Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Bill

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

14 February 2006

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CONTENTS

Changes to the tax depreciation rules

OVERVIEW

Clauses 53, 54, 55, 56, 57, 58, 80, 151, 168, 169 and 194

The bill and Supplementary Order Paper No. 382 introduce a number of changes to the tax depreciation rules. The key changes have been the subject of earlier public consultation, in an officials' issues paper released in July 2004.

The purpose of the changes is to:

- reduce the impact that tax depreciation rates may have on investment decisions, by changing the methods of calculating tax depreciation rates so they more closely match estimates of economic depreciation; and
- reduce compliance costs associated with the current tax depreciation rules.

Economic theory suggests that tax depreciation rates should mirror how an asset actually declines in value. Having tax depreciation rates that mirror economic depreciation avoids the situation whereby tax depreciation rates artificially encourage or discourage investment in particular types of assets.

Below is a summary of the key changes in the bill as introduced:

Clause 53 maintains the old depreciation rates for plant and equipment acquired before 1 April 2005 and for buildings acquired before 19 May 2005.

Clause 54 sets out the proposed amendment for how the tax depreciation rate for an item of plant and equipment is calculated. The amendment introduces the formula for double declining balance (2 / estimated useful life of an asset). This formula creates a tax depreciation rate that is generally likely to provide better estimates of how plant and equipment decline in value. Applying the new formula will increase depreciation rates for shorter-life plant and equipment and will not change depreciation rates for longer-life plant and equipment. The Supplementary Order Paper sets depreciation rates for certain motor vehicles and aircraft. These changes affect assets acquired from 1 April 2005 and the new rates will apply from the 2005–06 and subsequent income years.

Clause 54 also sets out the proposed amendment for how tax depreciation rates for buildings are calculated. The amendment introduces the straight-line depreciation formula. This formula and its diminishing value equivalent are likely to produce a present value of depreciation deductions that more closely mirror how buildings decline in value over their useful life. Applying the new formula decreases depreciation rates for buildings. These changes will affect buildings acquired on or after 19 May 2005, and will apply from the 2005–06 and subsequent income years.

Clause 55 is a compliance cost-saving measure. It is aimed at allowing taxpayers the option of continuing to depreciate plant and equipment acquired after 1 April 2005 at the current depreciation rates for the 2005–06 income year and beyond. Without this clause, taxpayers would be required to depreciate these assets at the proposed new rates from the beginning of their 2005–06 income year.

Clause 56 proposes changes to the low-value asset thresholds. The first threshold allows an immediate deduction for capital expenditure that is less than $500. The second threshold, known as the single supplier rule, allows an immediate deduction for capital expenditure of up to $500 on items that have the same depreciation rates and that are purchased at the same time from a single supplier.

Clause 57 proposes that the cost of selling or disposing of an asset is fully deductible. This change ensures that when the cost of selling an asset exceeds the amount received, any resulting loss is fully deductible. This change applies to asset disposals from the 2005–06 income year.

There are some consequential proposed changes because of the new methods for calculating tax depreciation rates. Together the bill and Supplementary Order Paper No. 382 provide the following amendments to definitions:

- Clause 58, as amended, includes references to the new sections EE 25 to EE 25D in the definition of economic rate.
- Clause 143 amends the definition of "finance lease" in section OB 1 to also include reference to the new sections EE 25B, to EE 25D.

Clause 80 extends section GC 6 to allow a deduction to be denied when the Commissioner of Inland Revenue is of the opinion that certain arrangements are intended to allow the taxpayer to apply the new higher depreciation rates to existing assets. The concern is that the introduction of the new higher depreciation rates will provide taxpayers with an incentive to sell and re-acquire assets for the benefit of the higher depreciation rates.

Clause 151 inserts new Schedule 11B. The Schedule specifies the new depreciation rate bands (both straight line and diminishing value) for plant and equipment, and buildings. For administrative reasons, the legislation groups a band of depreciation rates into a single depreciation rate. Having depreciation bands reduces the number of depreciation rates that taxpayers and the department have to consider.

Clauses 168 and 169 propose amendments to sections 91AAF and 91AAG of the Tax Administration Act 1994. These amendments result from the new methods for calculating the tax depreciation rates. The proposed amendments require the Commissioner to have regard to the proposed new methods when determining an asset's depreciation rate. These changes apply to plant and equipment acquired after 1 April 2005 and for buildings acquired on or after 19 May 2005.

Eight submissions have been received on the changes to the tax depreciation rules introduced in the bill. The overall tenor of submissions is:

- general support for changes that increase tax depreciation rates;
- general criticism of the changes that seek to reduce building depreciation rates; and
- that the changes to the low-value asset thresholds do not go far enough.

CHANGE TO THE METHOD OF CALCULATING DEPRECIATION RATES FOR PLANT AND EQUIPMENT

Issue: Scope of change

Clause 54

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

Taxpayers should have the option to apply the new depreciation rates to all plant and equipment, without reference to the date that the asset was purchased.

Comment

Allowing taxpayers to apply the proposed depreciation rates for all existing plant and equipment will add significant cost to the proposal. The revenue cost over the next five years of the gradual introduction of double declining balance depreciation rates for plant and equipment is approximately $720 million. The revenue cost of allowing the total stock of plant and equipment (between $130 and $150 billion) to apply double declining balance depreciation rates from 1 April 2005 is estimated to be $1,200 million for the next five years.

Allowing higher depreciation rates would arguably provide existing owners of plant and equipment with a windfall gain. Not extending faster depreciation rates to plant and equipment is the mirror image of not providing slower depreciation rates to existing buildings. The general approach is aimed at ensuring that taxpayers acquiring assets are as informed as possible about future depreciation on these assets.

Recommendation

That the submissions be declined.

Issue: Application dates

Clause 54

Submission
(29 – Corporate Taxpayers Group)

Taxpayers should be able to apply the new depreciation rates for short-lived assets from 1 April 2005, regardless of the taxpayer's balance date. The submitter also suggests that the new depreciation rates should be mandatory only from the 2006–07 income year. The submission believes these suggestions would make the rules less complex and reduce compliance risks with the transition from the old to the new depreciation rates for plant and equipment.

Comment

The proposed application date rules for plant and equipment are somewhat complex. The complexity is increased by the requirements that the new provisions apply to assets acquired from 1 April 2005, but from the start of the 2005–06 income year.

This complexity is the result of managing competing objectives. The first objective is to ensure that the new rules do not create tax incentives to delay investment decisions. This is a reason for not making the higher depreciation rates apply only to assets acquired after the start of the 2005–06 income year. The proposal to introduce double declining balance depreciation was announced by the government in the 2005 Budget. Making the proposed change apply to assets purchased after 1 April 2005 reduced a concern that most late balance date taxpayers (those whose 2004–05 tax year ends between 31 May and 30 September 2005) would have incentives to delay capital expenditure if the change was to apply to assets acquired at the beginning of the 2005–06 income year.

As suggested by the Corporate Taxpayers Group an alternative would have been to apply the new higher rates to all assets from 1 April 2005 and to allow late balance date taxpayers higher depreciation rates in their 2004–05 income tax years. However, this proposal is not without problems. By the time this bill is enacted almost all late balance date filers will have already filed their 2004–05 income tax returns based upon the current law. They would need to apply to the Commissioner to have their assessments amended in order to apply any new depreciation rates. This imposes its own compliance issues and costs. In addition, the Corporate Taxpayers Group submission points out that there are difficulties changing depreciation rates mid-way through an income year. The problems with mid-year changes are increased risk of errors and the additional compliance costs of monitoring fixed asset registers.

Officials believe that the proposed application date is the one that best manages these concerns and that changing the application date at this stage is likely to lead to additional compliance costs. The New Zealand Institute of Chartered Accountants in their oral submission to the Committee asked that the application dates not be changed, as taxpayers understand the current proposed application dates.

The proposal that the new depreciation method apply to plant and equipment acquired from the beginning of the 2006–07 income should be accepted. This measure would reduce the compliance cost of having to re-enter the new higher depreciation rates for assets already in the books for the 2005–06 income year. Such a rule would reduce the transition costs from the old rules to the new rules for some taxpayers. This option is revenue positive for the government and is optional, as taxpayers would elect in their 2005–06 tax return to apply the old depreciation rates to plant and equipment acquired in the 2005–06 income year.

Recommendation

That the submission be partly accepted, as detailed above.

Issue: Catch-up for partial deductions

Clause 54

Submission
(48 – New Zealand Institute of Chartered Accountants)

The rules ought to provide taxpayers with the ability to catch up for any deductions that they were not in a position to apply at the time of preparing their 2006 income tax return.

Comment

The submitter's concern is that taxpayers with early or standard balance dates may not be in a position to claim depreciation deductions in accordance with the new depreciation rates that Parliament enacts. This issue applies equally to increases or decreases in asset depreciation rates.

The Commissioner has the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment to ensure its correctness. The Commissioner has agreed to amend 2006 income tax assessments for taxpayers who have not been able to apply changes to the tax depreciation law as a result of the taxpayer's return filing date being too close to, or prior to, the date that the bill is enacted.

However, we note that it will be very unlikely that any 2006 income year tax returns will be filed before this tax bill is enacted. In part, this is because Inland Revenue will only provide 2006 tax returns to taxpayers in March 2006.

Recommendation

That the submission be noted.

LOWER DEPRECIATION RATES FOR BUILDINGS

Issue: Depreciation rates for buildings

Clause 54

Submission
(11W – Business New Zealand, 46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The pace of change (including technological and consumer preferences) means that the estimated useful life of some buildings is shorter than the 50 years currently used. This supports the view that building depreciation rates ought to be higher than what is provided for in current legislation rather than lower.

Comment

Most submissions do not support a reduction in depreciation rates for buildings.

How best to allow for depreciation on structures is a more complex problem and involves balancing conflicting considerations. An important class of structure is residential rental housing. It might seem that the most direct way of checking whether current depreciation rates are reasonable would be to use data on government valuations.

Officials have examined government valuations for houses, as published between 1995 through to 2002.[1] The data reflect unweighted average valuations across the different local authorities and are presented in the table below.

Between 1995 and 2002 the average capital value of a house rose from $105,594 to $142,791, a 35.2 percent increase. It is possible that capital values might rise, even if buildings fall in value, if land is appreciating sufficiently quickly. Between 1995 and 2002 land rose from $32,548 to $51,021 (a 56.8 percent increase) and improvements rose from $73,046 to $91,770 (a 25.6 percent increase). Thus, even if one focuses solely on the value of improvements, government valuation data would seem to suggest that housing is appreciating, not depreciating. Moreover, the appreciation in the value of improvements appears higher than inflation. For example, the CPI rose by only 12.2 percent between December 1995 and June 2002.

[1] Note that publication dates include a three-year spread of valuations. For example, the 1995 publication has valuation dates from 1993 to 1995. The valuation dates differ between local authorities, but are always within a three-year band. The publication dates selected reflect the three-year valuation cycle and are based on July end, with the exception of 1995, which is December year-end.

Table 1: Data from Valuation New Zealand and Quotable Value

	1995	1998	2000	2002
Average capital value	$105,594	$121,994	$130,480	$142,791
Average value of improvements	$73,046	$82,166	$86,027	$91,770
Average land value	$32,548	$39,829	$44,453	$51,021

At first sight, this data would appear to provide a case against allowing any depreciation deductions for residential rental accommodation. However, there are at least two qualifications. First, there may be important cyclical elements in building prices. For example, variations in supply and demand for construction could affect construction prices and the value of improvements, and this may be a partial explanation for the increased value of improvements in table 1. Second, and more fundamentally, there is an obvious problem arising because the government valuation data reflects average values of buildings. Even if buildings depreciate, the data may increase through time because of higher value new homes or because of extensions and capital improvements to existing homes. Nonetheless, the data provide us with concerns that current depreciation rates for housing may be set too high.

Another approach is to look at research on building depreciation. Perhaps the most well-known studies of economic depreciation are by Hulten and Wykoff,[2] who estimated declining balance (a diminishing value equivalent) rates of depreciation for various building types, but excluding rental housing. Their best geometric approximations to economic depreciation were 2.02 percent for retail stores, 2.47 percent for offices, 2.73 percent for warehouses and 3.61 percent for factories. A study by Jorgenson and Sullivan (1981) extended the analysis to owner-occupied housing, finding a rate of economic depreciation of 1.3 percent.[3] Based on the results of empirical studies on the prices of used structures in the United States, the Bureau of Economic Analysis has estimated economic depreciation rates which include 1.14 percent for new residential buildings with one to four-unit structures (with an 80-year economic life), 1.40 percent for new residential structures with more units (with a 65-year economic life),[4] 3.14 percent (31-year economic life) for industrial buildings and 2.47 percent (36-year economic life) for office buildings.

In our view, the Hulten and Wykoff studies do not provide strong enough grounds for providing taxpayers with a less favourable treatment than straight-line depreciation for structures. Nor, however, do they support the status quo.

[2] *The measurement of economic depreciation using vintage asset prices: An application of the Box-Cox power transformation,* Hulten, Charles R. and Wykoff, Frank C. Journal of Econometrics 15 No. 8 (April 1981).
[3] *Inflation and corporate capital recovery*, Jorgenson, Dale W. and Sullivan, Martin A in Depreciation, Inflation and the Taxation of Income from Capital, edited by Hulten, Charles R. 1981.
[4] *The measure of depreciation in the US national income and production accounts,* Fraumeni, Barbara M. Survey of Current Business, July 1997.

Currently, the 13.5 percent assumed residual value formulation comes close to allowing double declining balance depreciation for long-lived assets such as most structures. To our knowledge, unlike the case of plant and equipment, the empirical evidence does not suggest that allowing straight-line depreciation over an asset's life would lead to an inappropriately low present value of depreciation deductions for buildings and other structures. Thus for buildings and other structures, we suggest there is a prima facie case for allowing straight-line deductions over their economic life. This would be consistent with the current tax treatment of intangible property. At present, taxpayers investing in structures could be given the choice of a diminishing value alternative where the diminishing value rate was chosen to lead to a present value of deductions similar to that which straight-line depreciation would provide.

Most buildings currently have an estimated economic life of 50 years. This is consistent with the requirement for the structure of a building to last no less than 50 years or the specified intended life (section B2.3 of the Building Code 1992). The Building Act 2004 (section 113) also requires that when it is the intention that the building will last for less than 50 years, a building consent must say how the building must be altered, removed, or demolished on or before the end of the specified intended life. Without these conditions the consent cannot be issued. This has been a requirement since 1991. Anecdotal evidence from Auckland, Wellington and Christchurch City Councils suggests that very few building consent applications specify an intended life of less than 50 years.

Using a 50-year estimated useful life would convert to a straight-line depreciation rate of 2 percent per annum. The diminishing value equivalent rate would be approximately 3 percent. Although economic depreciation rates will never be measured with precision, these rates do not appear to us to be out of line with international studies of economic depreciation for buildings.

In cases when the Commissioner is satisfied that a building does have an intended useful life of less than 50 years the Commissioner may issue a special depreciation rate. If the estimated useful life is clearly incorrect on average, or is clearly incorrect for a particular building, the Commissioner can consider the issue. When a taxpayer is able to justify to the Commissioner's satisfaction that a different estimated useful life ought to apply to a building, the Commissioner may issue a special rate for this building or revise the general rate. This flexibility deals with the concern being raised.

Recommendation

That the submission be declined.

Issue: No change to building depreciation rates

Clause 54

Submissions
(11W – Business New Zealand, 18W – Metro Law, 29 – Corporate Taxpayers Group, 46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

Building depreciation rates should not be reduced for the following reasons:

- changing the rates will result in two classes of building owner, one getting a higher depreciation rate than the other;
- changes to building depreciation rates are designed to encourage taxpayers to invest in other assets rather than buildings and residential investment properties;
- newer buildings tend to be less durable than older buildings; and
- that this is being done to offset the fiscal costs of introducing the double declining balance depreciation method to setting the depreciation rates for plant and equipment.

Comment

The government does not want to affect past investments. This is why there is no proposed change to the tax treatment of buildings acquired before 19 May 2005. To change the tax treatment of these buildings could undermine investor confidence. Consequently, there will be for the foreseeable future, building depreciation rates that differ for identical buildings because of the building purchase date. Officials do not see this as being particularly problematic. There will also be different depreciation rates for otherwise identical items of plant and equipment depending on the date of purchase, yet no one has raised this as a concern.

The proposed change to building tax-depreciation rates is to reduce an investment distortion by providing rates of depreciation that are thought to better reflect how buildings depreciate.

It is very difficult to determine how long a building will be useful. However, for the purposes of the Building Act 2004 and the Building Regulations 1992, the presumption is that buildings will typically last more than 50 years. Anecdotal evidence from Auckland, Wellington and Christchurch City Councils suggests that very few building consent applications specify an intended life of less than 50 years.

The government always considers fiscal matters. However, this was not the reason for reducing building depreciation rates. The purpose of this proposal is to better reflect how buildings are likely to depreciate.

Recommendation

That the submissions be declined.

Issue: Definition of a building

Clause 54

Submission
(46 – PricewaterhouseCoopers)

The term "building" should be defined for income tax purposes.

Comment

Officials want to ensure that New Zealand's tax rules are clear and create certainty. In cases when there is a general sense of ambiguity or uncertainty with a term or phrase, it is often helpful for Parliament to define what is meant. However, it is extremely difficult to provide a definition of many assets and doing so may create scope for litigation.

We are not aware of any general uncertainty around what is a "building". This suggests that the law as to what is a building is reasonably settled.

For these reasons, we do not consider that the term "building" needs defining in the Income Tax Act 2004.

Recommendation

That the submission be declined.

Issue: Delay application date

Clause 54

Submission
(18W – Metro Law)

If the changes to building depreciation rates are enacted, they should apply only to buildings acquired after the date the new legislation receives Royal assent.

Comment

The submission suggests that some taxpayers who acquire a building after 19 May 2005 and before the date that the bill is enacted may be disadvantaged because they will be oblivious to any proposed changes to building depreciation rates.

The changes announced by the government as part of Budget 2005 were consulted on as part of the generic tax policy process. Officials considered and analysed over 2,000 submissions during the policy development process. The proposed changes were also widely reported, together with other announcements in Budget 2005.

Officials would have concerns with the proposed changes applying from the date of enactment. The concern is that this timing would provide scope for taxpayers to bring forward the date of building investments to benefit from the higher depreciation rate. This is likely to distort investment decisions and artificially encourage building investment up to the date of Royal assent.

Recommendation

That the submission be declined.

Issue: Transfers of buildings between associated parties

Clause 54

Submission
(18W – Metro Law)

A concession should be provided for transfers of buildings between associated persons, which occur after 19 May 2005, to preserve the current building depreciation rates for buildings transferred to associated persons.

Comment

As the bill is drafted, the transfer of a building to another person means that the new owner uses the proposed lower building depreciation rate. However, the current law prevents an increase in depreciation rates when assets, other than buildings, are transferred between associated persons. Thus, there appears to be a lack of even-handedness with this proposal.

The proposed legislation may lead to economic inefficiencies. The change to the building depreciation rates triggered by the transfer of an asset from one taxpayer to another may affect the reorganisation of assets within a group of companies. Some companies may not reorganise or only partly reorganise.

On the other hand, it is our view that it would not be appropriate, for example, to allow a daughter who buys a rental property that was previously owned by her parents to continue to depreciate the building at the current depreciation rates. To do so would provide an artificial bias towards property being traded within a family.

Officials therefore recommend that the submission only be accepted in part, with relief allowed only in limited circumstances. We suggest that relief be allowed in the case of transfers between companies where there is 100 percent common ownership. For individuals we suggest that relief only be allowed for transfers of relationship property between wives and husbands, de facto couples or same-sex partners. The transfer of property from a mother to a daughter (as noted above) would not be eligible for relief.

The fiscal cost of allowing rollover relief is difficult to determine. Officials have no data on transfers of buildings between associated persons. However, we do not think that the costs will be material. It is likely, as is generally the case with this type of relief, that there will be some added complexity to the tax depreciation rules.

Recommendation

That the submission be partially accepted, as detailed above.

Issue: Scope of savings provision

Clause 54

Submission
(29 – Corporate Taxpayers Group, 47 – New Zealand Law Society)

The bill should be clarified to more clearly identify those contracts for buildings that are covered by the savings provision in section EE 25C(6).

Comment

The intention of all of the proposed changes is, as far as possible, not to interfere with earlier investment decisions. For example, when a taxpayer has legally committed to purchase a building, whether the building is built or is to be constructed, and the commitment was made before 19 May 2005, the policy intention is that the building depreciation rate at that time ought to apply. Any sale, after 19 May 2005, of the building or the right to own a building yet to be built should be subject to the building depreciation rates proposed in the bill.

Further clarification of the policy intent will be published in the *Tax Information Bulletin* article on the proposed new rules.

Recommendation

That the submission be declined.

CHANGES TO THE LOW-VALUE ASSET THRESHOLDS

Issue: Further increases to low-value asset thresholds

Clause 56

Submission

(11W – Business New Zealand, 29 – Corporate Taxpayers Group, 46 – PricewaterhouseCoopers, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

Submitters support the increase in the low-value asset thresholds from $200 to $500. However, they consider that the proposed thresholds of $500 do not go far enough. The suggestions for the low-value threshold range from $1,000 to $5,000 and for the single supplier threshold from $5,000 to $10,000.

