Recommendation

That the submission be accepted.

Issue: Sale and leaseback of intangibles

Submission
(Matter raised by officials)

The leasing terminology in the definition of "finance lease" in section OB 1 and in section FC 8B(2) and (3) of the Income Tax Act 2004 should be amended so that it is consistent with the leasing terminology used in other provisions in the Income Tax Act 2004. The amendments should apply from the 2005-06 income year. The definitions of "finance lease" in the Income Tax Act 1994 and Income Tax Act 2004 also need to be amended to be made consistent.

Comment

The Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 made amendments to the finance lease rules in the Income Tax Act 1994 and Income Tax Act 2004 to ensure that taxpayers entering into transactions involving the sale and leaseback of intangibles do not receive deductions for what are, in effect, repayments of loan principal.

Some of the amendments made to the finance lease rules in the Income Tax Act 2004 are not consistent with the leasing terminology used in that Act. Several minor changes should be made to ensure consistency of terminology.

First, the various references to "lease term" in the definition of "finance lease" in section OB 1 and in section FC 8B(2) and (3) should be replaced with "term of the lease".

Secondly, the use of the term "personal property lease asset" in the definition of "finance lease" in section OB 1 of the Income Tax Act 2004 should be standardised.

Thirdly, the reference to the term "lease payments" in the definition of "finance lease" in section OB 1 of the Income Tax Act 2004 should be replaced with "personal property lease payments".

Several features of the definitions of "finance lease" in the Income Tax Act 1994 and Income Tax Act 2004 also need to be amended for consistency purposes.

First, the requirement that the definition in the Income Tax Act 1994 applies to leases entered on or after 20 May 1999 should be reinstated.

Secondly, the requirement that it be ascertained whether or not a leasing arrangement is a finance lease at the time the lease is entered into should apply to all limbs of the definition except an arrangement involving a lease term that is more than 75% of the lease asset's estimated useful life. The exception is necessary because consecutive or successive leases may satisfy the 75% requirement only sometime after the commencement of the lease.

Recommendation

That the submission be accepted.

Issue: Refund of excess tax

Submission
(Matter raised by officials)

The terminology used in the new refund provision in section 45 of the Goods and Services Tax Act 1985 should be aligned where appropriate with the terminology used in the new refund provisions in the Income Tax Act 2004. Section 45(3) should be redrafted to deal with net refund situations only. The amendments should have the same application date as the new section 45 of the GST Act.

Comment

The Taxation (Venture Capital and Miscellaneous Provisions) Act 2004 amended the timeframes within which tax refunds are allowed under the Income Tax Act 1994 and Income Tax Act 2004 and section 45 of the GST Act.

The terminology used in the refund provision in section 45 of the GST Act should be aligned where appropriate with the terminology used in the Income Tax Act refund provisions.

First, the references to "amount properly assessed" in section 45 of the GST Act should be replaced with "amount properly payable".

Secondly, the references to "expired" should be replaced with "ended".

Section 45(3) should be redrafted to improve its comprehensibility. This would be achieved if the provision dealt with net refund situations only and applied if the original refund is less than the amount properly refundable.

Recommendation

That the submission be accepted.

Issue: Research or development

Submission
(Matter raised by officials)

The references to "tax year" in section DB 26 of the Income Tax Act 1994 (which relates to research and development expenditure) should be replaced with "income year", with application from the 2005-06 income year.

Comment

The meaning of the term "income year" in the Income Tax Act 2004 has been changed from its meaning in the Income Tax Act 1994 to now include non-standard income years. Under the Income Tax Act 1994, the term "income year" meant the year ending 31 March.

Section DB 26 of the Income Tax Act 2004 is intended to apply to taxpayers with non-standard income years as well as to those with standard income years (that is, the year ending 31 March). Accordingly, the references to "tax year" in section DB 26(5)(a) and (7) should be replaced with "income year".

Although all taxpayers with a non-standard balance date also have a tax year, the drafting approach generally taken in the Income Tax Act 2004 is to refer to expenditure incurred or income derived in a person's income year and to refer to a tax year in relation to a person's taxable income and income tax liability.

Recommendation

That the submission be accepted.

Issue: Months for payment of provisional tax

Submission
(Matter raised by officials)

A drafting error in schedule 13 of the Income Tax Act 2004 – which concerns the payment dates for provisional tax and terminal tax – should be corrected, with application from the commencement of the Income Tax Act 2004.

Comment

Column C contained in the table in part A of schedule 13 of the Income Tax Act 2004 concerns the month for payment of the third instalment of provisional tax. The provision currently refers to the "month preceding the balance date". This reference should be changed to "month of the balance date" as this wording more accurately reflects how the provision is applied.

Recommendation

That the submission be accepted.

Issue: Use-of-money interest for income statement recipients

Submission
(Matter raised by officials)

Paragraph (b)(iii) of the definition of "interest period" in section 120C(1) and the Tax Administration Act 1994 should be repealed, with application from the 2004-05 income year.

Comment

The provisions concerning the calculation of use-of-money interest in relation to income statement recipients can produce incorrect results. In particular, paragraph (b)(iii) of the definition of "interest period" in section 120C(1) of the Tax Administration Act 1994 does not work properly in some cases and can result in an interest end-date that is before the interest start-date. The provision is also unnecessary as the general provisions cater adequately for income statement recipients. Accordingly, this provision should be repealed.

Recommendation

That the submission be accepted.