Comment

As discussed earlier, the proposed tax rules will be neutral for investment when deductions for capital expenditure are based on the fall in an asset's market value (economic depreciation). In the case of low-value assets, the proposed tax rules depart from this important principle because of the compliance costs of requiring taxpayers to capitalise and depreciate all capital expenditure.

The proposal to increase the low-value assets threshold arose because the $200 threshold was not achieving the same compliance cost savings as it did in 1993. The proposed $500 threshold more than doubles the present level and is also more than an inflation adjustment.[5]

It also makes sense for the low-value asset threshold and the single supplier-rule threshold to remain aligned. This is because it would be difficult to manage the risks of a single asset being purchased from a single supplier at the higher threshold.

The proposed threshold of $500 compares well with Australia's immediate deduction thresholds. The Australian threshold for immediate deduction for assets used to produce non-business income is $300 and for business income it is $100. However, Australia uses a low value asset pool for equipment. The low value pool allows a 37.5 percent diminishing value deduction for equipment that has a book value of less than $1,000. New Zealand also allows for pool depreciation but the rate is based on the rate of the slowest depreciating asset in the pool.

The single supplier threshold requires the costs over a certain total value, for purchases of assets with the same depreciation rate, from a single supplier at the same time to be capitalised. This threshold is designed to counter a tax avoidance opportunity that arises because of the low-value asset threshold. The concern is that taxpayers may be able to structure capital expenditure into $200 units, when they are in fact purchasing a single, more expensive asset.

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[5] Indexing the low-value asset thresholds, based on the average inflation rate of 2.1 percent for the period 1993 to 2005, suggests thresholds of approximately $260.

Officials suggest that further raising the thresholds would lead to the following concerns:

- Significantly higher thresholds create a greater risk of taxpayers breaking assets down into sub-components. For example, with a $1,000 threshold, a $3,000 computer could be broken down into a $950 LCD monitor, a $1,000 CPU, and the balance in sundries, such as keyboard and mouse. While the present legislation is designed to guard against this, it is difficult to ensure its effective application.
- Higher thresholds may also increase incentives for taxpayers to make inefficient purchases of single assets when, in the absence of tax, it would make more sense to bulk purchase.
- The fiscal costs of the suggested thresholds are likely to be large. The cost of increasing the thresholds from $200 to $500 was estimated to be $350 million over the next five years. We estimate that increasing the threshold from $500 to $1,000 would add a further $450 million over the next five years to the cost of the current proposal.
- A significant increase in the low-value asset thresholds may encourage inefficient investment. At the margin this may bias investment away from more costly to less costly capital goods. A significant increase in the thresholds may also favour industries that tend to employ lower cost capital goods.

Recommendation

That the submissions be declined.

Issue: Assets with tax book values below the thresholds

Clause 56

Submission
(46 – PricewaterhouseCoopers)

The rules should allow an immediate deduction when the tax value of an asset falls below the low-value asset threshold.

Comment

The submitter's argument is that if such a rule were introduced it would reduce the compliance costs of having to track large numbers of low-value assets.

Officials understand that most compliance costs are incurred at the time a business acquires the asset. Once an asset has been acquired, the business must record the asset and set up the asset register to ensure the correct amount of depreciation is deducted. From this point on the process is largely automated. Periodic checks of assets may occur from time to time, but over time assets become less important and less valuable to the business and checks are less frequent. The result is that some assets remain in asset registers and are a source of annoyance, rather than a compliance cost, for most businesses. However, there is a cost for firms that periodically clean out their asset register.

Officials do not have sufficient information to provide a reasonable estimate of the cost of this proposal. However, we believe that allowing an immediate deduction when the tax value of an asset falls below the low-value asset threshold policy would have a fiscal cost greater than the cost of the proposed increase to the low value asset thresholds. In the first year, the existing stock of assets with book values below the low value asset threshold would be immediately deductible.

Officials consider that the cost of this proposal outweighs any benefits.

Recommendation

That the submission be declined.

Issue: Regular reviews of the thresholds

Clause 56

Submission

(48 – New Zealand Institute of Chartered Accountants)

The level of the low-value asset thresholds should be regularly reviewed.

Comment

Officials agree that the low-value asset thresholds should be regularly reviewed. The process for changing the level of the low-value asset thresholds is relatively simple. The government changes the thresholds by Order in Council.

Determining the timing of any review is more difficult. One option is to review the thresholds say, every 10 years. Alternatively, the timing of a review could be based on taxpayers' concerns that the low-value asset thresholds are no longer providing compliance-cost savings.

The threshold has been reviewed periodically based on taxpayers' concerns. For example, the issue of raising the "low-value" asset thresholds was considered by the Committee of Experts on Tax Compliance in 1998. The committee concluded that although the benefit of raising the threshold for immediately expensing "low-value" assets would be a reduction in compliance costs, it considered that the revenue costs of such a measure, although transitional, would be significant. Further, an increase in the "low-value" asset threshold could increase the possibility that the rules could be abused. Finally, the committee considered that the pool method of depreciation could be used for assets valued between $200 and $2,000, thereby resulting in simpler depreciation rules.

The current process appears to work. The current change to the threshold was prompted by taxpayer concerns that the current thresholds were too low.

Recommendation

That this submission be noted.

Issue: Allow catch-up adjustments

Clause 56

Submission
(46 – PricewaterhouseCoopers)

That taxpayers should be able to have a catch-up adjustment in their 2006 income tax return when, in their 2005 income tax return, they did not apply any increases in the low-value asset thresholds.

Comment

The concern raised is that taxpayers with 31 May to 30 September balance dates (taxpayers with late balance dates) will not be able to apply the new low-value asset thresholds for assets acquired between 19 May 2005 and their 2005 balance date because their 2005 tax return is due by 31 March 2006 at the latest.

The Commissioner of Inland Revenue has the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment to ensure its correctness. The Commissioner has agreed to amend 2005 assessments for taxpayers who have not been able to apply any changes to the tax depreciation rules due to the taxpayer's return filing date being too close to, or after the date that the bill receives assent.

Recommendation

That the submission be noted.

OTHER CONCERNS

Issue: Use of the term "negative consideration"

Clause 57

Submission
(48 – New Zealand Institute of Chartered Accountants)

Section EE 38(1) should be amended to remove the nexus to negative consideration.

Comment

While the submitter agrees with the intention of the change, they suggest it would be easier to allow a deduction for costs incurred in the disposal of an asset.

Section EE 38(1) defines consideration for the purposes of working out whether the disposal of an asset generates a depreciation recovery or a depreciation loss. The submission suggests a different way of reaching the same goal.

The purpose of this amendment is to allow nil or negative consideration for the purpose of sections EE 41 to EE 44. Officials believe that the suggestion relates to the style of the change and can see no advantage. The wording in the amendment is consistent with this part of the Act.

Recommendation

That the submission be declined.

Issue: Retrospective application date

Clause 57

Submission
(29 – Corporate Taxpayers Group, 46 – PricewaterhouseCoopers, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

The proposed rule that clarifies that disposal costs are fully deductible should apply retrospectively rather than from the 2005–06 income tax year. Since the proposal is a clarification, it should be allowed for earlier income years.

Comment

This amendment changes the current law so that a deduction for the cost of demolition or disposal of an asset can be claimed. The law has been clarified to allow the economically correct outcome. Changing the law so that it is clear that this can now happen may remove an artificial impediment to more environmentally friendly asset-disposal practices.

This proposal was designed to be prospective and is consistent with other changes to income tax legislation. Retrospective law changes occur infrequently as they can raise equity issues by creating new tax liabilities or windfalls. Identical concerns are what cause us to not want to change past investments.

Recommendation

That the submission be declined.

Issue: Changing depreciation methods in mid-useful life

Submission
(46 – PricewaterhouseCoopers)

The straight-line depreciation rate should be higher when a taxpayer changes from the diminishing value to the straight-line depreciation method. This is because the asset is depreciated for a period longer than its estimated useful life.

Comment

The submission notes that when a taxpayer changes from the diminishing value to the straight-line depreciation method the result is that the asset is depreciated for a period that is longer than its remaining estimated useful life.

The current rules for switching between depreciation methods (and the calculation of straight-line equivalents) reflect the necessity to prevent taxpayers gaming the diminishing value/straight-line choice of depreciation rates and taking advantage of the rules.

Recommendation

That the submission be declined.

DRAFTING ISSUES

Clause 54

Submission
(29 – Corporate Taxpayers Group, 46 – PricewaterhouseCoopers, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

The opening words of section EE 25C(3) should read, "To set the straight line rate for a kind of item of depreciable property".

Comment

This submission corrects a drafting mistake.

Recommendation

That the submission be accepted.

Clause 55

Submission
(48 – New Zealand Institute of Chartered Accountants)

The reference to "sections EE 25B" in section EE 26B should refer to "section EE 25".

Comment

The current wording requires the taxpayer to elect to apply the proposed law. The correct approach is for taxpayers to elect out of the proposed rule because of the compliance cost of having to recalculate asset depreciation rates.

Recommendation

That the submission be accepted.

Clause 80

Submission
(46 – PricewaterhouseCoopers, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

Section GC 6 should be redrafted to restrict its scope to the depreciation rules only.

Recommendation

That the submission be accepted.

Clause 151 and Schedule 1

Submission
(46 – PricewaterhouseCoopers)

The wording in Schedule 11B, "Other assets (excluding intangible depreciable property and buildings)" should be amended to read: "Other assets (excluding depreciable intangible property and buildings)".

Comment

The submission suggests wording that is consistent with terms already in use. Officials suggest for completeness that "excluded depreciable property" ought to be added to the list. We recommend that the wording change to: "Other assets (excluding depreciable intangible property, excluded depreciable property and buildings)".

Recommendation

That the submission, as amended by officials, be accepted.

ISSUES RAISED BY OFFICIALS

Issue: High residual value assets

Submission
(Matter raised by officials)

The Commissioner of Inland Revenue should be allowed to set a depreciation rate using the depreciation formula in section EE 25(4) for assets with an estimated residual or scrap value greater than 13.5 percent that are acquired on or after the application date of the proposed changes. This proposal would apply in certain limited circumstances and ensures that such assets are afforded a more economically correct depreciation rate, than would apply under the proposed changes.

Comment

Using double declining balance depreciation for equipment may provide better measures of economic depreciation for assets with negligible residual value at the end of their economic lives. However, this approach is likely to overstate economic depreciation for assets with substantial residual values. Currently, equipment with an estimated residual value of more than 13.5 percent can be depreciated at a diminishing value rate, which leads to book value being equal to the estimated residual value at the end of the economic life. The current method of calculating depreciation for such assets seems to be most appropriate in these cases.

Under normal circumstances this issue does not affect assets currently in Depreciation Determination 1. However, under certain conditions, an asset may have a higher residual value at the end of its useful life than the average asset. A case in point is when an asset is purchased and the vendor guarantees to buy the asset back at a set price. The buy-back price can sometimes be very high. We have heard of buy-back prices being as high as 80 percent of the asset's original cost after nearly 75 percent of the asset's estimated useful life.

To set a tax depreciation rate that closely approximates economic depreciation, the Commissioner may sometimes need to use a depreciation formula that contains a residual value term. Section EE 25(4) provides such a formula, but the application dates in the bill mean that this section applies only to assets acquired before 1 April 2005 or 19 May 2005 for buildings.

To allow the Commissioner to set an economically correct depreciation rate for assets that are expected to have a residual or scrap value greater than 13.5 percent of cost, the Commissioner should be allowed to apply the depreciation formula in section EE 25(4) in the following limited cases:

- following an application by a taxpayer for a special depreciation rate;

- when determining the depreciation rate for an asset where there currently is no general depreciation rate; or
- when reviewing the existing general depreciation rate for a type of asset.

Recommendation

That the submission be accepted.

Issue: Redundant change

Clause 143

Submission
(Matter raised by officials)

It was proposed to amend the definition of "finance lease". However, the definition of finance lease does not need changing to reflect the proposed changes to depreciation methods. This change is redundant. However, the reference to section EE 53 in the definition of finance lease should be changed to "EE 54".

Recommendation

That this submission be accepted.

Issue: Depreciation loading for second-hand assets

Submission
(29 – Corporate Taxpayers Group, 46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

Second-hand assets should be entitled to the 20% depreciation loading, according to the suggestion in the officials' issues paper.

Comment

There is an argument for extending depreciation loading to second-hand assets. However, this has a significant fiscal cost. The original estimate was approximately $340 million over three years. Moreover, there was a concern that if this change occurred at the same time as the change to double declining balance depreciation, the incentives would be greater for businesses to turn assets over merely to access higher depreciation rates. Accordingly, the government decided not to proceed with extending loading to second-hand assets at this time.

Recommendation

That the submission be declined.

Issue: Variable loading

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The 20% depreciation loading should be replaced with a variable rate loading system that increases the amount of loading for short-lived assets and decreases loading for long-lived assets.

Comment

Variable loading was raised in the officials' issues paper but drew little support. Both variable depreciation loading methods discussed in the officials' issues paper would have been more costly than the status quo. Other less costly variable loading options can be considered.

More work is planned on issues associated with depreciation loading and less costly options of variable loading could be reconsidered at that time.

Recommendation

That the submission be noted.

Issue: Losses on buildings

Submission
(11W – Business New Zealand, 24 – Federated Farmers, 29 – Corporate Taxpayers Group, 46 – PricewaterhouseCoopers, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

Losses incurred on the sale or disposal of buildings should be allowed for taxpayers that use buildings in the course of carrying on a business for the purposes of deriving assessable income.

Comment

This submission is outside the scope of the bill. However, officials have previously agreed to do further work on this issue and other issues associated with non-deductible and non-depreciable expenditure.

Recommendation

That this submission be declined.

Issue: Depreciation and other policy goals

Submission
(46 – PricewaterhouseCoopers)

Consideration should be given to how the tax depreciation rules can be used to achieve other policy goals.

Comment

Such an approach goes against the basic policy framework that drives New Zealand's tax laws. New Zealand's tax system is based on a broad base, low-rate model. Under such a model, the legislation attempts to tax most activities in an evenhanded way. This allows a lower across the board tax rate.

On occasions market failures may provide grounds for considering cash or tax subsidies for particular activities. But these need to be considered on a case by case basis.

Recommendation

That the submission be noted.

Aligning the payment of provisional tax with GST and basing provisional tax payments on a percentage of GST taxable supplies

OVERVIEW

Changes are proposed to the way provisional tax and GST payments are made as a result of market research undertaken with small and medium-sized enterprises. The Inland Revenue survey identified two main contributors to tax compliance costs faced by small businesses, namely the time needed to fill out forms, and the fact that provisional tax payments were not aligned with cashflow. To address these problems the government's discussion document, *Making tax easier for small businesses*, proposed aligning the payment dates for GST and provisional tax and to base provisional tax on a percentage of GST taxable supplies.

Currently provisional tax payments are due three times a year on the 7th of the month. GST payments are due monthly, two-monthly, or six-monthly on the last working day of the month.

The bill introduces changes to allow provisional tax to be paid on the same dates as GST payments are made, thereby reducing the compliance requirements of the two taxes to one date. Both tax payments can be made on one form, thereby reducing the number of interactions taxpayers have with Inland Revenue.

The due date for the payment of provisional tax and GST will change from the 7th of the month and last working day of the month respectively to the 28th of the month. The 28th was chosen as it is common to all months, and because it falls near the end of the month, would be easy for taxpayers to remember.

Most GST taxpayers who are subject to provisional tax have their GST taxable periods aligned to their balance date. However, there are 13,000 taxpayers (13 percent of GST-registered taxpayers) whose GST taxable periods are not aligned with their income tax balance date. These taxpayers will need to align their GST taxable periods so their provisional tax payments can be paid along with GST.

The changes also provide an option for provisional taxpayers who qualify to base their provisional tax payments on a percentage of their GST taxable supplies, which allows them to pay their provisional tax at the same time as they earn their income.

Eleven submissions were received, with more than half supporting the proposed changes to align provisional tax with GST, change the GST due date and the introduction of another method of calculating provisional tax by basing it on a percentage of GST taxable supplies.

Issue: Support for aligning provisional tax payments with GST payments

Clause 100

Submissions

(11W – Business New Zealand, 20 – New Zealand Retailers Association, 24 – Federated Farmers, 29 – Corporate Taxpayers Group, 46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The alignment of tax dates is supported as this will assist small business taxpayers to complete their returns for both provisional tax and GST at the same time. As GST is related to turnover, the payments should, therefore, be made at a time when the cash flow of the business is at its most positive. Doing both calculations and completing the returns at the same time should also achieve reductions in the cost of compliance. *(New Zealand Retailers Association)*

We support the GST ratio proposal and commend the government on its innovative approach to addressing the fact that provisional tax payments often do not match a business's income-earning process. *(PricewaterhouseCoopers)*

The involuntary exposure to use-of-money interest through uncertainty as to the final tax liability at the time provisional payments need to be made will be improved by the proposal. *(New Zealand Institute of Chartered Accountants)*

Recommendation

That the submissions be noted.

ALIGNING THE PAYMENT OF PROVISIONAL TAX WITH GST PAYMENT DATES

Issue: Paying provisional tax along with GST and aligning taxable periods with balance dates

Clause 100

Submission

(3W – Webster and Company Ltd, 3WA – Gordon S Tye, 3WB – Richard Herbert, 5W – Cockcroft ATS Ltd, 26W – National Council of Women of New Zealand, 46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

Four accountants submitted that the current situation where some clients whose taxable periods are aligned with their balance date and others whose taxable periods are not aligned allows accountants to spread their work load and should be retained.

Aligning provisional tax with GST is also opposed as this will lead to a significant increase in workload in generating provisional tax reminders for taxpayers and recording that payments have been made. The reminders will in future be linked to GST return frequencies rather than the current three fixed payment dates.

One submission proposes that only provisional taxpayers who use the GST ratio method should have to align their GST taxable periods with their balance dates. Those taxpayers who are not using the GST ratio method or who are not provisional taxpayers will not receive the benefits from alignment. Also, alignment may preclude some taxpayers who are currently part of a GST group from continuing to be part of a group because aligning their taxable periods may mean their new taxable periods are out of alignment with those of the group.

The New Zealand Institute of Chartered Accountants submitted that the forced alignment of taxpayers' GST taxable periods to their balance date would have a significant impact on the work flow of many tax agents because clients' workloads were previously spread evenly throughout the year. Following the changes, the workload would be at three peak dates during the year. They have suggested that Inland Revenue relaxes the restrictions on taxpayers adopting a non-standard balance date to enable taxpayers to operate a non-standard balance date and ease agents' work flows.

It is also submitted that businesses may incur costs in complying with the new requirements or changing their systems because provisional tax is currently calculated by the tax agent and GST returns are done by the taxpayer.

Comment

The first issue deals with the concentration of accountants' workload as a result of the alignment of a taxpayer's GST taxable periods to their balance date. There are 13,000 taxpayers who pay both GST and provisional tax and who will be required to align their taxable periods to their balance dates.

Aligning GST taxable periods with balance dates is central to the proposal as it reduces the number of payments and concentrates the compliance activity for two taxes at one time of the month.

Alignment is required only for those taxpayers who are liable for both provisional tax and GST. Those taxpayers who are not liable for both provisional tax and GST will not be aligned.

Officials expect that, for the majority of tax agents, the alignment of GST taxable periods to balance dates for their clients will not unduly concentrate their workload. However, there may be some smaller tax agents for whom the number of clients changing their taxable periods relative to the agent's overall client base could result in the agents' workload being unduly concentrated around a few dates. In these situations Inland Revenue will consider relaxing the balance date policy (by a month) for the agent's clients who will be forced to align, to ease the agent's workload.

The second issue relates to tax agents providing a reminder system for provisional tax payments. Those clients who are liable to pay both provisional tax and GST will pay their provisional tax on their GST return. The GST return will provide a reminder that the provisional tax is due. This should reduce agents' workloads. For those taxpayers who pay provisional tax, but who are not subject to GST, the accountants can continue to use the reminder system for provisional tax.

Taxpayers who are part of a group and whose taxable periods will be aligned have the ability to change their balance date (and therefore their GST taxable periods) to coincide with the group's taxable periods. If this remains a problem then officials propose to consider the issue as part of a review of the grouping rules.

The last issue relates to increased compliance costs for business. There will be costs associated with:

- aligning GST taxable periods to balance date;
- changes to taxpayers' and tax agents' systems;
- taxpayers losing the use of the GST money for up to three days.

However, these costs are likely to be offset by:

- reducing compliance costs for businesses as a result of rationalising their tax payments;
- having fewer tax payment dates and fewer contacts with Inland Revenue;
- taxpayers being able to match their provisional tax payments to their income stream;
- having an additional 52 days to calculate and pay provisional tax, and use of the provisional tax money.

Recommendation

That the submissions be noted.

Issue: Application date of the proposal to align provisional tax payments with GST payments

Clauses 2 and 100(2)

Submission
(48 – New Zealand Institute of Chartered Accountants)

The Institute submits that the application date of the proposal be delayed for one year to enable further consultation so that the rules can be developed further.

If the introduction is not delayed then the introduction of the ratio method should be delayed a year to enable the proposal to base provisional tax payments on a percentage of GST turnover to be extended to all taxpayers.

Comment

Officials have recommended later in this report that a change be made to the application date of the GST/provisional tax provisions to give effect to the government's decision to delay the application date of the proposal by a year.

Recommendation

That the submission be noted.

Issue: Amend rules to determine how many instalments of provisional tax a new provisional taxpayer must pay

Clause 100 (MB 8(8)(a))

Submission
(46 – PricewaterhouseCoopers)

The provision that refers to when a new provisional taxpayer begins paying provisional tax should be amended to provide for the payment of two instalments of provisional tax when the taxpayer starts business after the first instalment but before the second instalment.

Comment

In section MB 8(8) the situation of a new provisional taxpayer paying only two provisional tax instalments during the year has been dealt with by providing a cross-reference to section MB 13. Section MB 13 deals with paying two instalments of provisional tax in a year. Therefore, the provision as currently drafted addresses the submission.

Recommendation

That the submission be declined.

Issue: Offsetting GST refunds against provisional tax

Clause 100 (MB 11)

Submission
(Matter raised by officials)

The bill proposes that a taxpayer who has a GST refund can offset the amount against their provisional tax liability. However, where the GST refund is reduced, due to an error in the return, the amendments are silent on whether the shortfall relates to GST or provisional tax.

Comment

An underlying objective of the reforms was that a GST refund should be allowed to be offset against a provisional tax liability that is due on the same due date. When the taxpayer makes a mistake in the computation of the GST refund, which the taxpayer has directed be transferred to pay their provisional tax debt, additional time should be allowed to pay the resulting provisional tax debt.

Officials propose that the debt remain with provisional tax because it is easier for taxpayers to understand.

Recommendation

That the submission be accepted.

Issue: Due date for payment of GST

Clause 100 (MB8)

Submission
(3W – Webster and Company Ltd, 3WA – Gordon S Tye, 3WB – Richard Herbert, 5W – Cockcroft ATS Ltd, 26W – National Council of Women of New Zealand, 29 – Corporate Taxpayers Group, 48 – New Zealand Institute of Chartered Accountants)

One submission proposed that the due date for the payment of terminal tax, FBT and PAYE payments also be aligned to the 28th of the month, along with GST and provisional tax.

Five submissions proposed that the due date should remain at the last working day of the month because of the significant increase in workload they would experience.

One submission suggested moving the due date to the 1st of the month and was also concerned about the size of the payment due for GST and provisional tax if both are due on the same day.

Comment

The policy rationale behind the due date change was to align similar taxes on the same dates. For example, PAYE and FBT are payroll taxes that are due on the 20th of the month. The bill proposes to align the due dates for business taxes (GST and provisional tax) on one date, being the 28th of the month.

Having two payment dates, the 20th and the 28th of the month, resulted from consultations with businesses that identified cash flow concerns with having one payment date for all payroll and businesses taxes. Consideration will continue to be given to aligning all payments of tax (GST, provisional tax, FBT, and PAYE and withholding payments) on the 28th of the month. However, officials want to consult further with businesses and tax agents to ensure that such a change does not put financial strain on businesses. It is recommended that any changes following consultation be incorporated in a later taxation bill.

The four tax agents who made submissions stated that moving the due date from the last working date to the 28th of the month would put undue pressure on them to collate and prepare returns in time. They also pointed out that the 28th is difficult to remember.

The issue of tax agents' increased workload seems to stem more from two issues – moving the due date forward by three days and the alignment of taxpayers' GST taxable periods to their balance date. The alignment issue is discussed in more detail later in this report together with a possible solution to tax agents' concerns.

Concerns relating to moving the due date forward by three days will result in work being undertaken by agents earlier. This may be a problem for some agents, although under the current due date they are required to file earlier if the last working day falls on a weekend. Also although agents will have to file GST returns earlier they will also get at least 52 additional days to file provisional tax payments, which could offset the bringing forward of their GST workload.

Results of market research undertaken with small and medium-sized businesses shows that the majority of businesses consulted either liked or did not mind the due date changing to the 28th.

There was little support shown (just 2 percent) in the market research for the 1st of the month as a due date.

Recommendation

That the submission be noted. Officials will consult with businesses further on the merits of having one due date for the payment of all taxes.

Issue: Income tax – due date for payments over the Christmas period

Clauses 100 (MB 20(2)(3)), 152(1) and 212(2)

Submission
(Matter raised by officials)

The bill outlines the due dates for the payment of provisional tax and GST payments. When the due date for payments falls within the Christmas period, the bill provides that the due date will be the following 20th of January.

Comment

The 20th of January was chosen as it was one date on which all provisional tax, terminal tax, GST and PAYE payments could be made when the payments fell over the Christmas period. However, having all payments due on one date over the Christmas period would have a significant impact on Inland Revenue and the Westpac bank that processes Inland Revenue payments, resulting in a backlog of payments.

Taxpayers would also be required to find a significant amount of money for payment of provisional tax, GST, terminal tax, and PAYE, all of which would be due on the 20th of January.

It is therefore recommended that the due date for the payment of provisional tax and GST payments remains on the 15th of January. This will stagger the payment of GST/provisional tax and the payment of PAYE to smooth workflows and the financial impact on taxpayers.

Recommendation

That this submission be accepted.

BASING PROVISIONAL TAX PAYMENTS ON A PERCENTAGE OF GST TAXABLE SUPPLIES

Issue: Qualifying criteria for using the provisional tax ratio method

Clause 100 (MB 15)

Submission
(20 – New Zealand Retailers Association, 46 – PricewaterhouseCoopers)

The submission proposed several amendments to the eligibility criteria for using the provisional tax ratio method.

Two suggestions were made concerning the upper limit for qualifications. One submission proposed that taxpayers should qualify where they meet either the previous year's residual income tax liability of $150,000 or whose prior year's turnover is less than $5 million. Another submission suggested there should be no upper limit and that the ratio should be extended to all provisional taxpayers liable to file a GST return.

It was also submitted that taxpayers who have made a loss for the previous year should be able to use the provisional tax ratio method.

Another submission suggested that six-monthly GST payers should be entitled to use the ratio method.

Lastly, one submission recommended that the ratio method should be extended to all groups of taxpayers – including partnerships, close companies, trusts and new businesses.

Comment

The provisional tax ratio method aims to strike a balance between accuracy and compliance costs. Therefore, as the upper limit for qualification increases there is a corresponding increase in the risk to the revenue. Also, the more qualifying criteria there are, the greater the compliance costs a taxpayer faces in determining whether they qualify to use the ratio method.

Officials originally proposed a $1.3 million turnover threshold. This was later changed to a residual income tax threshold of $100,000 as, during consultation, it was submitted that this would better reflect the differing profit margins of businesses. Also, the residual income tax figure is readily available because it is calculated by the tax agent as part of the income tax return process. The residual income tax threshold was subsequently increased from $100,000 to $150,000 (which could be a $1.5–$2 million turnover) following further consultations. The current $150,000 threshold enables 95 percent of businesses to potentially qualify to use the ratio method.

The threshold provides a balance between enabling the vast majority of businesses to use the ratio method while limiting risk to the revenue and keeping compliance costs to a minimum. It is therefore recommended that the submission to extend the ratio threshold be declined.

The second submission proposes to extend the ratio method to taxpayers who have made a loss in the previous year. Those taxpayers would use the tax and GST figures for the year prior to the year of loss to calculate the ratio.

Generally, the further back in time you go to determine the figures to use to calculate the ratio, the more likely that the ratio calculated will not reflect the current tax liability of a business, due to business and market changes over time.

Currently, the provisional tax rules allow businesses with extensions of time to file tax returns using figures from the year before the last year to determine their provisional tax liability. Allowing a taxpayer who made a loss to use the loss year's figures to determine the ratio will extend the period to four or more years when the taxpayer has had multiple loss years.

Officials have concerns about the accuracy of using figures which are three or more years old to determine the ratio calculation and recommend that the submission be declined at this point. It is proposed that a review of the ratio method be undertaken to consider how the method could be extended and it would be appropriate to consider the proposal to include businesses that have made a loss at this time.

The third submission proposes that six-monthly GST payers be able to use the ratio method. To qualify as a six-monthly GST payer, a taxpayer must have taxable supplies of $250,000 or less.

Six-monthly GST payers moving from three provisional tax payments to two payments a year does not assist in addressing cash flow difficulties for small businesses as although they have fewer payment dates, the payment amounts may be significant. Six-monthly GST filers would only benefit from the ratio proposal when they earn a significant amount of their income in the later part of the year.

Allowing taxpayers choices can increase compliance costs as taxpayers determine the best option for them to use. Six-monthly GST filers only have two payments and accessing the ratio would only benefit taxpayers who earn a significant proportion of their income in the later half of the year. If there are significant benefits to taxpayers from using the ratio option they could become two-monthly filers and pay the majority of their GST and provisional tax on the last provisional tax/GST payment date.

The last submission proposes that the ratio method be extended to partnerships, close companies, trusts and new businesses. This issue will be considered as part of a future review of the ratio method.

Recommendation

That all four submissions be declined and that the proposals to extend the ratio method to partnerships, close companies, trusts, new businesses and businesses in a loss situation will be considered when the ratio method is reviewed.

Issue: Method by which taxpayers are notified of the ratio percentage

Clause 100 (MB 7(4))

Submission
(46 – PricewaterhouseCoopers)

The submission requests that either:

- the requirements for the Commissioner of Inland Revenue to notify the taxpayer of their ratio percentage on their GST return, in writing, by telephone, or any other means is unnecessary as section 14 of the Tax Administration Act outlines how the Commissioner should notify the taxpayer; or
- the methods above should be extended to all circumstances in which the Commissioner is required to give notice, not just for advising of the ratio.

Comment

The current methods of advising taxpayers may not be suitable for the ratio option as they can be time consuming and can lead to further contacts by phone (as the receipt often generates a phone call). Given that there are less than three months from the beginning of the year to the first payment for Inland Revenue to process the application, advise taxpayers of their ratio and for the taxpayer to calculate and pay their provisional tax, the method chosen to advise taxpayers of the ratio must be one that suits individual taxpayers – hence the proposed choices.

Officials do not consider that phone contact should be extended to all circumstances where the taxpayer interacts with the department. There are instances when notification must be in writing for evidential reasons.

Recommendation

That the submission be declined.

OTHER

Issue: Communicating the provisional tax changes

Clause 100

Submission

(11W – Business New Zealand, 48 – New Zealand Institute of Chartered Accountants)

Submitters request that the provisional tax changes are effectively and clearly communicated to businesses and tax agents. The proposed changes should be widely advertised in the business community. *(Business New Zealand, New Zealand Institute of Chartered Accountants)*

Because the legislative changes are quite complex, clear guidelines would help to avoid any penalties that businesses may incur for incorrect implementation. *(Business New Zealand)*

Comment

Inland Revenue will be consulting with tax agents and industry organisations on the implementation of the GST/provisional tax changes. This consultation will seek feedback on the best way to publicise the changes to businesses. The methods likely to be used include advertising in target audience publications and major newspapers, presentations to industry organisations, seminars, including information in industry and trade newsletters, online newsletters, and on related websites such as the Ministry of Economic Development website.

Inland Revenue will also use its own communication products to advertise the changes, such as GST newsletters and returns, and tax agent newsletters.

The staggered implementation of the proposals will enable simple and clear messages to be delivered to the businesses affected.

Recommendation

That the submission be noted.

Issue: Due date for the payment of terminal tax

Clause 101(1)(b)

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The terminal tax due dates should be aligned with provisional tax and GST payment dates (the 28th of the relevant month). *(PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)*

If the terminal tax due date is not changed, the incorrect reference in the legislation to when terminal tax is payable when the due date falls within the Christmas period should be amended. *(PricewaterhouseCoopers)*

Comment

Currently, the due date for the payment of terminal tax falls on the 7th of the month, with the date being extended to the 15th of January if the due date is the 7th of January. Shifting the terminal tax date from the 7th of the month to the 28th of the month would have a significant cost to the government and is outside the scope of these proposals.

The bill, as drafted, incorrectly refers to terminal tax payments that are due in December now being due on the 20th of January.

Officials recommend that the Committee agrees to amend the bill to ensure that when terminal tax payments are due in January they will be due on the 15th of January.

Recommendation

That the submission be accepted in part, namely, the recommendation to amend the legislation to ensure that when terminal tax payments are due in January they will be due on the 15th of January, be accepted.

Issue: Other measures to reduce exposure to use-of-money interest

Submission
(48 – New Zealand Institute of Chartered Accountants)

The submission suggests that other measures be introduced which will reduce taxpayers' exposure to use-of-money interest, for example:

- aligning the use-of-money interest rates so that both rates are equal;
- improving the estimation process;
- allowing unequal instalments;
- allowing for one-off items as an exception to the use-of-money calculation.

The submission also requests that a full review of how provisional tax works and is administered should be undertaken.

Comment

The issues raised are outside the scope of the current provisions included in the bill.

Recommendation

That the submission be declined.

Issue: Income tax – student loan repayments for provisional taxpayers

Clause 221

Submission
(Matter raised by officials)

Incorrect section references in the new provision give the impression that provisional taxpayers are only required to make two student loan repayments during the year.

Comment

The policy intent of the proposal is that provisional taxpayers who are liable to pay student loans continue to make three student loan repayments, regardless of when they pay their GST. As the due date for provisional tax is to shift, the date for student loan repayments would also shift from the 7th to the 28th of the month.

Officials propose that the provision be amended to ensure that provisional taxpayers would continue to pay student loan repayments on the 28th of August, 20th of January and 28th of April.

Recommendation

That the submission be accepted.

Issue: Late filing of GST returns by ratio taxpayer

Clause 100 (MB 15 (6))

Submission
(Matter raised by officials)

The proposed section MB 15(6) states that if a taxpayer uses the ratio method of paying provisional tax and does not provide a GST return, they will cease to be entitled to use the ratio method.

This section does not provide any flexibility for the Commissioner of Inland Revenue to accept a late GST return. The Commissioner should also have the power to reinstate the ratio option when the failure to file was due to reasonable cause.

The section wording is confusing because the methods used to calculate the outstanding payment amount are also applied to the remaining provisional tax instalments for the year.

Comment

Officials consider that the Commissioner should have the discretion to accept a late return (which is not unduly late) without the taxpayer being removed from the ratio method. If the taxpayer fails to provide the return within a reasonable period following the due date they cease to be entitled to use the ratio method.

Officials recommend that this section should be amended to clarify that if the taxpayer using the ratio method of paying provisional tax does not provide a GST return within 60 days of the due date for filing the GST return, they will cease to be entitled to use the ratio method.

Officials also recommend that the Commissioner should be given the discretion to reinstate the ratio method if the non-filing has been caused by an event or circumstance that provides reasonable justification for non-filing and the non-filing was rectified as soon as possible. Examples of such events are an accident, disaster, illness, or emotional or mental distress. This would be consistent with the policies for the remission of penalties.

Also, if a taxpayer has been removed from the ratio method they will be required to estimate their provisional tax instalments for the remainder of the year.

Recommendation

That the submission be accepted.

Issue: Ability to change GST taxable periods, request a refund, or provide a provisional tax estimate by phone, electronic or other means

Clauses 100 (MB 6(2), MB 16(2), MB 36(2) & (3)) and 211 (156 (1) & (2))

Submission

(Matter raised by officials)

Currently, where a taxpayer:

- requests a change in GST taxable periods (for example, from two-monthly to six-monthly); or
- requests a refund of the amount of provisional tax paid; or
- wants to make an estimate of their provisional tax liability;

the request must be in writing.

Also, to elect to use the provisional tax ratio method the taxpayer's election must be either in writing or by phone.

Comment

More taxpayers are interacting with Inland Revenue by phone and electronic channels. Requiring taxpayers to notify Inland Revenue in writing or have Inland Revenue notify them in writing, limits Inland Revenue's ability to interact with taxpayers in the most efficient way. Officials propose that taxpayers be given the option of advising Inland Revenue by phone when requesting a change in a GST taxable period, seeking a refund of the amount of provisional tax paid, or providing an estimate of their provisional tax liability.

Officials also propose that taxpayers should be given flexibility to use whatever means Inland Revenue provides to elect to use the ratio – for example, advising an Inland Revenue officer during an advisory visit.

Recommendation

That the submission be accepted.

DRAFTING

Issue: Minor drafting amendments

Clauses 100, 172, 173, 177, 180, 211, 212 and 213

Submission
(46 – PricewaterhouseCoopers)

The submission proposes a number of drafting changes relating to the aligning of provisional tax payment dates with GST, including:

- alignment of the drafting of proposed section MB 8(3) and MB 8(4);
- updating the legislative reference table in section MB 8;
- amending the reference to the number of days in the example in section MB 13;
- rewording the example in section MB 14;
- reformatting the formulas in sections MB 21(2) and (4) and MB 22(2);
- rewording the examples in sections MB 26 and MB 27;
- correcting a cross-reference error in section MB 28(2)(c);
- minor drafting changes to sections MB 30(2) and MB 34;
- a minor drafting change to section 16B of the GST Act;
- filing of final GST returns in December, section 16(2) of the GST Act;
- correcting a cross-reference error in section 15D of the GST Act;
- enabling credit use-of-money to be paid for voluntary provisional tax payments – section 120C(1) of the Tax Administration Act;
- minor drafting changes to section 120KC and 120KD of the Tax Administration Act;
- clarifying the amendments to the late payment and shortfall provisions.

Officials agree with the amendments proposed in the submission.

Issue: Minor legislative changes/cross-references

Clause 100

Submission
(Matters raised by officials)

A number of minor drafting changes should be made to improve the accuracy of the legislation.

Sections MB 2(1)(a) and (3), MB 5(4)(b), MB 8(3), MB 8(9), MB 13(1)(b)(ii), MB 14(1)(b)(ii) and clause 117 (MZ 8(2))

These sections refer to the threshold level at which a taxpayer becomes liable for provisional tax. The threshold levels need to be clarified to ensure that a taxpayer only becomes liable for provisional tax when residual income tax exceeds $2,500 (and they are not liable if their residual income tax is $2,500 or less).

Section MB 7(8)

This is a drafting error. The reference in section MB 7(8) to "total value of supplies" should have been to "total value of taxable supplies". Other changes should be made to ensure that the reference is to "total supplies" rather than "taxable supplies".

Section MB 9

The drafting of section MB 9 should be amended so that it is clear that this provision deals with calculating the amount of provisional tax for a tax year.

Section MB 12

A drafting error has resulted in the new section MB 12 not fully reflecting recently legislated changes. The section should be updated.

Section MB 15(6)

The section currently makes use of a GST ratio conditional on a taxpayer providing a GST return. It should also be conditional on the GST return being provided by the due date. Also, the words "that remain for the tax year or corresponding income year" should be deleted for greater clarity.

Section MB 19(1)

The section should be clarified to ensure that it applies when "last year" or the "year before last" is a transitional year.

Section MB 20(5)(b)

The reference to "new return date" in section MB 20(5)(b) should be replaced by "new balance date".

Section MB 33(4)(c)

The drafting section does not reflect the current legislation and should be amended to allow a company to provide a notice to the Commissioner within the timeframe for filing a return or such other time as the Commissioner may allow.

Section MB 38

The drafting of the amendment to section MB 38 of the Income Tax Act unintentionally narrows the application of the relief provision to farming, agricultural and fishing businesses. It is recommended that the provision be amended to reflect the application of the current "adverse event" provision.

Recommendation

That the submission be accepted.

Issue: Application dates of GST/provisional tax provisions

Clauses 2, 100(2), 119(3) and 221

Submission
(Matter raised by officials)

The application date of the GST/provisional tax proposal should be deferred.

Comment

Officials have reported to the government on the application date of the GST/provisional tax proposal.

GST/provisional tax

Currently the GST/provisional tax changes have a staggered application date of:

- 1 April 2006 for the GST due date change;
- the 2007–08 income year for provisional tax payments to be paid on GST due dates.

For Inland Revenue to implement the GST/provisional tax changes by 1 April 2006, legislation would need to have been enacted by January 2006 to enable Inland Revenue to make system changes and to notify taxpayers, and for taxpayers to make the necessary changes to their systems by 1 April 2006.

The government has therefore agreed to delay the application date of the GST/provisional tax proposals by one year. The new application dates will be:

- 1 April 2007 for the GST due date change;
- the 2008–09 income year for provisional tax payments to be paid on GST due dates.

The wording of the application date provision could also be made more specific by stating that the provisional tax changes "apply to provisional tax payments made for the income year corresponding to the 2008–09 and subsequent tax years".

Recommendation

That the submission be accepted.

Subsidy for payroll agents

OVERVIEW

The PAYE subsidy proposal is a tax simplification initiative outlined in 2003 in the government discussion document, *Making tax easier for small businesses*.