Issue: Reduction of penalties for previous behaviour

Submission
(Matter raised by officials)

Section 141FB(5) of the Tax Administration Act 1994 should be amended to apply to subsections (1) and (2). This amendment should have the same application date as the new section 141FB, that is, 21 December 2004.

Comment

Section 141FB(5) allows tax shortfalls to be grouped and effectively treated as one offence. This means that all of the grouped tax shortfalls qualify for the reduction for previous behaviour. This minor remedial amendment is necessary to ensure that the section applies where a shortfall penalty for evasion is imposed.

Recommendation

That the submission be accepted.

Remedial amendments for the rewrite of the Income Tax Act

REWRITE ADVISORY PANEL – RETROSPECTIVE AMENDMENTS TO INCOME TAX ACT 2004

Submission

(Matter raised by officials)

Corrections of unintended changes in legislative outcomes in the Income Tax Act 2004 should be included in the bill.

The provisions affected are section DZ 13 (unamortised balances of expenditures in the farming and agricultural sector), sections EH 37 and EH 81 (income equalisation schemes), section LE 3(3) (section LE 3 holding companies), the definition of beneficiary income in section OB 1, and schedule 22A.

Comment

At the time of enactment of the Income Tax Act 2004 (2004 Act), the Finance and Expenditure Committee (FEC) noted that there was a concern that the new legislation could contain adverse unintended policy changes. To alleviate that concern, FEC recommended that a panel of tax specialists be appointed to review submissions, stating that a provision of the 2004 Act contains an unintended policy change. In this context, an unintended policy change is one that gives rise to a different outcome from the corresponding provision in the Income Tax Act 1994 (1994 Act). The Rewrite Advisory Panel (the Panel) accepted this review role.

The government also announced that it would consider promoting retrospective legislation to correct unintended changes in the legislative outcome of a provision in the 2004 Act.

Recommendation

That the amendments be included in the bill and that they apply from the beginning of the 2005-06 tax year, that being the commencement date for the 2004 Act.

Section DZ 13

Submission

Section DZ 13 of the 2004 Act is unclear as to its outcome.

Comment

The Panel considers it should be amended to more clearly state the intended outcome of providing a transitional rule for unamortised balances of expenditures to which section DO 4 of the 1994 Act applied.

Recommendation

That section DZ 13 be amended to more clearly state its intended outcome.

Schedule 22A

Submission

That section DZ 13 contains an unintended policy change and this should be noted in schedule 22A.

Comment

The Panel considers that section DZ 13 contains a minor policy change that simplifies the treatment of unamortised expenditures relating to the farming and agricultural sector in the transition from the 1994 to the 2004 Act.

Recommendation

That schedule 22A be amended to include section DZ 13.

Sections EH 37 and EH 81

Submission

That the definition of "specified period" in section OB 1 contains an unintended policy change in its reference to the defined term tax year.

Comment

The Panel agreed that the definition in section OB 1 of "specified period" as it relates to the income equalisation scheme contained an inadvertent change in wording that would mean all deposits to the scheme must be made by 30 September of each year. The correct policy is that deposits to the income equalisation scheme should be made within six months of the end of the person's balance date for income tax purposes.

The Panel recommended that this definition be amended to restore the position under the 1994 Act.

Recommendation

That the definition of "specified period" be amended to ensure that it relates to the depositor's approved balance date for income tax purposes (accounting year as defined in the 2004 Act).

Section LE 3 holding companies

Submission

That section LE 3(3)(e) contains an unintended policy change in its reference to exempt dividends.

Comment

Section LE 3 ensures that foreign investment into New Zealand through a New Zealand holding company is able to take advantage of the foreign investor tax credit regime. In the 2004 Act, section LE 3(3)(e) is incorrectly referenced to sections CW 9 to CW 11, which has the effect of revoking the section LE 3 company status for most companies.

The Panel agreed that this reference in section LE 3(3)(e) should be amended to restore the position existing under the 1994 Act.

Recommendation

That section LE 3(3)(e) be amended to restore the position existing under the 1994 Act.

Beneficiary income

Submission

That the definition of "beneficiary income" in paragraph (b)(ii), should cross-refer to section CC 3(2) of the 2004 Act.

Comment

The definition of "beneficiary income", in paragraph (b)(ii), cross-refers to section CC 3. The Panel concluded that this cross-reference is too broad, as it leads to the result that no accrual income can be included in beneficiary income. The correct policy is that for taxation purposes, beneficiary income cannot include income derived by a trustee from the forgiveness of a debt owed by the trustee.

Recommendation

That the definition of beneficiary income be amended in paragraph (b)(ii) to cross-refer to section CC 3(2).

POST-ASSENT CHANGES TO INCOME TAX ACT 2004

Submission
(Matter raised by officials)

The Income Tax Act 2004 was assented on 7 May 2004. After the Royal assent and in the course of preparing for print the version of the Act that is available for purchase, changes were made in 10 places to the text of the assented Act.

The changes involved one correction to a "compare note", one correction to the layout of a formula, three corrections to signs in formulae, removal of a surplus bracket, correction of the placement of a phrase in a definition, correction of a cross-reference in schedule 21, and the correction of three cross-references in schedule 23.

The changes were necessary to ensure accurate rewriting of the former 1994 Act and one set of regulations made under it. Standing Order 310 authorises the making of "amendments of a verbal or formal nature" and the "correction of clerical or typographical errors", both in the course of preparation of a bill for Royal assent.

As the amendments were made after the Royal assent, they can be considered to lack authority. To remove that doubt, officials propose that the corrections be re-enacted as minor remedial amendments and included in the bill when reported back.

Recommendation

That the submission be accepted.