Under this proposal, the government will subsidise or partly subsidise the cost of an employer engaging a payroll intermediary. The subsidy will be available to an employer for up to five employees per month. To obtain the subsidy an employer must engage a listed payroll intermediary. The listed payroll intermediary will also be eligible to receive a subsidy from the government. Under the proposed rules, payroll service providers who are accredited payroll intermediaries may apply to become listed payroll intermediaries.

To receive the subsidy, a listed payroll intermediary must provide Inland Revenue with an employer monthly schedule and PAYE payment for each employer and a subsidy claim form.

A decision on the final amount and structure of the subsidy will be made early in 2006 and will be authorised by Order in Council.

Two out of five submissions support the initiative but suggest that the number of employees for whom a subsidy can be paid be increased.

One submission is generally supportive of the proposal, but considers that the subsidy will have a limited appeal. This submission makes suggestions on how to improve the proposal.

Two submissions oppose the proposal. One of these expresses the view that a subsidy is not the way to reduce compliance costs placed on employers. The other considers that it is not Inland Revenue's role to provide subsidies to private businesses.

SCOPE OF THE SUBSIDY

Issue: Number of eligible employees

Clause 119

Submission
(20 – New Zealand Retailers Association)
The subsidy should apply to full-time equivalents or for the first eight employees.

(11W – Business New Zealand)
The payroll subsidy should be paid for the first 10 employees.

Comment

The New Zealand Retailers Association is concerned that the payroll subsidy applies only to the first five employees. It states that it is a common feature of the retail industry to employ part-time personnel. It is therefore possible for a retailer to have more than five employees, but five or fewer full-time equivalent employees. Accordingly, either extending the subsidy to the first eight employees or applying the subsidy to full-time equivalents would overcome this problem.

Business New Zealand recommends that the subsidy should be extended to include ten employees, rather than the proposed five so that 93 percent of small businesses are potentially eligible for the subsidy.

Officials consider that while these arguments have some merit, they are insufficient to justify a change to the number of eligible employees for the following reasons:

- Applying the subsidy to full-time equivalents would require employers to determine the hours of every employee and for Inland Revenue to check the information provided. This would increase employers' and payroll agents' compliance costs and Inland Revenue's administrative costs.
- Increasing the number of eligible employees would correspondingly increase the cost of the proposal to the government.
- Seventy-one percent of all employers have five or fewer employees and would receive the full subsidy for each of their employees if the number of eligible employees were capped at five employees. The subsidy payment would continue to be paid once an employer took on more than five employees. Twenty-two percent of employers have more than five employees but are not large employers. These employers would receive the subsidy for their first five employees and would be required to pay the payroll agent only the balance of any costs.

It should be noted that the proposed subsidy will be subsequently reviewed. There is a possibility that, in the future, the scope of the subsidy will be extended to include other types of employers and non-PAYE compliance obligations.

Recommendation

That the submissions be declined.

Issue: The government should not introduce the subsidy

Submission
(22W – National Council of Women of New Zealand)

The subsidy should not be introduced for the following reasons:

- Inland Revenue's role is to administer taxation legislation and ensure compliance to protect the tax base, and not to provide taxpayer-funded subsidies to private businesses.
- The subsidy will be available for small employers whose total PAYE liability is less than $100,000 annually. The NCWNZ believes that businesses whose annual PAYE liability is around $100,000 are not small businesses, and therefore can afford the cost of PAYE preparation.

Comment

Officials believe that the benefits of providing the subsidy to private businesses outweigh the costs of funding it. The benefits of the subsidy include:

- Reduced compliance costs for small businesses.
- Improvement of the PAYE system – payroll intermediaries would provide services to a larger number of employers, using their skills and technology to increase the accuracy and timeliness of returns. Better PAYE compliance will benefit employers, whose exposure to penalties for non-compliance will be reduced.
- Outsourcing of compliance obligations faced by small businesses will allow small employers to focus their efforts on their business, rather than compliance activities.
- Lower administrative costs for Inland Revenue as a result of dealing with payroll specialists who use automated systems rather than small employers who use manual systems.
- Improved timeliness of payments and better quality of information supplied to Inland Revenue and an anticipated reduction in penalties imposed.

In relation to the second issue, there is no uniform definition of a small employer. Officials estimate that making the subsidy available to employers with a PAYE liability under $100,000 should cover a large number of smaller employers.

It is possible to make it more difficult to qualify as a small employer. However, the need to monitor compliance with the requirements would impose extra compliance costs on payroll intermediaries and employers and administrative costs on Inland Revenue, which would undermine the effectiveness of the subsidy.

Recommendation

That the submission be declined.

Issue: The scope of and the need for the subsidy

Submissions
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The criteria for determining which employers will be eligible to benefit from the subsidy are too narrow. The proposal will not assist small employers who decide not to use a payroll agent or medium-sized and larger employers. *(PricewaterhouseCoopers)*

The PAYE system should be reviewed, given the complexity of the rules. *(New Zealand Institute of Chartered Accountants)*

Comment

PricewaterhouseCoopers state that the objective of reducing employers' compliance costs could be achieved by other means. It is suggested that the government could subsidise the costs of payroll software for those employers who choose to retain control of their payroll rather than engage PAYE intermediaries.

Alternatively, PricewaterhouseCoopers contends that the government could repeal the 39% personal marginal tax rate to reduce the complexity of the PAYE rules and thus reduce compliance costs to employers.

The New Zealand Institute of Chartered Accountants contends that simplifying the PAYE system would be more helpful to small businesses than encouraging them to engage payroll intermediaries.

The main purpose of the proposal is to reduce compliance costs imposed on smaller employers, who are less likely to have established and efficient payroll systems.

By using a payroll agent, small employers will be able to focus their efforts on their core business, and reduce their exposure to penalties and interest related to late or inaccurate return filing. The proposal will also result in better timeliness and accuracy of payments received by Inland Revenue.

These benefits would not be available if the government subsidised payroll software and the employer undertook the obligations.

The reduction of tax rates and the simplification of the PAYE system are beyond the scope of this proposal.

Recommendation

That the submission be declined.

Issue: Subsidy should be available to all employers

Submission
(48 – New Zealand Institute of Chartered Accountants)

Instead of providing a subsidy to payroll intermediaries in respect of small employers, the subsidy should be available to employers (large or small) who complete PAYE returns.

Comment

The current proposal stipulates that the payroll subsidy will be granted only to payroll intermediaries dealing with small employers. The reason behind the limited application of the subsidy is because small employers, particularly new employers, need more assistance with meeting their PAYE obligations than more established employers who already have established PAYE procedures in place. Proportionally, payroll costs are higher per employee for smaller employers than for larger employers.

The subsidy will increase the time that small employers spend on their business rather than on complying with their PAYE obligations.

It should be noted that the proposed subsidy will be subsequently reviewed and assessed. Therefore, there is a possibility that, in the future, the scope of the subsidy could be extended.

Recommendation

That the submission be declined.

Issue: Self-assessment, identical rules and contracts

Submission
(48 – New Zealand Institute of Chartered Accountants)

To simply the administration of the subsidy:

- Instead of the subsidy being paid by Inland Revenue to payroll intermediaries, payroll intermediaries should be able to self-assess the subsidy and deduct it off the PAYE due for the period. This will relieve payroll intermediaries from having to apply for a subsidy in a subscribed form.
- There should be the same set of requirements for all payroll intermediaries.
- There should be only one set of rules for accreditation and revocation of accreditation for payroll intermediaries, without making a distinction on accredited and listed payroll intermediaries. Any further rules in relation to those payroll intermediaries who wish to register to receive a subsidy can be imposed through a contractual arrangement.
- The rules governing the process of claiming the subsidy, such as filing a claim form, amending a claim form, withholding the subsidy and so forth, should be imposed through a contractual arrangement and not by way of legislation.
- The rules governing administrative processes that are to be followed when an arrangement between an employer and intermediary is terminated should be specified in a contractual arrangement between Inland Revenue and a payroll intermediary.

Comment

Officials believe that a self-assessment system is not suitable for administering the subsidy. Inland Revenue would want to be certain that a payroll intermediary supplied it with correct payroll information and that the employer was still eligible to receive a subsidy before making a subsidy payment. By allowing payroll intermediaries to offset the amount of subsidy against the gross PAYE liability of employers, Inland Revenue would lose the ability to test the amount of the subsidy prior to its payment.

To become an accredited payroll intermediary, a person will have to comply with the current rules for payroll intermediaries specified in subpart NBA of the Income Tax Act 2004. A payroll intermediary who wishes to become a listed payroll intermediary in order to receive a subsidy will still have to comply with subpart NBA. The only new rules imposed by the proposed legislation are those necessary for administering the subsidy, such as the requirement to file a claim form electronically. Officials consider that the additional rules are essential for administering the subsidy and should not significantly complicate the PAYE rules.

Officials do not consider that removing the rules governing the subsidy from the legislation and transferring them to contractual arrangements with payroll intermediaries is a better way of managing the subsidy.

- Including the rules governing the administration of the subsidy and behaviour of listed payroll intermediaries in the legislation will make it consistent with the way the existing payroll intermediaries are regulated. Currently, all rules in relation to payroll intermediaries are contained in the legislation.
- Legislation is more transparent than a contract. Any person who is considering becoming a listed payroll intermediary will have a clear understanding of all requirements, rights and obligations by simply checking the publicly available legislation.
- It could be claimed that by entering into a contractual arrangement, Inland Revenue has "appointed" a payroll intermediary as its agent. This puts Inland Revenue at risk that the actions of the payroll intermediary are, if effect, the actions of Inland Revenue.

Therefore, officials consider that the subsidy rules should be set by legislation.

Recommendation

That the submission be declined.

Issue: Application date of payroll subsidy

Clauses 2 and 119(3)

Submission
(Matter raised by officials)

The application date of the payroll subsidy proposal should be deferred.

Comment

Officials have reported to the government on the application date of the payroll subsidy proposal.

The payroll subsidy provisions will require regulations to give full effect to the policy intent of the proposal, and enactment of the legislation in March 2006 will not give sufficient time for the necessary regulations to be prepared and promulgated 28 days before the intended commencement date of 1 April 2006. There are also indications that a 1 April 2006 commencement date will not provide sufficient time for all the system changes that payroll intermediaries and Inland Revenue need to make.

The government has therefore agreed that the commencement date be deferred. The new commencement date is 1 October 2006.

It is recommended that the application date of the proposal in the bill be amended to reflect the government's decision to defer the application date and to clarify the wording of the application provision.

Recommendation

That the submission be accepted.

MINOR DRAFTING CHANGES

Submission
(Matters raised by officials)

A number of drafting changes need to be made so the subsidy functions as intended.

Clause 119, section NBB 6(2)(b)

The reference to "pay frequency" in the proposed section NBB 6(2)(b) needs to be replaced by a provision allowing the Commissioner to include on an electronic notice any other information that Inland Revenue deems necessary.

Clause 119, section NBB 6(2)(c)

A drafting error has resulted in the proposed section NBB 6(2)(c) referring to "PAYE period", which is not relevant for payroll subsidy purposes. The reference should be changed to "period".

Clause 143(28)(d)

A drafting error has resulted in clause 143(28)(d) referring to "pay period", which is not relevant for payroll subsidy purposes. The reference to "pay period" should be replaced by "period".

Clause 143(28)(e)

Clause 143(28)(e) refers to "pay frequency" which is irrelevant for payroll subsidy purposes. The clause should be amended to refer to the number of payments made by the listed PAYE intermediary to each employee for a particular subsidy period.

Recommendation

That the submission be accepted.

Fringe benefit tax

OVERVIEW

Clauses 14 to 16, 24 to 33, 40, 81, 121 to 132, 143, 145 and 148

The bill includes a range of changes to fringe benefit tax (FBT). The changes arise from a review of FBT and were signalled in the government discussion document, *Streamlining the taxation of fringe benefits*, released in December 2003. They are designed to reduce compliance costs and remove anomalies in the rules while maintaining the objectives of FBT. This includes changes to motor vehicle fringe benefits, although the underlying presumptions used in calculating the value of the benefit have been retained. The main changes are:

Motor vehicles

- Owners will have the choice of calculating the benefit based on the vehicle's depreciated tax value (with a minimum value) or, as at present, its cost.[6]
- The rate applying to either the cost price or tax value is being reduced in recognition of lower real motoring costs since the rate was set in the early 1980s. This reduces the rate from 24% to 20% of the cost of the vehicle. (The equivalent rate under the new tax value option is 36%.)
- The treatment of leased vehicles is being aligned with that of owned vehicles so that the fringe benefit from a leased vehicle is based on either its cost or tax value, rather than its market value as at present.
- To remove the potential for private use of a motor vehicle within a 24-hour period being treated as two days' private use, employers will be able to elect the start time for an FBT day. The election would last for two years.
- To overcome the avoidance of FBT by employees leasing their own vehicles to their employers and "suspending" the leases when private use occurs (known as 9 to 5 or flip-flop leases), the "suspension" is being legislatively overridden for FBT purposes so that private use is treated as a fringe benefit.

Other issues

- Employers will have the option of valuing their loans to employees at a market rate as an alternative to the current prescribed rate of interest. The market rate will be the rate that the lender is charging to other comparable groups of an adequate size on an arm's-length basis, which need not be a rate that is available to the public.
- The minimum value thresholds that apply to unclassified fringe benefits are being increased. The employee threshold is being increased from $75 to $200 per quarter and the employer threshold is being increased from $450 per quarter to $15,000 per annum.

[6] The tax value method is designed to more appropriately value the benefit when the car has been owned for more than five years.

- The private use of employer-owned or leased business tools such as cellphones and laptops will be exempt from FBT when they have been provided to the employee primarily for business purposes, subject to the cost price of a tool not exceeding $5,000.
- Benefits that arise in relation to employer health and safety obligations will be exempt from FBT irrespective of whether provided on or off-premises.
- The general anti-avoidance rule for income tax is to apply to FBT.
- The provision of credit cards and other short-term credit facilities by a charity to an employee will be subject to FBT when the value of the benefit exceeds 5% of the employee's salary.
- An exemption from FBT will be available when an employer pays for an employee's family to travel to visit the employee, provided the employee would have been eligible for a tax-free reimbursement of their travel expenses had the employee instead visited his/her family. This exemption will be limited to the amount that would have been reimbursable.
- Employees will be able to claim a deduction against their income for income protection insurance premiums paid by their employer on their behalf.

Submissions were generally supportive of the changes – in particular, the reduction in the valuation rate for motor vehicles (from 24 percent to 20 percent of the vehicle's cost price), the alternative of valuing the benefit as a percentage of the vehicle's tax value, and making more unclassified fringe benefits exempt from FBT. However, several submitters favoured retaining the current treatment with regard to 9 to 5 and flip-flop leases because they considered such leases enabled shareholder-employees to achieve the same business/private cost allocation as sole traders and partners. There was also some concern that the legislation was unclear about how re-leased vehicles could be valued for FBT purposes. A range of minor technical amendments were also suggested.

Officials consider that the changes to 9 to 5 and flip-flop leases are necessary to achieve the intention of the current legislation that shareholder-employees should come within the ambit of the FBT rules rather than the rules applying to sole traders and partners. While submitters have raised a broader issue regarding the relative treatment of shareholder-employees, this is outside the scope of the FBT review. We do recommend, however, that a full deduction of fixed and variable private motoring costs should be allowed in relation to the vehicles covered by the 9 to 5 leases, the same as occurs in other situations when FBT is applied.

Other changes officials recommend as a result of submissions are:

- That the cost price of a previously leased vehicle would be its market value at the start of the new lease provided the lessee and any previous lessee (or owner) of the vehicle are not associated persons.
- That there should be an FBT exemption for income protection insurance premiums paid by an employer rather than, as originally proposed, the employee receiving a deduction in respect of those premiums.

- That any member of a group of companies containing a person who is in the business of providing public transport can value any transport benefits that they provide their staff at the same rate as the public transport provider would be able to use in relation to its staff for FBT purposes.
- That the fringe benefits that arise from advances against salary and wages be exempt from FBT when the aggregate amount advanced to an employee does not exceed $2,000 and the advances are not part of an employment package.
- Several technical and drafting changes to improve the clarity of the legislation's intent and to better align it with the intended policy objective.

Otherwise, officials recommend adoption of the changes set out in the draft legislation. Several submissions suggested that there should be transitional arrangements for year by year leases already in operation at the time the legislative changes come into effect (1 April 2006). Officials do not recommend any transitional arrangements given that the changes have been known for at least 10 months and the leases in question have been structured with the principal purpose of minimising the FBT payable.

Issue: 9 to 5 and flip-flop leases

Clause 25

Submission

(3W – Webster & Company Ltd, 3WA – Gordon Tye, 3WB – Richard Herbert, 5W – John Cockcroft, 7W – Murray Pashby, 11W – Business New Zealand, 20 – New Zealand Retailers Association, 43W – Deloitte, 48 – New Zealand Institute of Chartered Accountants, 49 – Stephen Lace & Co)

The treatment of 9 to 5 and flip-flop leases should not be changed. The change biases the tax system in favour of operating under a self-employed structure.

Comment

Over the past decade an increasing number of employees (usually shareholder-employees) have entered into arrangements to lease their own vehicles to their employers for business use during specified hours in exchange for a market rental. The leases enable the employees to enjoy private use of the vehicles when they are not being used for business purposes. Because the leases are in effect "suspended" when the private use occurs, there is no FBT liability.

In earlier cases, Inland Revenue was able to apply FBT to 9 to 5 leases when there was evidence that the vehicle was available for private use during the "business lease" period (for example, evidence that taxpayers have used the vehicle to pick up children from school). The arrangements then evolved into "flip-flop" leases, where the lease agreement does not specify a "business lease" time, but instead says that the vehicle is not available for private use whenever it is being used for business purposes, and vice versa. This has the effect of creating a legal fiction that technically gets around the concept of availability for private use that underpins the FBT rules, to allow unlimited private use and the apportionment of fixed costs between private and (alleged) business use.[7] Although the vehicle is owned by the employee, this is an undesirable policy outcome because the arrangement allows the employer to subsidise the fixed costs of the employee's vehicle and therefore provide a form of untaxed remuneration to employees.

Officials contend that the economic outcome of a 9 to 5 or flip-flop lease is the same as if the employer had either leased the vehicle from a company specialising in leasing cars to businesses, or had purchased the vehicle, and in both cases made it available to the employee for their private use. This is because in all these scenarios the employer receives the use of a vehicle for business purposes and the employee is also able to use the vehicle for private purposes.

[7] The fringe benefit received from a motor vehicle takes into account the private benefit that an employee gets from avoiding having to incur fixed costs such as depreciation and interest (known as the benefits from availability for private use) as well as the running costs, such as fuel, arising from actual use of the vehicle. In contrast, under an apportionment approach, the approach (favoured by submitters), these fixed costs are pro-rated between business and private purposes so that a portion of the fixed costs can be deducted.

The proposed solution provided in the bill involves the ability to "suspend" the lease, which allows the lease to run for only specified periods. This "suspension" would be legislatively overridden for FBT purposes so that the lease would be continuous for its full term (unless ceased earlier) and the employee would then receive a fringe benefit from the private use. While this would make 9 to 5 and flip-flop leases unattractive, officials argue that the change is only restoring what Parliament originally intended.

The submitters' main concern is that this change inappropriately biases the tax system in favour of operating under a self-employed structure, such as a sole trader or partnership, compared with the business incorporating as a company. They would prefer that the self-employed model also applies to shareholder-employees, which is what the 9 to 5 and flip-flip leases achieve. Under that model, there is a straight apportionment of expenses between business and private purposes, with only the business portion being able to be deducted against income. A company can deduct all expenditure against its income but FBT is applied to any private benefit that the company provides.[8]

The FBT rules cover all employees, including shareholder-employees of close companies. This means that from a tax policy perspective employers of shareholder-employees are supposed to pay FBT whereas partners and sole traders apply the apportionment approach to their expenditure. Hence, someone such as a plumber, who moves from being a sole trader to setting up and working in their own plumbing company, has to deal with fringe benefit tax. This is simply a result of corporatising.

Officials acknowledge that this does create some boundary issues, but unless one treatment is applied in all situations, the problem of a boundary is unavoidable.[9] Currently the boundary has been drawn to incorporate shareholder-employees within FBT. The reason for bringing shareholder-employees within the net arose from a concern in the late 1980s about the use of the major shareholder-employee in close companies to overcome FBT in circumstances when it should apply, and as a means of bolstering the dividend rules. Most non-cash benefits received by shareholder-employees are subject to FBT rather than being treated as a dividend because of the difficulty in deciding whether the benefit has been received in a shareholder or employee capacity.

The Valabh Committee considered this issue in the 1990s in the context of the treatment of shareholders of close companies. Although the committee recommended that the profits and losses of companies with few shareholders should be able to be allocated to individual shareholders, as is the case for partners and sole traders, it concluded that FBT should continue to apply to in-kind benefits provided to shareholder-employees by both qualifying companies and non-qualifying companies.

Officials do accept, however, that a full deduction of all costs, not just the business portion, should be allowed when FBT is paid. This would replicate the treatment applying when a company owns or leases the vehicle and pays FBT on making it available to an employee for their private use.

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[8] Quite apart from the boundary arguments raised by submitters, there has also been an underlying dislike of the FBT approach from many accountants ever since the introduction of FBT as they would prefer the motor vehicle benefit generally to be based on actual use rather than availability for use. FBT based on actual use would result in some form of apportionment.

[9] In this context the difference in tax treatment is just one factor to be taken into consideration. There are a range of benefits from adopting a company structure. If one approach had to be applied across all situations, then arguably it is the FBT treatment rather than the apportionment model that should be more widely applied.

Recommendation

That the submission be declined, but agree to a legislative amendment that ensures that for 9 to 5 and flip-flop leases, the full costs (both business and private) of operating the motor vehicle can be deducted by the lessor when FBT is paid by the lessee.

Submission
(3W – Webster & Company Ltd, 3WA – Gordon Tye, 3WB – Richard Herbert)

The proposed change should be confined to non-shareholder employees.

Comment

The submission argues that this limitation is necessary to maintain the relative treatment, in the case of leased vehicles, between shareholder-employees and the self-employed. However, the submission acknowledges this would exclude around 99 percent of 9 to 5 or flip-flop lease agreements. As discussed in the previous submission, officials consider there are good reasons for the change and that continuation of the current situation would undermine compliance with FBT.

Recommendation

That the submission be declined.

Submission
(43W – Deloitte)

As a minimum, there should be transitional provisions for 9 to 5 and flip-flop leases which are part-way through their term when the amending legislation is enacted.

Comment

A transition that excluded 9 to 5 and flip-flop leases that are in operation on 1 April 2006 from the proposed change in treatment of such leases would in effect nullify the change because it would enable the tax advantages from such arrangements to be locked in.

By the time the change applies, businesses will have had ten months in which to plan for it. Moreover, since the vast majority of these arrangements involve shareholder-employees it seems that they could be fairly readily terminated if the participants found that the tax changes made them no longer economic.

Recommendation

That the submission be declined.

Submission
(47 – New Zealand Law Society)

Where a fringe benefit arises as a result of a close company making a motor vehicle available for the private use of a shareholder-employee, the employer should be given the option of not claiming the proportion of the motor vehicle expenses that relate to the private use by the employee of that motor vehicle, rather than accounting for fringe benefit tax.

(48 – New Zealand Institute of Chartered Accountants)

Close companies should be treated as "look-through" entities for the purposes of the FBT rules or, alternatively, the value of the fringe benefit could be based on an amount that is the now-deductible private-related portion.

Comment

These submissions amount to applying the same treatment to shareholder-employees as currently applies to sole traders and partnerships.

As noted in an earlier submission, officials suggest that if there was to be an alignment of the treatment of the self-employed with that applying to shareholder-employees, then arguably it is the FBT treatment rather than the apportionment of expenses that should apply more widely. This is because, by taking into consideration the fixed cost savings, the FBT approach better reflects the benefit that someone gets from the private use of a motor vehicle.

Recommendation

That the submissions be declined.

Submission
(47 – New Zealand Law Society)

"Suspension" of right to use a motor vehicle should be defined in section CX 6C.

Comment

The submitter is concerned that there is no limit on the length of suspension covered. The problem with introducing a time limit on the length of suspension is that it is relatively arbitrary where to draw the line and provides a possible loophole for exploitation. It would still be possible to avoid FBT and, in effect, the application of apportionment by entering into a lease and suspending it for the rest of the year or even indefinitely.

Recommendation

That the submission be declined.

Submission
(Matter raised by officials)

- that the legislative changes in new sections CX 6B and 6C with regard to 9 to 5 and flip-flop leases should be clarified to ensure that they include such leases involving persons associated with either the employer or the employee; and
- that the section OD 8(3) definition of "associated person" applies for the purposes of those provisions.

Comment

These changes relating to associated persons are anti-avoidance in nature. Draft sections CX 6B and CX 6C specifically refer to a lease of a motor vehicle between an employer and an employee. But it is possible for the lease to be arranged, for example, between the employee and a person associated with the employer or between the employer and a person associated with the employee. The provisions should also encapsulate these alternative scenarios to reinforce their effectiveness.

The Income Tax Act contains anti-avoidance provisions designed to capture associated person scenarios. However, a trustee and a beneficiary of a trust are currently not included in the general definition of "associated persons" that currently applies in the case of the FBT rules. This means that an obvious way to circumvent the proposed change that is being made to ensure that FBT applies to 9 to 5 and flip-flop leases is for the employee to transfer the vehicle to a trust under which the employee is a beneficiary. The lease agreement is then between the employer and the trust rather than between the employer and the employee.

To rectify this problem officials suggest that the more comprehensive definition of "associated persons" in section OD 8(3) of the Income Tax Act should be used when the FBT rules are applied in the context of sections CX 6B and 6C. That definition specifically associates a trustee of a trust with a beneficiary of the trust.

Recommendation

That the submission be accepted.

Issue: Re-leased vehicles

Clauses 121 and 148

Submission
(10 – Financial Services Federation (FSF), 21W – Flexi Lease Limited, 29 – Corporate Taxpayers Group, 38W – Esanda Fleet Partners, 48 – New Zealand Institute of Chartered Accountants)

That a lessee who leases a previously leased vehicle should be able to use, for the purposes of determining its cost price, its market value at the start of the new lease provided the lessee is not associated with the previous lessee.

Comment

The submitters are concerned to ensure that the policy intent of aligning the treatment of leased vehicles with that of owned vehicles is achieved for re-leased vehicles.

The general proposal for leased vehicles is that they must be valued for FBT purposes at either 20% of their cost price or 36% of their depreciated tax value. This is the same treatment as proposed for purchased vehicles. But the submitters are concerned that in the case of re-leased vehicles this change will bias decisions about whether to buy or lease an older vehicle in favour of buying. The Financial Services Federation has indicated that about 15 percent of its members' leases involve vehicles that have previously been leased, although this percentage varies widely from member to member (Flexi Lease has indicated that around 90 percent of its business involves previously leased vehicles).

The submitters' concern arises partly from unclear wording in the draft legislation about what valuation options are available to a lessee of a previously leased vehicle (see later submission). But there is also concern because a purchaser can use the cost of the vehicle to them as the basis for their FBT calculations, which in normal circumstances would be the market price, whereas that option is not open to a lessee of a re-leased vehicle. A lessee of a re-leased vehicle must use either the lessor's cost price or tax book value as the basis for their calculation.

It is not the intention that a subsequent lessee be required to continue to use the valuation method chosen by an earlier lessee – they can, for example, use the tax value in the lessor's books at the time of the new lease. Officials agree that the legislation should be clarified.

Whether the changes favour purchasing over leasing in the case of older vehicles will depend on such factors as the age of the vehicle when it is re-leased and its market value relative to its depreciated value at that time. Given that the tax depreciation on motor vehicles can, given the 20% loading on the rate, exceed the reduction in market value, it is possible for the tax value method to produce a lower FBT liability even though that method requires a higher valuation rate to be used.

The submitters suggest that the best solution is for lessees be able to use the market value of the vehicle at the time the re-lease begins. Provided the market value is independently derived, it would produce the same answer as if the lessee had purchased the vehicle. But, in the case of previously leased vehicles, this means retaining the current treatment which has been exploited to produce a lower FBT liability than the government intended. Many leases have been structured so that they become renewable each year. These are known as 1x1x1 leases and result in a new market value each year and a progressively lower FBT liability. The majority of leases are now on this basis, and hence the proposed change to remove the market value option.

As a safeguard, the submitters have suggested a requirement that the market value could only be used when the two lessees are unassociated. Officials agree that this would stop the most blatant rollover of short-term leases. Conceivably this would still allow the rules to be circumvented – for example, by unassociated parties swapping vehicles or the use of structures such as trusts which are not included in the definition of "associated persons". Some reliance would need to be placed on the Income Tax

Act's anti-avoidance rules as a backstop for overturning such arrangements. These potential problems are not, however, confined to lease situations; they are also relevant for purchased vehicles.

Recommendation

That the submission be accepted so that the cost price for a re-leased vehicles would be its market value at the start of the lease, provided the lessee and any previous lessee (or owner) of the vehicle are not associated persons.

Submission
(46 – PricewaterhouseCoopers)

When calculating the value of the fringe benefit, the lease payments made by an employer to an employee should be taken into account, so that FBT is imposed on the value of the benefit only when it exceeds the amount of the lease payment. The submitter further suggests that the FBT liability be scaled back so that it covers only the part of the day that the vehicle is used for private purposes to more accurately reflect the private-use portion of the vehicle.

Comment

The submitter is concerned that under the current rules and in conjunction with the proposed amendment for 9 to 5 leases, FBT would potentially arise for every day that the vehicle is leased, irrespective of the amount of actual private use that occurs on any particular day.

Officials do not agree with the submission as it ignores the fact that the business use of the vehicle does not generally impede the employee's ability to use the vehicle for private use. In other words, the vehicle is available for private use by the employee when the employee needs to use it. The fact that the lessor (employee) is taxed on the lease payments they receive is irrelevant. An equivalent vehicle could have been leased from an independent party and the value of the fringe benefit in such a case would not be reduced.

Officials have recommended that a legislative amendment be made for 9 to 5 and flip-flop leases that ensures that the full costs (both business and private) of operating the motor vehicle can be deducted. This deals with any potential over-taxation from applying FBT to these leases. Also, if the vehicle is not available for private use on a particular day, then FBT does not apply on that day.

Recommendation

That the submission be declined.

Issue: Treatment of leases already in operation

Clause 148

Submission 1
(11W – Business New Zealand, 21W – Flexi Lease Limited)

There should be a transition period for leases that have not completed their term, during which the old rules would apply until the leases expire.

Comment

The intended application date for the changes to the treatment of leases has been known from at least May this year and the possibility of change was first raised back in December 2003. This has given employers time to plan when entering into such leases. The lowering of the valuation rate from 24% to 20% helps to reduce some of the impact of the increased FBT liability.

Given that many leases are technically renewed annually, being 1x1x1 leases, they would have at most a year to run when the legislative changes come into effect. This would mean that a transition period would in most cases be less than a year.

In these circumstances officials cannot see any benefit from a compliance perspective from grandparenting the change. Rather, the request for a transition appears to be based on saving lessees from paying more FBT in the interim. The submission from Business New Zealand acknowledges this when it refers to the cost in the final year of a 1x1x1 lease being high-based on its cost or tax value rather than its market value. This is exactly the reason for the change.

Flexi Lease suggests that without a transition the change would in effect be retrospective. This is not the case, as even though it would apply to some lease contracts entered into before 1 April 2006, it applies only to fringe benefits that arise in relation to those leased vehicles from 1 April 2006. It is commonplace for tax changes to impact in this way on arrangements entered into before the change is made.

Recommendation

That the submission be declined.

Submission 2
(48 – New Zealand Institute of Chartered Accountants)

With the likely timing of the enactment of this legislation, if the changes apply from 1 April 2006, this will penalise many with vehicle leases in place that are unable to be changed for the 2007 year.

Comment

The reasons outlined in the comments on the preceding submission apply here too.

Recommendation

That the submission be declined.

Issue: Valuation options

Submission
(38W – Esanda Fleet Partners)

Clause 121 should be redrafted to make it clear that if the value of the benefit is calculated using the cost price of the vehicle in a return relating to that vehicle, this valuation method does not have to be used following disposal of the vehicle or when the vehicle ceases to be leased.

(48 – New Zealand Institute of Chartered Accountants)

Whether the second lessee has the ability to use the tax value method in a next-lease scenario when the original lessee chose to use the original cost method should be clarified.

Comment

The submissions are concerned that the changes to section ND 1A do not explicitly allow a new lessee to choose a valuation method for the vehicles that they are leasing and they may be locked into the valuation choices of an earlier lessee and governed in terms of switching between the two valuation methods as if they were the previous lessee.

It is not the intention that a subsequent lessee should be required to continue to use the valuation method chosen by an earlier lessee – they can, for example, use the tax value in the lessor's books at the time of the new lease. Officials agree that the legislation should be clarified.

Recommendation

That the submissions be accepted and the legislation clarified to confirm that the lessee of a previously leased vehicle starts afresh when determining which valuation method they can use and their ability to switch between valuation options.

Submission
(29 – Corporate Taxpayers Group)

Lessors should not be required to disclose to lessees the cost price or book value of the vehicles being leased, but rather the valuation of motor vehicle benefits should be based on the market value of the vehicle.

(48 – New Zealand Institute of Chartered Accountants)

That successive leases should be treated as one lease.

Comment

The Corporate Taxpayers Group is concerned that the provision in clause 148 that requires a lessor to disclose to a lessee the cost price or book value of the leased vehicles is unworkable and requires the disclosure of commercially sensitive information.

Both submissions prefer to correct the problem of 1x1x1 leases by allowing lessees to continue to use market value but ensure that sets of leases are treated as one lease in the legislation.

In the case of re-leased vehicles, where there is a distinct difference in the proposed treatments, officials are now recommending the use of market value to better align the two treatments. The change proposed by the submissions would not align the treatment of leased and owned vehicles as it would preclude lessees from using the tax value method.

Officials sought feedback on the disclosure requirement from the Financial Services Federation as it represents the major lessors who would be affected by this change. The Federation's response, after canvassing its members, was that while a vehicle's cost price could be in theory regarded as commercially sensitive because it allows the lessor's purchasing discount to be derived, "actual cost price" (being an accepted taxable value for FBT on a new vehicle) has been widely disclosed by lessors to lessees since the existing FBT rules were enacted. Consequently, they see little compromise to the existing situation from the proposal.

Moreover, the alternative suggestion of using the market value at the start of the first lease entered into by the lessee could result in a higher FBT liability for lessees. This is because the market price charged to the general public could well be higher than the cost price for the lessor, given the lessor's ability to often negotiate a discount on the market price.

Recommendation

That the submission be declined.

Submission
(46 – PricewaterhouseCoopers)

Clause 121

The new subsections ND 1A(1B)-(1E) are unclear and confusing and should be redrafted so their intention is clear and unequivocal.

It is unclear from the wording of the provisions how they will apply to second-hand motor vehicles.

Comment

Officials agree that some drafting changes should be made to these provisions to clarify their intent, which is to set out the circumstances in which an employer can use the tax value and cost price options. For second-hand motor vehicles, the intent is that the new owner will not generally be bound by the valuation choices of any previous owner(s).

Recommendation

That the submissions be accepted.

Submission
(48 – New Zealand Institute of Chartered Accountants)

There appears to be a cross-referencing error in section ND 1A(1E). The references to subsection (1C) and (1D) should be (1D)(a) and (1D)(b) respectively.

Comment

This section is being revised to clarify its meaning. The reference is correct but the meaning has been lost.

Recommendation

That the submission be noted.

Submission
(43W – Deloitte)

Clause 148

The provision should be clarified to the effect that the tax value should be updated annually with the taxpayer having the option of doing the update as at either 31 March or the taxpayer's balance date.

Comment

This is a technical change to clarify when the tax value is updated. The intent is that the tax value is the depreciated value, as determined under subpart EE of the Income Tax Act, at the beginning of the relevant period covered by the FBT return. Usually the depreciated value of an asset is adjusted under subpart EE annually, at the taxpayer's balance date. This means, for example, that if a taxpayer has an annual balance date of 30 June and can file an annual FBT return for the period 1 July 2005–30 June 2006, then the tax value of the vehicle will be the value as at 1 July 2005, or as at the date of purchase if the vehicle is purchased after that date but before 30 June 2006.

If the same taxpayer has to file an FBT return for the year to 31 March, then for the year to 31 March 2007, the tax value would also be the depreciated value as at 1 July 2006.

If the same taxpayer with a 30 June balance date pays FBT quarterly then the value of the vehicle would be different for the September FBT return compared with the June return.

Currently the draft legislation refers only to "the value ...as determined under subpart EE", which could be interpreted as the value at either the beginning or at the end of the reporting period.

While officials agree with the submitter that it needs to be clarified that the update is done annually, we do not agree that taxpayers should have the option of doing the update as at 31 March or their balance date. Rather, it should be related to their FBT-return period (whether annual or quarterly). This approach limits compliance costs and is, in practice, likely to have the same outcome suggested by the submitter.

Recommendation

That the submission be partly accepted and agree that the tax value be the depreciated value as determined under subpart EE of the Income Tax Act, at the beginning of the relevant period covered by the FBT return or at the time of purchase of the vehicle if the vehicle is acquired during the FBT-return period.

Submission
(1W – H P Hanna & Co Ltd)

Clause 121

For vehicles owned before 1 April 2006, employers should not have to wait five years before they can switch to the tax value option.

Comment

The policy intent is that the valuation rules should apply equally to all vehicles irrespective of whether they were acquired before on or after 1 April 2006. This means for a vehicle that is in an employer's books on 31 March 2006, that the employer can switch to the tax value method if the vehicle has already been in the employer's books for five years.

To allow employers to switch earlier than that would enable them to reduce the amount of FBT that they pay over the first five years relative to what they would have paid had the tax value option (as well as the cost price option) been available when they acquired the vehicle. It is not consistent with the policy intent that the employer should be in a neutral position under either option after the first five years.

Recommendation

That the submission be declined.

Submission
(47 – New Zealand Institute of Chartered Accountants)

If the taxpayer chooses the option to use the adjusted tax value rather than cost, and if the vehicle is sold or destroyed within five years, the taxpayer should be allowed to adjust FBT to what they would have paid if they had used the 20% rate, if the FBT paid exceeds that under the cost option.

Comment

Officials consider that the submitter's suggestion would add unnecessary complexity to what are already complex rules. Furthermore, officials do not expect many new vehicles to be valued under the tax value method as this would result in the payment of more FBT in the early years of ownership.

The submitter is particularly concerned about the treatment of vehicles that are disposed of after, for example, being written off in an accident. If a vehicle is written off, the insurance company usually funds a replacement with a vehicle of comparable value. This means that the employer has the choice, from an FBT perspective, of using the cost price or tax value of the new vehicle at that point. The employer will be either better off or neutral relative to the vehicle not having been written off as the cost price will be lower and should be around the same value as the tax book value of the written-off vehicle. Hence there should be no over-taxation. Similarly, if a taxpayer self-insures (does not have motor vehicle insurance) and purchases a replacement vehicle, the employer again has the choice of using both valuation options.

If the vehicle has to be sold, say after two years because the business is downsizing, then this is a normal business risk and no ex-post adjustment should be provided.

Recommendation

That the submission be declined.

Submission
(47 – New Zealand Institute of Chartered Accountants)

The amount of $8,333 in clause 8 of Schedule 2, Part A, be deleted.

Comment

The submitter expresses concern that the $8,333 minimum value that applies in the tax value method will result in over-taxation. This threshold equates to $3,000 of benefits, which covers the average on-going savings that employees make each year from having an employer-provided vehicle, irrespective of the vehicle's value. It is therefore appropriate to have this minimum value. The savings represented by this amount cover warranting, registration, insurance and running costs.

Recommendation

That the submission be declined.

Submission
(20 – New Zealand Retailers Association)

The principle of having the option between book value or the cost for motor vehicles is sound but the rates proposal does not produce the desired outcome.

(11W – Business New Zealand)

That the 36% rate should be lowered.

Comment

The submitters noted that the book value approach results in more FBT being paid over the first four to five years of the life of the vehicle and it is not until the life of the asset goes beyond this timeframe that some savings accrue. As many companies have a policy of turning vehicles over every three years, the submitter considers that the book value approach offers no benefit. The New Zealand Retailers Association suggests the risk is that FBT could become a driver for having a fleet with a higher average age.

It was not the intention that the tax value option should provide a lower FBT impost over that period relative to the cost price option. This outcome was acknowledged by the McCaw Committee when they developed their methodology for valuing a motor vehicle fringe benefit in the early 1980s. Officials consider that methodology to still be valid. As a result, officials anticipate the tax value method to be mainly of benefit to those employers who have owned a vehicle for more than five years.

Officials consider that the practice of employers' retaining vehicles for just three years is not necessarily relevant as the book value calculations are trying to measure the benefit to the employee. Our calculation is driven by the Automobile Association's published figures on motoring costs, which are based on the first five years of ownership because the costs are reasonably predictable over that time. Submissions suggest that individuals tend to hold vehicles bought new for longer than businesses would as businesses often hold a vehicle just for the three-year warranty period. However, for the reasons given we therefore consider that there is insufficient reason to change the basis on which the book value rate is calculated. This is the same methodology adopted by the McCaw Committee when they were considering how to value motor vehicle fringe benefits.

If the calculations were based on three years rather than five years, then the rate used under the cost price option would rise from the proposed 20% to 22%.[10] The tax book value rate that produces the same FBT payment at the end of the three-year period would be around 32%. Consequently, if most employers continue to use the cost price option, as we suspect will be the case, they will pay more FBT if a three-year basis is adopted because the rate will be higher.

Recommendation

That the submissions be declined.

Submission
(47 – New Zealand Law Society)

If an employee reimburses their employer for the private use of the employee's motor vehicle at the same mileage rate (62c a kilometre) that the employer would have reimbursed the employee for business use of the employee's motor vehicle, then the taxable value of the fringe benefit provided should be nil.

Comment

Fringe benefit tax focuses on the benefit that the employee is likely to receive rather than the costs that the employer incurs in providing the benefit. Consequently, the fringe benefit received from a motor vehicle takes into account the private benefit that an employee gets from avoiding having to incur the fixed costs (known as the benefits from availability for private use) as well as the running costs, such as fuel, arising from the actual use of the vehicle. This benefit can be offset by the employee paying the employer a lump sum which includes this availability benefit.

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[10] The reason for the increased rate is that the depreciated value of the vehicle in year 1 rather than in year 2 (being the mid-point of three years rather than five years) is used when calculating the average interest and depreciation charges. This means that the fixed costs represent a higher proportion of the cost price.

In contrast, the submitter's suggested approach, which involves the employee reimbursing the employer a fixed amount for each kilometre of private travel, would make reimbursement of fixed costs very much dependent on the actual amount of private motoring undertaken. If there were little private use of the vehicle then there would be little reimbursement of the fixed costs and hence the fringe benefit would be significantly understated. Depending on the per kilometre reimbursement rate and the type of vehicle used, the employee might have to do around 50,000kms per annum before fixed costs were covered, which would be far more than the average annual private motoring (14,000kms) assumed by the Automobile Association. A per kilometre charge would therefore be a very poorly targeted method for reimbursing the value of the benefit.

Recommendation

That the submission be declined.

Issue: Work-related vehicles

Submission 1
(48 – New Zealand Institute of Chartered Accountants)

The work-related vehicle exemption should be reviewed as a matter of priority.

Submission 2
(37W – Toovey Eaton & MacDonald Ltd)

A legislative discretion should be provided to the Commissioner of Inland Revenue to waive the logo requirement for work-related vehicles in certain circumstances.

Comment

Currently, most cars that are provided to employees are subject to FBT even if the cars are only available for very limited private use. In contrast, work-related vehicles such as trucks and utilities are exempt from FBT provided private use is restricted to home-to-work travel and the vehicle has the employer's identifier (logo) attached. Officials recognise that this distinction, which was set 20 years ago doesn't necessary reflect businesses' current vehicle needs, can distort business decisions, and result in over-taxation in some cases.

The government discussion document, *Streamlining the taxation of fringe benefits*, explored a number of options to deal with this problem, including an option to replace the work-related vehicle exemption with a wider category on which FBT would be charged at a low rate. Entry into this category would not be based on the appearance of vehicles as it is currently, but rather on the primary use to which they are put. Private use would still be restricted to home-to-work travel.

The government announced in April 2005 that it would not change the boundary for vehicles used for both business and private purposes at this stage. It was noted that the overwhelming view of submissions favoured the most fiscally expensive option – that is, to retain the exemption for work-related vehicles but also halve the FBT rate on other vehicles used primarily for work purposes. The government considered that given the high fiscal cost of this option further consultation should be undertaken. But in recognition of this being a major area of concern for submitters, the government instructed officials to undertake further policy work in the future to achieve the best balance between the appropriate recognition of the business use of a vehicle and the need to tax the private benefit element.

Submission 1

The New Zealand Institute of Chartered Accountants was disappointed that the submissions they made on work-related vehicles in the earlier stages of policy development have not been reflected in the bill. Those submissions proposed a broadening of the range of vehicles that would be exempt from FBT. This would be achieved through widening the work-related vehicle category so that it focussed on the use to which the vehicles were put rather than the type of vehicle.

Officials agree that further work should be undertaken on the issue and will report to the government accordingly.

Submission 2

A specific proposal explored in the discussion document involved allowing the Commissioner of Inland Revenue the discretion to waive the logo requirement when the employer could demonstrate that it would seriously compromise the nature of their business.

Officials view an Inland Revenue discretion over the work-related vehicles logo requirement as being inappropriate at this time for two reasons. First, it would be a piecemeal change that softens the boundary between work-related and other employer-provided vehicles. In the context of the further policy work that may be done in this area in the future, such a change may itself be subject to further change. Secondly, there are sound policy arguments against the use of discretions. The primary one is the potential for inconsistency when exercising the discretion, even with the development of guidelines. This could result in unfair outcomes for some taxpayers.

Recommendation

That submission 1 be noted.

That submission 2 be declined.

Submission
(1W – H P Hanna & Co Ltd)

GST should not be applied to FBT.

Comment

The submitter suggests that adding GST to the value of a fringe benefit is unreasonable and should be abolished as it is really a tax on a tax, and notes that the value of a fringe benefit is already calculated on the cost of the car inclusive of GST.

The reason for using the GST-inclusive cost of the car as the basis for calculating the benefit is that this is the price the employee would normally pay if they had to purchase the vehicle. Basing the value of the benefit on what the employee would normally pay is a reasonable approach to its worth to the employee.

The justification for applying GST to the taxable value of the fringe benefit is that the employer, by providing the employee with a private benefit, is in effect making a taxable supply to a final consumer. The way the GST system works is that GST is ultimately paid by the private/final consumer. This means that the employer can claim a GST input tax credit against the GST paid on the car (and on running costs), and GST output tax is subsequently paid when a taxable supply is made by the employer. Taxable supplies can take many forms, including fringe benefits supplied to employees and products supplied to the public.

Recommendation

That the submission be declined.

START OF FBT DAY

Clause 122

Submission
(48 – New Zealand Institute of Chartered Accountants)

The requirement to make an election in clause 122 for private use of a motor vehicle for a 24-hour period should be removed.

Comment

FBT is charged on a daily basis, with any private use or availability for private use in a day incurring one day's worth of FBT. Currently the FBT day starts from midnight. This can be a problem if a vehicle is taken home only periodically because even though the vehicle may be taken home in the evening and returned the next morning (within 24 hours) two days' worth of FBT is due. To overcome this over-taxation, an employer will be able to elect a start-time for their FBT day other than midnight. The election will last for a minimum of two years and apply to all of the employer's vehicles.

Employers will be required to notify Inland Revenue if they make an election. The reason for requiring notification is that it serves as a useful check that a decision has been made and when it was made. There are a number of similar election requirements already in the Income Tax Act.

The submitter considers that this new election requirement is cumbersome and could penalise those who neglect to make it. The submitter would prefer a general 24-hour test. Officials do not agree that the election is cumbersome. Once a decision to make a change has been made, the employer simply indicates their choice with the FBT return first affected by the change. If an employer neglects to advise Inland Revenue of their election, then the default situation applies – in other words, their FBT continues to start from midnight. Our expectation is that most employers will continue with the default option and will therefore not need to provide notification. The new option and the associated notification requirement will be well advertised.

The submitter's suggestion of a general 24-hour test would be unworkable as it would provide no firm basis on which to calculate the benefit.

Recommendation

That the submission be declined.

Submission
(48 – New Zealand Institute of Chartered Accountants)

Rather than making a written election, an election should be treated as being made by filing the FBT return or by simply noting in the taxpayer's records – for example, in their logbook, when the 24-hour period begins.

Comment

As noted earlier, the reason for requiring notification is that it serves as a useful check that a decision has been made and when it was made. If the taxpayer simply notes it in their records, this would provide less of an independent check from an auditing perspective. Likewise, the suggestion that an election is treated as being made by simply filing the FBT return provides no indication of the employer's decision and would give rise to confusion for those employers who decide to continue with the default option.

However, officials do suggest a small change be made to clause 122. New section ND 1AB requires that the notice of election be given in the first FBT return to which it applies. Officials have been advised that this would require modifying the FBT return as well as other systems changes to capture the extra piece of data provided on the return. This process can be streamlined by allowing the election to be made with the return.

Recommendation

That the submission be declined but that a minor technical change be made to clause 122 to enable the election to be made with the return rather than in the first FBT return to which it first applies.

Submission
(47 – New Zealand Law Society)

Subsection ND 1AB(3)(a) should be redrafted so that it refers to a person choosing an hour as the start point of the day.

Comment

The submitter is concerned that the wording "choose an hour in the 24-hour period starting at midnight as the starting point of the day" is too confusing and should be simplified.

Officials agree that the relevant wording can be made clearer and recommend an appropriate alteration to the legislation.

Recommendation

That the submission be accepted.

INCOME PROTECTION INSURANCE

Clauses 15, 16, 26 and 40

Submission
(29 – Corporate Taxpayers Group, 43W – Deloitte, 48 – New Zealand Institute of Chartered Accountants)

Income protection insurance premiums paid by employers on behalf of their employees should be exempt from FBT rather than employees getting income tax deductions for the premiums paid by their employers.

Comment

The proposed legislation allows employees to claim a deduction against their income for income protection insurance premiums paid by their employer on their behalf. The draft legislation also includes a consequential change to specifically include the amounts derived under a policy of income protection insurance as income of the employee rather than leaving it to be considered as income under ordinary concepts.

The purpose of these changes is to put the employee in the same position as they would have been had their employer paid them a cash amount and the employee had then paid the premium directly. This is not the case currently. Employees who pay the premium directly can be eligible for a deduction for the premium paid, to the extent that any payout on the policy would be taxable income, but employees do not receive a deduction when the employer pays the premium on their behalf.

The 2003 discussion document, *Streamlining the taxation of fringe benefits*, proposed that the premium be exempt from FBT, as recommended by the submitters, but on further analysis officials concluded that this did not produce a neutral outcome in all situations relative to the employer paying the employee the equivalent amount in salary and the employee then paying the premium themselves. This means that in some situations employers pay more FBT and in other cases less FBT than they theoretically ought to, although we acknowledge the differences are relatively small.

On the other hand, there are more compliance costs associated with providing employees with a deduction as the employer has to include the relevant premium amounts in their FBT return and notify the employee of how much it has paid on their behalf, and the employee then has to claim the deduction. In some cases this may mean employees have to file a tax return when they currently have no need to do so, and having two parties make adjustments increases the chance of errors. With an FBT exemption, the employer simply does not include the premium amount as a benefit in their FBT return, and the employee does nothing.

The submitters are clearly of the view that the extra compliance costs outweigh any accuracy benefits from the deduction approach. They also indicate that there is potentially a significant number of employees who could be eligible to claim deductions. Officials understand that income protection insurance is now commonplace for professional firms such as accountants. The Investment Savings & Insurance Association estimated that there were around 300,000 income protection insurance policies as at 31 March 2005. If the premiums on just 10 percent of these policies were paid by the employer, it would mean that 30,000 employees would be eligible to claim deductions, which would involve significant compliance and administrative costs.

In these circumstances we agree that providing an FBT exemption would be preferable.

Recommendation

That the submission be accepted.

Submission
(47 – New Zealand Law Society)

New section CX 15B should be redrafted to state that a fringe benefit arises when an employer pays or contributes to the payment of a premium for income protection insurance for the benefit of the employee.

Comment

As section CX 15B is currently drafted, a fringe benefit arises when an employer has a liability to pay or contribute to the payment of a premium for income protection insurance for the benefit of an employee. This reference to an employer liability is deliberate to ensure that there is no overlap with the employment provisions of the Income Tax Act.

Take, for example, the situation where an employee takes out income protection insurance but their employer pays the premium on their behalf. In this case, the liability to pay remains with the employee and it is our understanding that the payment would be treated as employment income under section CE 1(b) – expenditure on account of an employee that is expenditure on account of the person. This income is then included in the employee's income. Therefore, adopting the change suggested by the submitter would lead to confusion in these cases as potentially both the employer and the employee would face a tax impost on the same amount, one under the FBT rules, the other under the employment rules.

Recommendation

That the submission be declined.

Submission
(48 – New Zealand Institute of Chartered Accountants)

With regard to the previous NZICA proposal that income protection insurance premiums paid by employers on behalf of the employee should be excluded from FBT, income protection insurance premiums should also be excluded from the definition of expenditure on account of an employee.

Comment

Officials do not agree with this submission for, as noted earlier, the crucial test of whether an item falls within the employment income provisions or the FBT provisions rests on who has the liability to pay. Given that the FBT exemption will not apply to all situations when an employer pays the premium on the employee's behalf, a blanket exclusion from the definition of "expenditure on account of an employee" is inappropriate.

Recommendation

That the submission be declined.

Submission
(46 – PricewaterhouseCoopers)

Non-filing taxpayers should be entitled to claim the proposed deduction in relation to income protection insurance premiums by way of a separate claim form similar to the donations rebate claim form. Alternatively, the deduction entitlement could be allocated to the employee via the PAYE system.

Comment

This submission is aimed at reducing compliance costs for those employees that no longer have to file income tax returns. We recommended acceptance of the solution suggested in an earlier submission that the premium should be exempted from FBT rather than the employee receiving a deduction. This would make the change suggested by this submitter unnecessary.

Recommendation

That the submission be declined.

OTHERWISE DEDUCTIBLE RULE

Submission
(29 – Corporate Taxpayers Group)

An "otherwise deductible" rule similar to that in Australia should be adopted.

Comment

This rule would exempt from FBT expenditure by the employer on behalf of the employee if the employee would have been entitled to a tax deduction if they had incurred the expenditure themselves. The submitter sees this approach as a generic solution to concerns such as the treatment of employer-paid income protection insurance premiums.

An "otherwise deductible" rule was considered as part of the review of fringe benefit tax. The concern had also been previously considered by officials in 1994–95 in the context of employee share loan benefits. At that stage it was rejected, largely on compliance cost grounds, in favour of a specific exemption from FBT for low interest loans provided by employers to enable employees to purchase shares in the employer company.

Officials consider that there are no new grounds for introducing an "otherwise deductible" rule. The compliance burdens would still be present with a general rule. These compliance costs arise because of the potentially very wide nature of such a rule. Not only would it cover, for example, employer-paid income protection insurance premiums, but it could also potentially exempt from FBT any employer-provided low-interest loans that were made to employees to acquire any income-earning asset. This is on the grounds that the funds from the loan are used in the production of gross income and the employee would, had they paid interest on the loan, be entitled to deduct that interest. Because of this potentially wide nature, there needs to be clear confirmation that the benefits are associated with income earning activities.

In Australia, where such a rule exists, the employer has to obtain a declaration from employees stating the percentage to which the benefit has been used for income-producing purposes, to qualify for the FBT exemption. This results in significant compliance costs for both employers and employees. Furthermore, the definition of what an income earning asset is may change from situation to situation. The Australian Tax Office has also found that the rule has produced additional administrative costs, mainly through increased auditing of both employers and employees.

In contrast, specific limited exclusions or deductions suffer less from these problems. For example, in the case of low-interest loans in respect of employee share loan benefits, the employer would hold the substantiating documentation relating to the loan and the employee share purchase, making verification relatively easy.

Recommendation

That the submission be declined.

CHARITIES PROVIDING SHORT-TERM CREDIT FACILITIES

Clauses 31 and 124

Submission
(48 – New Zealand Institute of Chartered Accountants)

Clause 31, which deals with benefits provided by charities, requires some further guidelines.

Comment

Clause 31 limits, in certain circumstances, the current exemption that charities have from FBT. Those circumstances are when a charity provides credit cards and other short-term credit facilities to an employee and the value of the benefit from those facilities for the employee in an income year exceeds 5% of the employee's salary or wages for that income year. The value of the benefit, as set out in new section ND 1IB, is essentially the amount that the charity pays towards the purchase or hire of the goods or services obtained by the employee under the short-term credit facility, plus any interest and account fees incurred.

The submitter is seeking further clarity on when the benefits should be included in FBT returns. The intention is that the benefits should be included in FBT returns as and when they are provided. As the benefits are cumulative, this means that once the 5% threshold is exceeded in the year, the benefits must be included in the charity's FBT return at that stage. If further benefits are provided in the next quarter and the charity has to file quarterly FBT returns, then those additional benefits must also be included in the next quarter's FBT return, and so forth. Officials agree that the legislation could provide more guidance on this timing aspect.

Recommendation

That the submission be accepted.

Submission
(Matter raised by officials)

The proposed limitation to the charities' exemption from FBT needs to include debit cards.

Comment

The limitation focuses on short-term credit facilities, but this term is something of a misnomer as there are also debit cards which would provide employees with a similar ability to charge day-to-day items to an account that the employer would be liable to pay. To ensure that the limitation cannot be readily circumvented through switching to these debit card-type arrangements, officials recommend a minor wording change so that the limitation also applies to them.

Recommendation

That the submission be accepted.

APPLICATION OF GENERAL ANTI-AVOIDANCE RULE TO FBT

Clause 81

Submission
(48 – New Zealand Institute of Chartered Accountants)

The anti-avoidance provision in clause 81 is not required.

Comment

The change in clause 81, to enable the Income Tax Act's general anti-avoidance rule to be applied to FBT, is being made to correct a technical anomaly. The submitter is concerned that this change has not been thought through and may have unintended consequences.

Officials see no reason for the change not proceeding. While FBT has its own anti-avoidance rules, unlike many other specific anti-avoidance rules elsewhere in the Act, it is not bolstered by the Act's general anti-avoidance rule (which enables a tax avoidance arrangement to be voided and any associated tax advantage to be counteracted). The benefit of the change is that it would increase the chances that an arrangement that survived a specific anti-avoidance rule on a technicality would be nevertheless caught as avoidance.

Recommendation

That the submission be declined.

Submission
(16W – Small Business Advisory Group)

With respect to motor vehicle fringe benefits, employers should have the option of including the FBT calculation directly into their annual tax return so that it is included in provisional tax calculations, as an alternative to filing separate FBT returns.

Comment

The Small Business Advisory Group (SBAG) approach is designed to reduce compliance costs by removing the need to file quarterly FBT returns. Return filing is considered more costly for small businesses because they need to use accounting firms to complete the returns when they do not have their own in-house accounting resources.

The SBAG submission raises several practical and conceptual concerns:

- It covers only motor vehicle fringe benefits so that employers providing non-vehicle benefits would still need to complete FBT returns and pay FBT. SBAG's response is that the FBT return data suggests that only about 25 percent of returns showing an FBT liability have non-vehicle benefits so that 75 percent (some 16,500 businesses) have only motor vehicle benefits and could therefore save having to file an FBT return under its proposed approach.
- Employers would also still need to keep adequate records and calculate the value of the benefit over the reporting period – for example, to deduct any days on which the motor vehicle benefit was not provided. SBAG has suggested that a test period could be used to establish when a vehicle is not available for private use. This facility is already available so the recommendation does not appear to lower compliance costs.
- It is not clear whether the end-of-year calculation of actual benefits envisaged by SBAG would take account of employees' individual marginal tax rates as currently occurs under the multi-rate square-up calculation. Applying a single tax rate to vehicle benefits would have equity as well as revenue implications, with some employers over-paying tax and others under-paying. On average it would likely result in an underpayment, particularly if employers can choose which approach they use.
- It would further muddy perceptions about why tax is paid on fringe benefits. FBT is, in effect, a tax on employees in relation to the non-cash remuneration they receive, but for compliance cost reasons this is collected by way of a final withholding tax paid by employers. Including the payment in employers' tax returns would give the impression that it is a direct tax on employers. If the return had to be amalgamated, it would be better conceptually to include it in the PAYE return/employer monthly schedules.

- The SBAG focus is on small and medium enterprises (SMEs), but ideally any scheme should be open to any employer unless it can be demonstrated that SMEs face higher relative compliance costs. Also there is no universal definition of a SME.
- There would be cashflow implications from the SBAG recommendation:
  - It would result in some deferral of tax payments because provisional tax would be paid either twice or three times a year, whereas currently many taxpayers are paying FBT every quarter.
  - Entities making losses or who have accumulated losses against which to offset profits would also get a deferral of tax payments.
  - More generally, it would add to the bunching of tax liabilities so that some employers would ultimately pay GST, plus their standard provisional tax, plus the FBT add-on all at the same time – causing some employers cash-flow difficulties.

These arguments suggest that it is not clear that the compliance savings from the SBAG recommendation outweigh the various costs.

Officials' preferred approach

Officials have looked at alternative ways of addressing SBAG's underlying concerns. The aim of reducing the number of interfaces between employers and Inland Revenue can be driven by not only compliance cost concerns, but also by concerns about getting calculations wrong or making errors on the return.

On-line calculator

The on-line calculator put forward in the 2003 discussion document was aimed at alleviating such concerns through Inland Revenue providing a calculator that would accumulate fringe benefit data from the quarterly returns and undertake the end-of-year multi-rate calculation. This option is still being explored.

Raising the threshold for paying FBT annually

Another way to alleviate SME concerns would be to allow more employers to file FBT returns just once a year. Currently employers whose deductions of PAYE and specified superannuation contributions withholding tax (SSCWT) do not exceed $100,000 can file just one FBT return a year. Raising this threshold to $250,000 or even $500,000 should produce compliance cost savings at least comparable to those from the SBAG proposal for up to 10,000 employers and 12,000 employers respectively, without the drawbacks associated with the SBAG proposal.[11] Even better, advertising of the current limit would produce compliance savings as there appears to be confusion about it – for example, some assume that it is $100,000 of wage payments rather than the tax on those payments.

[11] These numbers include approximately 7,000 employers who currently file quarterly FBT returns even though their PAYE and SSCWT payments do not exceed $100,000.

Given that any change in this area would require advance notice, it should be consulted on with the aim of introducing it in a later tax bill. The measure would need to give taxpayers time to consider the changes and to file elections if they wished to change from quarterly, to once a year filing. Inland Revenue would also need more time to allocate resources to publicising and processing the change.

Recommendation

That the submission be declined, but that the Committee note that officials are exploring other ways of further reducing FBT-related compliance costs for small businesses, in particular:

- the option of significantly raising the threshold for annual filing; and
- the feasibility of an on-line calculator.

CAR PARKS

No clause

Submission
(29 – Corporate Taxpayers Group, 11W – Business New Zealand, 48 – New Zealand Institute of Chartered Accountants)

All car parks should be exempt from FBT.

Comment

Although submissions generally welcomed the government's decision not to bring all employer-provided car parks into the FBT net, three submissions preferred that all car parks be exempt from FBT.

Currently, car parks provided to employees on an employer's premises are exempt from FBT through the general exemption of benefits provided on an employer's premises. This extends to leased car parks because a lease is legally treated as an interest in land. A leased car park may, however, be far removed from the physical premises of the employer. In contrast, licensed car parks are subject to FBT if provided to an employee, even though they may be right alongside the leased parks.

The Corporate Taxpayers Group submitted that the FBT boundary between leased and licensed car parks is arbitrary and unnecessary and that the tax treatment should be the same regardless of whether a car park is leased or licensed. The submission further argued that most car parks provided to employees are not in substitution of wages that would otherwise be payable, so all car parks should be exempt.

NZICA's proposed solution to the leased/licensed boundary was that employer-provided car parks should be deemed to be part of the employer's premises.

Business New Zealand submitted that car parks are "a necessary condition of employment and are in some instances a health and safety obligation".

The discussion document, *Streamlining the taxation of fringe benefits,* included a proposal that employer-provided car parks should generally be subject to FBT on the basis that car parks have economic benefit to employees by saving them from having to pay for a car park themselves. However, submissions on the discussion document highlighted concerns about how the proposal would work in practice. These concerns were also expressed in subsequent consultations with interested parties.

The government then considered three options:

- making all employer-provided car parks subject to FBT;
- making all employer-provided car parks exempt from FBT;
- making no changes to the current FBT treatment of employer-provided car parks.

The government decided to make no change to the FBT treatment of car parks.

Officials do not believe there are any arguments in the submissions that have not been previously considered by the government, and would therefore warrant the government reconsidering its decision.

Recommendation

That the submission be declined.

No clause

Issue: Subsidised transport provided by group companies

Submission
(27W – Air New Zealand, 33W – KPMG, 48 – New Zealand Institute of Chartered Accountants)

The definition of "subsidised transport" should be amended to include an employer who is a member of a group of companies that contains a person in the business of providing public transport.

Comment

FBT on the provision of subsidised transport to an employee by an employer who is in the business of providing such transport is limited to 25% of the highest fare for that travel. However, if the transport provider offers subsidised travel to an employee of another company that is in the same group, full FBT applies because the other company is not in the business of providing transport.

The general "on-premises" exemption in section CX 20 is being extended by clause 29 of this bill to include the premises of other companies in the same group of companies who share 66 percent or greater common ownership with the employer company. This change recognises that entities within a group may operate more like a single economic entity. For example, an employee can be employed by one member company, but receive a benefit on the premises of another member company while on a secondment. This benefit would currently be subject to FBT, but for the changes made by clause 29.

The submissions argue that the principle behind the extension of the on-premises exemption should be applied to subsidised transport. That is, the business structure chosen by a business should not affect the FBT outcome. Officials agree the approach taken in extending the on-premises exemption should be also applied to subsidised transport.

Officials note that the 25% valuation rate may be outdated and further work should be done to review it, taking into account the range of discounted fares now available to the public, and the number of transport options to which the rate applies.

Recommendation

That the submission be accepted.

Issue: Transport benefits provided instead of allowances

Clause 27

Submission 1
(48 – New Zealand Institute of Chartered Accountants)

Clause 27 should be extended to allow the cost of visits of the whole family in certain circumstances.

Comment

If an employer pays for an out of town employee to return home to visit his or her family, this payment may currently be exempt from FBT. This is on the basis that the payment removes a need to pay the employee a reimbursement allowance for additional travel costs the employee incurs because of a temporary change in the employee's place of work. For example, the employee may have been seconded overseas. If the employer incurs the cost of a family member visiting the employee instead, the FBT outcome should arguably be the same and the benefit should be exempt.

Accordingly, new section CX 17(2) provides that a benefit that an employer provides to an employee is not a fringe benefit if it is an allowance that:

- is in substitution for an allowance that reimburses the employee for certain transport costs; and
- is brought about because the employee has a temporary change in their place of work while in the same employment; and
- reimburses the employee for transport costs that would have been incurred relating to travel by the employee's spouse or partner or relative for the purpose of visiting the employee in the temporary place of work.

NZICA submits that the proposal should be extended to allow the cost of visits of the whole family to be exempt from FBT in certain circumstances:

> "This area has huge shades of grey and requires wider considerations than just looking at the spouse. For example, there would be some circumstances where it would be appropriate for the spouse/partner and children to be transported to the temporary place of work, and these should be included in the exemption, provided that the cost does not exceed that which would be incurred in transporting the employee home."

Officials agree with this approach. It is not intended that only one family member should be allowed to travel under this exemption. Rather, the constraint is on the value of the travel not exceeding that which would be incurred in transporting the employee home. A minor modification to section CX 17(2) is suggested to put this beyond doubt.

Recommendation

That the recommendation be accepted.

Submission 2
(46 – PricewaterhouseCoopers)

The word "partner" used in new section CX 17(2)(c) should be clarified.

Comment

PricewaterhouseCoopers submits that new section CX 17(2)(c) should be consistent with changes made to the Income Tax Act 2004 by the Income Tax Amendment Act 2005. The amending act enacted the changes in terminology introduced in the Relationship (Statutory References) Bill bringing into effect, as from 26 April 2005, the concept of civil union partners and, from 1 April 2007, the concept of de facto partners.

The use of the word "partner" in section CX 17(2)(c) is intended to include civil union and de facto partners to broaden its application beyond spouses and relatives. Given this intention, officials agree with the submission that the word "partner" in new section 17(2)(c) should specifically incorporate both these relationships.

Recommendation

That the submission be accepted.

Issue: Goods provided at discount by third parties

Clause 32

Submission 1
(46 – PricewaterhouseCoopers)

The requirement that a group of employees being offered a discount by a third party must be comparable in size to another group of persons also being offered the discount to be exempt from FBT is unnecessary and unduly restrictive.

Comment

Normally, if an employer arranges for a third party to provide their employees with a benefit, such as a discount, the employer is regarded as having provided the benefits and FBT applies.

However, the government has agreed that FBT should not apply to benefits that arise when an employer has secured a bulk discount for its staff from a third party merely because they represent a significant group. If the discount were available to the employees as members of some other group unrelated to their employment, it would be difficult to consider the discount a fringe benefit.

The key element to the proposed change in new section CX 27B is therefore whether the group of employees would otherwise be able to get the discount for some other reason unrelated to employment. If so, the third party discounter must be offering the discount to other groups as well. To qualify for the exemption the other group of persons has to be comparable in size to the group of employees. The submission views this requirement as making the concession "unduly restrictive" and that the requirement of comparability imports an unnecessary element of subjectivity.

However, officials believe that the majority of discounts offered by third parties will be on the basis of a group's size and that size is most likely to influence the availability and extent of the discount. The submission supports this view by stating that "the likelihood of the discount offeror also offering the discount to a group comparable in size to the group of employees would be high…"

The use of the phrase "comparable in size" is a deliberate measure to broaden the scope of the exception beyond what it would be if the words "a group of the same size" were used. Bona fide discounts provided by third parties to a group of employees based on the group's size should easily meet this requirement.

Furthermore, the requirement also serves to ensure that the discount is genuinely provided to others in that it cannot be provided to just one or two other people. This is reinforced by the further requirement that the discount offered to the other group must have been negotiated on an arms-length basis.

For the above reasons officials do not agree with the submission.

Recommendation

That the submission be declined.

Submission 2
(47 – New Zealand Law Society)

That the phrase "comparable in size to the group of employees" should be changed to "comparable in number to the group of employees".

Comment

Officials consider that "size" in the context in which it is used only meaningfully means the number of employees but nevertheless recommend making the suggested change to put the matter beyond doubt.

Recommendation

That the submission be accepted.

Issue: Exemption for short-term advances

Submission
(48 – New Zealand Institute of Chartered Accountants)

A minimum threshold of $5,000 when an employer provides a loan to an employee should be introduced under section CX 9.

Comment

The FBT review has strived to remove compliance costs in situations when those costs exceed the small value of the fringe benefits involved. The issue raised by NZICA is such a case, and it is reasonable to try to resolve this issue. A key requirement of any solution, however, is that it should not provide a loophole for widespread avoidance of FBT on loans. The current definition of "loan" used in the FBT rules has been set deliberately wide for this reason.

This issue was originally raised with officials in the context of short-term advances against salary and wages. It is not uncommon for employers to provide low/nil interest advances against salary and wages on a temporary basis to assist employees to meet short-term commitments. Currently these advances would be subject to FBT but the compliance costs can be high compared with the size of the fringe benefit and associated FBT involved. Likewise, the administrative cost associated with charging interest on such advances is high relative to the amount of interest involved if an employer were to charge a market interest rate to avoid FBT.

In this context officials considered whether the benefits from loans made as advances against salary and wages could be exempt from FBT in particular circumstances, such as when provided in emergency situations. This immediately raised the question of defining what qualifies as a financial emergency. It would seem to require something unexpected which could be purely financially related or caused by an unforseen event.

This concept is used in section 177A of the Tax Administration Act, which allows the Commissioner of Inland Revenue to waive a tax liability in cases of serious hardship, such as arises from the taxpayer being unable to meet minimum living expenses according to normal community standards, or the cost of medical treatment for an illness or injury. These criteria are likely, however, to cover a far narrower set of circumstances than used by employers when providing short-term cash advances to employees against future salary. Also, there is still a degree of subjectivity inherent in these criteria so that clear guidelines would need to be provided to reduce wide interpretations being taken by employers. This then brings into question whether there are compliance savings from taking this approach.

Officials also considered the alternative approach of applying a cap to the amount exempted, as suggested by the submitter. This would involve setting a minimum value threshold before FBT applied, similar to that already applying to unclassified benefits. Given that the aim of the exemption would be to exclude small benefits that create disproportionate compliance costs, it would focus on benefits that are more likely to arise in the case of one-off or intermittent short-term loans. This would suggest that the threshold should be set quite low, particularly as it covers only one type of benefit compared with the unclassified benefits threshold which potentially covers a wide range of miscellaneous benefits.

The simplest cap would be to exempt loan benefits for advances up to a certain amount per employee rather than express the cap in terms of the value of fringe benefits as this would require the benefit to be calculated. Therefore, officials consider that a realistic threshold is $2,000 rather than the $5,000 suggested by the submitter. If a $2,000 loan were to run for a full year it would, based on a prescribed rate of interest of around 9%, equate to benefits of around $180 per annum.[12]

We also consider that it should only apply to loans made as advances against salary or wages that, to avoid widespread advantage being taken of the threshold, were not part of the employment package. Loans secured against real property, for example, would be likely to involve substantially larger amounts and even when the balance of those loans falls below $2,000, employers will generally have systems already established to account for them. $2,000 equates to around 2 to 3 weeks' after-tax pay for workers on the average wage.

This would mean that provided the total amount advanced to an employee against their salary and wages does not exceed $2,000 it would be excluded from being a fringe benefit in terms of section CX 9 of the Income Tax Act 2004.

Recommendations

That the concept of a minimum value threshold for employer-provided loans be agreed, but that the $5,000 threshold proposed by the submitter be declined, and instead the threshold be set to exempt fringe benefits that arise from advances against salary and wages when the aggregate amount advanced to an employee does not exceed $2,000 and the advance is not part of an employment package.

Issue: Ability to use market rate

Clause 123

Submission 1
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

As currently drafted, section ND 1D(4) restricts the market interest option to employers that are financial institutions. The option should also be available to other employers. To correct this, the word "means" should be replaced by "includes". *(New Zealand Institute of Chartered Accountants)*

[12] If, however, the alternative was that the employer had to use a credit card then the benefit would be double this as the interest rate on credit card advances is generally around 20%.

Submission 2

Subsections ND 1D(4)(a),(b) and (c) are unnecessary, unduly restrictive and should be deleted. *(PricewaterhouseCoopers)*

Comment

Submission 1

New section ND 1D allows employers the option of using market interest rates rather than the prescribed interest rates when determining the fringe benefit value of an employment-related loan.

Officials agree that the provision as drafted effectively confines its application to situations where the employer offers loans in the ordinary course of business. This is because in practice it is financial institutions who would want to use this option. Other employers are likely to find the compliance costs associated with the option too great to be worthwhile. This is because market interest rates can vary over a quarter and unless the rate being charged employees is kept up-to-date it would be easy for an employer to unwittingly incur an FBT liability, subjecting them to possible penalties. Monitoring market movements is relatively easy for someone in the business of lending but far more difficult for those who are not. Hence, officials do not agree with the submission that the option should be available to any employer. In fact we recommend that it be made more explicit that the employer must be lending more widely than just to employees to qualify for the option.

Submission 2

Officials do not agree with the PricewaterhouseCoopers' solution that subsection ND 1D(4) should be deleted. That subsection requires the group to which the third-party borrower belongs to:

- have a comparable credit risk to the employee's group;
- be employed by a person who is not associated with the employer; and
- be of a sufficient size to ensure a transaction on an arm's-length basis.

These requirements are necessary for a market rate to be determined as accurately as possible without contributing to an unreasonable compliance burden. Officials believe that the proposal would be open to abuse without these requirements since:

- The requirement that there is another group of borrowers that is not associated with the employer ensures that an independent market actually exists.
- Likewise, the requirement that the third party is of a similar size is to ensure that the market is of sufficient depth and breadth to be a true market.
- The requirement that the third party is of a similar risk profile is the simplest way to ensure that the market rate chosen by the employer is accurate, as risk is the key determinant of the interest rate offered.

Officials do, however, recommend that section ND 1D(4) be modified to clarify that the market rate covers rates offered to the general public as well as discounted rates provided to employees that are also offered to other groups. The market interest rate need not be the "publicly available rate". It could be a discounted rate that the employer provides to other groups for reasons other than employment. Currently, section ND 1D(4) particularly focuses on the latter situation and does not appear to sufficiently cater for market rates provided to the general public. Accordingly, officials' suggested changes to section ND 1D(4) are:

- that the third-party group should not be employed by a person who is associated with the employer; and
- that the third-party group conceptually includes, or can be part of, the general public.

Recommendation

That the submissions be declined but agree to the clarifications to subsection ND 1D(4) recommended by officials.

BUSINESS TOOLS EXEMPTION

Clauses 28 and 143

Issue: $5,000 threshold

Submission 1
(48 – New Zealand Institute of Chartered Accountants)

There should be no need to have a monetary limit of $5,000 to qualify for the exemption.

Submission 2
(43W – Deloitte)

It is unclear whether the "cost of the business tool to the employer" includes the costs of operating the tool, and examples should be published to clarify this point, incorporating both leased and owned scenarios.

Submission 3
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

As currently drafted, it is unclear whether the $5,000 threshold is GST inclusive or exclusive, and the threshold should be GST exclusive.

Comment

Submission 1

The monetary threshold of $5,000 prevents the term "business tool" being interpreted too widely. It was set at a level officials believe accommodates tools such as cellphones and laptop computers. Officials do not agree that the threshold is unnecessary, as suggested by NZICA.

Submission 2

Deloitte submitted that the proposal is unclear on whether the operating costs of a business tool would be included when determining whether the tool is under the $5,000 threshold. Examples of operating costs are cellphone and internet connections, and repairs and maintenance.

The benefit that this proposal is intended to exempt is the use, or availability for use, of certain business tools. The requirements that must be satisfied to qualify for this exemption refer to the actual tool or capital equipment itself. A business tool must:

- fit the definition of a business tool;
- cost the employer no more than $5,000; and
- be provided mainly for business use.

Although the commentary clearly states that new section CX 18B exempts the private use, and availability for private use, of business tools from FBT, officials recognise that the provision as currently drafted does not make it clear enough that the $5,000 threshold applies to the cost of the actual business tool itself (including the costs associated with getting the tool into a location and condition available for use), and not the ongoing costs of the business tool.

The submitter points out that a similar phrase in the FBT rules, "cost price of the motor vehicle" generated similar confusion when it was introduced. Officials believe that the confusion is unlikely to be repeated, because similar principles can be used to interpret the phrases "cost to the employer of the business tool" and "cost price of the motor vehicle". Interpretation of the latter phrase is now well understood, having been the subject of an Inland Revenue ruling.

Nonetheless, officials agree with the gist of the submission, and accordingly recommend a redrafted version of clause 28. The rewritten provision would make it clearer that it is the private use and availability for private use that is exempted from FBT, and that the $5,000 threshold relates to the value of the tool, not the value of the exemption. This includes clarification that if an employer leases a business tool, then for the purposes of the $5,000 threshold, it is the cost price that the employer would have incurred had they purchased the tool at the start of the lease.

Guidance on how taxpayers should interpret "cost to the employer" will be published at a later date. This will include examples as suggested by the submitter.

Submission 3

The draft legislation does not explicitly state whether the $5,000 threshold is GST inclusive or exclusive, and the submitter suggests that it should be GST exclusive.

It has always been intended that the $5,000 threshold be inclusive of all costs, including GST. To make the $5,000 business tools exemption threshold GST exclusive would be inconsistent with other parts of the FBT rules, causing confusion and possibly higher compliance costs.

FBT is a tax on employees' non-cash remuneration. Although the employer carries the burden of accounting for and paying FBT, it is in effect a tax on the employee. The employee would have to pay GST if they were to purchase the fringe benefits themselves because they would be the final consumer. This is why the GST inclusive price is used when calculating the value of benefits.

Arguably, given that costs, prices and fees are explicitly GST-inclusive for the purposes of the FBT rules, this intended meaning can also be imported into the new section CX 18B threshold. Nevertheless, officials agree that it would be helpful to clarify the provision by explicitly stating that the $5,000 threshold is GST-inclusive.

Recommendation

That submissions 1 and 3 be declined and submission 2 be accepted.

Issue: Definition of business tool

Submission

(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The portability requirement in the definition of "business tool" is unduly restrictive, and the definition should remove the portability requirement so that it includes all business tools, including items such as desktop computers that are not generally considered portable.

Comment

A prescribed list of what constitutes a "business tool" was considered in the policy development phase of this proposal. However, because technology and workplace developments would quickly make such a list obsolete, the definition of "business tool" has been designed so that it can be interpreted broadly, but within reason. The commentary to the bill indicates the type of business tools this exemption is aimed at by using laptop computers and cellphones as examples of business tools. Currently, the private use of these items would be considered an unclassified fringe benefit.

When the section OB 1 definition of "business tool" was drafted, officials envisaged that the ordinary meaning of "portable" would be used in its interpretation. It was thought this would be sufficiently broad, while still placing some reasonable limits on how far the interpretation of the "business tools" definition could be stretched. It effectively excludes, for example, motor vehicles. Arguably, the ordinary meaning of "portable item" would incorporate printers, facsimile machines and desktop computers. However, officials agree that the provision as currently drafted risks creating an arbitrary distinction between business tools which perform the same or similar functions but which differ in their degree of portability.

Accordingly, officials agree that the requirement of portability should be removed from the definition of "business tool" and, to ensure the original policy intent is preserved (for example, that cars would not be included), the exemption should be limited to business tools whose private use would otherwise be an unclassified benefit.

Recommendation

That the submission be accepted but that the exemption be limited to business tools whose private use would otherwise be an unclassified benefit.

Issue: Use of business tool away from employer's premises

Submission

(48 – New Zealand Institute of Chartered Accountants)

Section CX 18B(3) is a further test that is not necessary. Alternatively, guidance should be provided on what would constitute a "substantial" part of an employee's duties performed away from the employer's premises.

Comment

Officials do not agree with the submission that section CX 18B(3) should be removed. This section, which covers the situation where business tools are not taken to and used on the employer's premises, is not intended to be a further test in addition to the "mainly for business use test".

It is designed to widen the scope of "mainly for business use" by illustrating that if a business tool is not taken to and used on the employer's premises, it may nevertheless be provided mainly for business use if the employee performs a significant part of the employee's employment duties away from the premises.

In its submission, NZICA seeks guidance on what would constitute a "substantial" part of the employee's duties away from the premises. The word "substantial" does not appear in the draft legislation. Officials assume this is a typographical error, and that the submission seeks guidance on what constitutes "significant".

Officials reiterate that section CX 18B(3) is not designed to be a further test to section CX 18B(1). Rather, the use of the word "may" shows that it is designed to broaden section CX 18B(1) and illustrate its meaning. It is noted that under ordinary principles of statutory interpretation, the word "significantly" implies a lower test than "mainly".

Recommendation

That the submission be declined.

BENEFITS RELATED TO HEALTH AND SAFETY

Clause 30

Submission

(46 – PricewaterhouseCoopers, 43W – Deloitte, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

The proposal as currently drafted is too restrictive.

Sub-section CX 20B(b) should be deleted or widened so that the exemption will apply to all benefits provided to employees which relate to their health or safety, regardless of whether they are aimed at the elimination of hazards in the workplace. *(PricewaterhouseCoopers)*

The exemption should conceptually include benefits that isolate relevant hazards, and should include a list of specific benefits that are covered by it. *(Deloitte)*

Comment

Currently, benefits that might arise as the result of an employer carrying out health and safety obligations can fall within the scope of FBT, if they are not provided on the premises of the employer. There appears to be no good policy reason for basing exemption on location. This proposal is designed to exempt any benefits that may arise from the employer meeting their health and safety obligations irrespective of where they are provided.

PricewaterhouseCoopers supports an exemption from FBT for benefits arising from employer health and safety-related obligations, irrespective of where they are provided, but is of the view that the exemption should not be restricted to benefits aimed at the elimination of hazards in the workplace. PricewaterhouseCooper's reasoning is that although the term "hazard" is defined broadly in the Health and Safety in Employment Act 1992, there are still health and safety benefits which could fall outside the exemption. They suggest it would be easier for employers to comply with a policy that exempted all benefits relating to employee health and/or safety. Similarly, NZICA submits that the exemption should be widened beyond an employee's health and safety in relation to hazards.

Deloitte submits that the exemption should conceptually include benefits that isolate relevant hazards and should in addition include a list of specific benefits that are covered by it.

Officials' believe that a general health and safety exemption is too wide, goes beyond the original scope, and would add to the fiscal cost of this proposal. There would be increased potential for the exemption to be abused. A number of fringe benefits may become exempt because they are under the guise of health and safety, when conceptually they are closer to salary or wage substitutes than an employer simply fulfilling its legal obligations. Officials also view a prescriptive exemption, by way of a statutory list of exempt items, to be undesirable because health and safety obligations are continually evolving and individual to each employer. A statutory list of exempt health and safety benefits is unlikely to keep pace with future changes.

Because of the weaknesses in both general and prescriptive health and safety exemptions, the current proposal relates back to the Health and Safety in Employment Act 1992, which is where workplace health and safety obligations arise from. The link to health and safety legislation means that the FBT exemption will be able to adapt to changes in the health and safety expectations that employers face. Under that legislation, the definition of "hazard" is broad.

Officials recognise that the current provision as drafted may be too restrictive. Employers are required by the Health and Safety in Employment Act 1992 to (among other things) systematically identify hazards and then manage them by (in order of preference) elimination, isolation, or minimisation.

To recognise that not all hazards can be eliminated, officials propose to amend clause 30 by replacing "elimination of hazards" with "hazard management" to match the wording of the Health and Safety in Employment Act 1992. This would broaden the exemption to encompass other aspects of dealing with hazards, such as minimisation. An example of minimisation is that protective clothing must be provided to employees when a hazard cannot be eliminated or isolated. Officials would consider that this change would also be wide enough to ensure the exemption of influenza injections and eye tests – for example, in appropriate circumstances.

Examples of what would commonly qualify for the exemption will be published by Inland Revenue to provide further guidance to taxpayers.

Recommendation

That the submissions be noted, but that the reference to "elimination of hazards" be changed to "hazard management".

Submission
(46 – PricewaterhouseCoopers)

The phrase "health and safety" in sub-section CX 20B(a) should be replaced with the phrase "health or safety".

Comment

Officials agree that there may be instances, such as the provision of influenza injections, when a benefit is provided for either the employee's health or safety rather than both so that "and" should be changed to "or" as suggested by the submitter.

Recommendation

That the submission be accepted.

LOW-VALUE UNCLASSIFIED BENEFITS

Clause 126

Submission
(48 – New Zealand Institute of Chartered Accountants)

The employer-related threshold for minor fringe benefits should be removed. Or, if this is not accepted, there should be a higher threshold for employers with a large number of employees.

Comment

Section ND 1Q is being amended to increase the minimum value thresholds that have to be exceeded before unclassified fringe benefits are subject to FBT. The employee-related minimum value threshold is being increased to $200 per quarter (from $75) and the employer-related minimum value threshold is being increased to $15,000 per annum.

It was originally proposed in the discussion document, *Streamlining the taxation of fringe benefits*, that the employer-related threshold be raised from $450 to $2,000 per quarter. Submissions on the discussion document, including one from NZICA, resulted in the proposed threshold being further increased to $15,000 per annum.

The $15,000 threshold is designed to reduce compliance costs while ensuring that the tax base is not eroded and that the size of the associated fiscal cost is reasonable. While the aim is to reduce compliance costs for all employers, the new threshold particularly focuses on small to medium enterprises (SMEs) because they face a disproportionate share of the compliance burden in this area. It is based on the Ministry of Economic Development definition of a SME, being 19 employees or fewer.

In this context, it is the view of officials that the benefits from eliminating the employer-related threshold, as suggested by the submitter, would be outweighed by the potential fiscal cost.

Recommendation

That the submission be declined.

Taxation of share-lending transactions

OVERVIEW

Clauses 13, 18, 35, 36, 39, 48, 50, 51, 63, 64, 67, 82, 91, 93, 104, 105, 107 to 109, 133 to 140, 143, 153 and 157

The bill proposes changes to income tax legislation to clarify and reform the tax treatment of share-lending transactions by:

- introducing specific share-lending rules to allow the taxation of "qualifying" share-lending transactions on the basis of economic substance; and
- strengthening the tax rules to ensure that non-qualifying share-lending transactions do not give rise to an unintended fiscal cost.

Share-lending involves the lending of shares to another party for a fee and was developed to allow brokers to transact in shares in which they have a shortfall. Share-lending also provides a relatively risk-free way for larger holders of shares, such as banks, insurance companies, and funds managers to increase their overall portfolio returns. Internationally, share-lending represents a substantial part of the daily settlement value in many transaction systems and can play an important role in facilitating market liquidity.

New Zealand does not have an onshore share-lending market, in part because of the current tax treatment of these transactions. New Zealand, unlike many other jurisdictions, does not have special tax rules for share-lending. For New Zealand tax purposes, these transactions are taxed on the basis of legal form (a sale of shares) rather than economic substance (a loan), meaning that entering into a share-lending transaction is a taxable event.

There are several problems with the current New Zealand tax treatment of share-lending transactions:

- it is inconsistent with international trends;
- it is inconsistent with the economic and accounting treatment of these transactions; and
- it is inconsistent with the treatment of other commercial transactions.

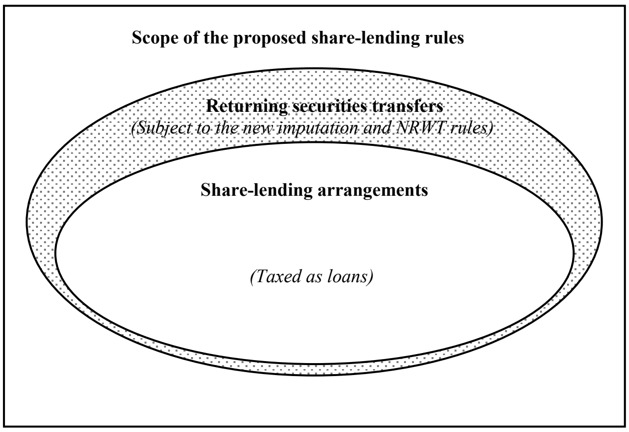
There are also tax avoidance concerns with the current tax treatment of share-lending transactions. There is evidence that share-lending transactions are being used to trade imputation credits and take advantage of the absence of specific tax rules in this area in New Zealand.

Proposed changes to the tax treatment of share-lending were set out in the government discussion document, *Taxing securities lending transactions: substance over form*, released in November 2004.

Summary of proposed amendments

The amendments to the Income Tax Act 2004 will introduce specific share-lending rules to tax "qualifying" share-lending transactions on the basis of economic substance rather than legal form. They will also strengthen the imputation and non-resident withholding tax (NRWT) rules to ensure that non-qualifying share-lending transactions do not give rise to an unintended fiscal cost.

These changes are being made to give greater consistency and more certainty to the tax treatment of share-lending transactions, and to protect the tax base by preventing taxpayers from using share-lending transactions to trade imputation credits and circumvent the NRWT rules.



The new rules revolve around the definition of a returning securities transfer. A returning securities transfer is an arrangement where:

- a person (the share supplier) disposes of a share which is listed on a recognised exchange or is ordinarily available for subscription or purchase by the public;
- the person who obtains the share (the share user) agrees to transfer the original shares or replacement shares back to the share supplier; and
- the share user makes replacement payments to pass on the rewards of ownership for any distributions paid on the original shares during the period of the transaction.

Returning securities transfers which meet a number of criteria (known as share-lending arrangements) will be taxed on the basis of their economic substance rather than legal form. This means that they will not be treated as a taxable disposal.

A “share-lending arrangement” is defined as a returning securities transfer where:

- the term of the transaction is no longer than 12 months;
- the original shares or replacement shares are transferred back to the share supplier;
- the share user maintains an imputation credit account (ICA);
- the share user pays withholding tax required under section NF 2(1)(g) for any replacement payment;
- the share user transfers to the share supplier any rights and options, or equivalent rights and options, granted or received in relation to the original shares during the period of the transaction;
- the terms of the securities lending transaction are ordinary commercial conditions which are consistent with those that would apply between parties negotiating at arm’s length; and
- the transaction is entered into in an income year after the new rules take effect.

To ensure that a minor breach of the qualification criteria does not disqualify commercial transactions from the new rules, the Commissioner of Inland Revenue will be given a discretion on the term of qualifying transactions and what constitutes a replacement share.

Returning securities transfers that do not qualify as share-lending arrangements will be subject to new imputation and NRWT rules. These new rules ensure that imputation credits remain with the economic owner of securities and that NRWT cannot be circumvented. They are designed to complement the new rules for share-lending arrangements and the existing anti-avoidance provisions.

The new base maintenance rules will apply when:

- A share user receives imputation credits as the holder of an original share acquired under a returning securities transfer.
- A share user makes a replacement payment to a non-resident which is intended to be economically equivalent to a reward of ownership which would be taxable in New Zealand if derived by the share supplier.

Under the new rules, the tax benefit obtained will be cancelled by a debit to the ICA account of the share user (if the tax benefit is in the form of imputation credits), or by denying the deduction for the replacement payment (if the tax benefit relates to the non-payment of NRWT).

Application date

The share-lending amendments will apply for income years beginning on or after the date of enactment. The associated base maintenance amendments will apply from the date that the amending legislation is enacted.

Submissions

Seven submissions were made on the proposed changes to the income tax treatment of share-lending transactions. All of the submissions supported the introduction of a revised tax treatment for these transactions but made various recommendations on technical aspects of the proposals.

The New Zealand Institute of Chartered Accountants supported the introduction of new rules for share-lending but opposed the introduction of the associated anti-avoidance rules. The Corporate Taxpayers Group made an oral submission supporting the introduction of the proposed rules. Officials have also made a number of recommendations to help clarify the proposed rules.

APPLICATION DATE

Submission
(28W – New Zealand Exchange Limited, 40 – Securities Industry Association, 45W – Asset Management Advisory Board, 48 – New Zealand Institute of Chartered Accountants)

Several submissions have been made on the application date for the proposed share-lending rules, including:

- that the application date for the share-lending legislation should be one set date; and
- that the rules should grandfather all transactions existing at the time of introduction.

Comment

The proposed share-lending rules have two application dates. The base maintenance changes for non-qualifying share-lending transactions will apply from Royal assent. This date was chosen because Inland Revenue has evidence that such transactions are currently being used to exploit the lack of specific tax rules in this area in New Zealand.

The other share-lending changes are intended to apply to income years beginning on or after enactment. This means that their application is dependent on a taxpayer's balance date.

Single application date

The New Zealand Exchange Limited, Securities Industry Association and Asset Management Advisory Board have submitted that the new share-lending rules should have a single application date. They argue that it is impractical and not commercially sensible to have different application dates depending on a person's balance date. They also argue that having an application date based on a taxpayer's balance date would mean that certain taxpayers would be given a commercial advantage as they would be able to enter into qualifying share-lending arrangements at an earlier date.

An application date based on balance dates was chosen to ensure that taxpayers had sufficient time to prepare for the change in tax rules. However, from a commercial perspective, officials can see the benefit of having the rules apply from a consistent date and recommend a single application date for share-lending rules of 1 July 2006.

Grandfathering

While the industry appears to favour a single application date, concerns have been raised about the impact of the new rules on existing transactions. The Securities Industry Association and New Zealand Institute of Chartered Accountants have submitted that the proposed share-lending rules should grandfather all existing transactions at the time of introduction. The Securities Industry Association is concerned that a compulsory regime (without grandfathering) will impose costs on market participants and could have a negative impact on New Zealand's financial markets.

Officials do not consider that the grandfathering of existing transactions is appropriate. The lack of a New Zealand share-lending market has been raised by the industry as a reason for the introduction of special tax rules. With no existing market, there should be limited commercial transactions affected by the introduction of the proposed rules.

In addition, the compulsory nature of the wider returning securities transfer rules is intentional. The proposed rules contain anti-avoidance measures to counter transactions aimed at trading imputation credits and avoiding NRWT. Industry participants were consulted (via a government discussion document in November 2004) on the proposed anti-avoidance rules to ensure these would not capture normal commercial transactions (other than those involving the trading of imputation credits or avoidance of NRWT).

Officials recommend dealing with concerns over the scope of the proposed anti-avoidance rules by broadening the definition of share-lending arrangement and better targeting the definition of a returning securities transfer rather than grandfathering any existing transactions. These proposed changes are discussed in the next section.

As discussed above, officials also recommend a deferred application date of 1 July 2006 to give the industry time to comply with the new rules.

Recommendation

That the submission on a single application date be accepted, but that a deferred application date of 1 July 2006 be used.

That the submission on grandfathering be declined, but that changes discussed in the next section, on types of securities, be made to the definition of share-lending arrangement and returning securities transfer to deal with concerns over the scope of the proposed anti-avoidance rules.

Submissions
(28W – New Zealand Exchange Limited, 31W – Goldman Sachs JBWere (NZ) Limited, 40 – Securities Industry Association, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

A number of submissions have been made about the types of securities covered by the proposed rules, including that:

- The share-lending rules should be extended beyond listed shares.
- A mechanism be introduced to allow other types of securities to be added to the rules over time.
- The definition of a "listed company" should be amended.
- The reference to an official list should be removed from the definition of a returning securities transfer.
- The definition of a returning securities transfer should be narrowed.

Comment

Listed shares restriction

A transaction will fall within the proposed share-lending rules only if it involves shares listed on a recognised exchange or ordinarily available for subscription or purchase by the public.

The Securities Industry Association has submitted that the proposed share-lending rules should be expanded to cover other securities such as:

- units, bonds, debentures, convertible notes, rights or options issued by a company, partnership or unit trust;
- government bonds, debentures or similar securities;
- commercial paper; and
- rights, options, forwards, futures, coupon strips, swapations and other derivatives over government and local authority securities.

This view is echoed in a number of other submissions.

Officials do not support expanding the list of qualifying securities at this time. The government discussion document, *Taxing securities lending transactions: substance over form*, initially proposed applying the new rules to both debt and equity securities. However, following a review of submissions, it was decided to limit the proposals to equity securities. This is because the majority of lending arrangements should relate to listed shares. Extending the scope beyond these is likely to require substantial changes to the tax rules without a corresponding increase in the number of lending transactions.

Officials also consider that the alternative criterion ("ordinarily available for subscription or purchase by the public") in paragraph (b) of the definition of a returning securities transfer should be removed. This criterion has a level of uncertainty which could give rise to debate over the parameters of the new rules. It has also been suggested that it is in conflict with the objective of improving market liquidity (as the equities are sold outside recognised markets). Limiting the new rules solely to listed shares will improve certainty around the breadth of the regime. There is potential that this change may disadvantage some participants by limiting the number of qualifying transactions. However, officials consider the impact to be minor and outweighed by the advantage of added certainty.

The Finance and Expenditure Committee has asked for details on expanding the proposed share-lending rules to cover other types of transactions.

It is difficult to estimate the fiscal cost of widening the share-lending rules. Tax lost to date from avoidance in this area is estimated to be $100 million. Given the technical nature of the proposals there is a risk of unintended tax consequences. While this has been countered in the design of the rules, the risk would be multiplied by attempting to expand the scope to cover debt and derivatives at this point.

New Zealand already has a debt lending market ($NZ9 billion). This shows that the current tax rules do not provide a barrier to debt lending (generally because participants tend to already be on revenue account). Therefore, the decision to exclude debt does not prevent debt lending as there is already a well established market under the current rules. The only issue is therefore the exclusion of derivatives. The industry has confirmed that the current proposals will cover the vast majority of lending transactions that participants will want to undertake. Interest in the lending of derivates is only likely to develop once the market has been established for some time. As part of the generic tax policy process, the share-lending rules will be reviewed post-implementation and the scope of the rules could be covered in this review.

Commissioner discretion

Officials do not support submissions to give the Commissioner discretion to add qualifying securities over time. There is a concern that such a discretion would not be broad enough to cover amendments required to other tax rules. More importantly, officials consider that such regulatory changes would benefit from the wider discussion that would attend a legislative amendment. Any such changes should be open to proper consultation, based on the generic tax policy process.

Listed company definition

A transaction will qualify under the proposed share-lending rules if it involves a share listed on the official list of a recognised exchange. The New Zealand Exchange Limited and Securities Industry Association have both submitted that the use of the term "official list" is unclear.

Taking the New Zealand capital markets as an example, New Zealand Exchange Limited runs both the NZSX Market and the NZAX Market, both of which are official equity markets. However, the term "official list" does not contemplate multiple markets. Officials agree that there could be uncertainty and recommend that this term be amended. The definition of "listed company" (which also refers to an official list) should also be amended to ensure consistency.

Recognised exchange

The Securities Industry Association has submitted that the definition of "recognised exchange" needs to be amended.

Officials consider that this will only be necessary if the proposed rules are extended to cover debt securities. Consistent with our earlier recommendation to limit the rules to listed shares, no change is required to the definition of recognised exchange. However, the definition will need to be reviewed should the types of qualifying securities be extended in the future.

Definition of a returning securities transfer

The Securities Industry Association, Goldman Sachs JBWere (NZ) Limited and the New Zealand Institute of Chartered Accountants are concerned that the definition of a returning securities transfer may inadvertently catch other commercial transactions such as share repurchase agreements, margin lending, instalment receipts, warrants, and the lodging of shares for collateral. They consider that these transactions fall outside the definition of a share-lending arrangement and as such would be subject to the proposed anti-avoidance rules. Specifically, they have suggested excluding transfers where the shares are held on trust for the benefit of the share supplier, or for security.

Officials agree that certain of these commercial arrangements (such as warrants and instalment receipts) are not akin to share-lending and should be excluded from the definition of a returning securities transfer and the proposed rules. However, most of the transactions listed above are similar and should receive the same tax treatment. As normal commercial transactions, they should not be subject to the proposed anti-avoidance rules. Officials therefore recommend amending the definition of a share-lending arrangement to cover these arrangements.

Officials note that unlike the initial position in the discussion document, this will mean that share repurchase agreements (as well as most of the other transactions listed above) will be covered by the proposed amendments. In discussions with the industry it became clear that share repurchase transactions and securities lending are virtually identical and should receive the same tax treatment.

Recommendations

Officials recommend that:

- The submission on expanding the proposed share-lending rules to cover other securities be declined and the alternative in the definition of a returning securities transfer should be removed.

- The submission on including a mechanism (such as a Commissioner discretion) to allow qualifying securities to be added over time be declined.
- The submissions on the term “official list” be accepted.
- The submission on “recognised exchange” be declined.
- In general, the submission regarding narrowing the definition of a returning securities transfer be declined. Instead, the definition of a share-lending arrangement should be amended to cover other types of similar arrangements. Officials also recommend that the term “returning securities transfer” is changed to “returning share transfer”. This will clarify that debt and other listed securities are not covered by the new rules and should help to alleviate concerns about the scope of the rules.

RELATIONSHIP WITH SUBPART CB

Submissions
(28W – New Zealand Exchange Limited, 40 – Securities Industry Association, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

Submissions have been made about the relationship between the proposed share-lending rules and subpart CB which treats disposals of revenue account property as assessable income, in particular that:

- Section CX 44B(1)(a) should be deleted.
- The reference to "consideration" should be removed.
- The proposed rules should clarify whether a taxpayer undertaking a share-lending arrangement is automatically on revenue account.
- The proposed rules should better clarify what happens when a share user returns shares to the share supplier.
- Participants should not be required to track shares to determine if they are original or replacement shares.
- The rules should clarify what is meant by "market value".

Comment

Section CX 44B

The aim of the proposed share-lending rules is to tax qualifying transactions as loans rather than as the sale and re-acquisition of shares. To achieve this, section CX 44B ensures that consideration derived by a share supplier under a share-lending arrangement on the disposal of an original share is excluded income. However, under subsection (1)(a) this exclusion only applies where the share supplier has acquired the share:

- for the purposes of a business;
- for the purposes of an undertaking or scheme that the person enters or devises with the purpose of making a profit;
- for the purpose of disposing of the share; or
- when in a business of dealing in shares.

These criteria were included because only revenue account holders should be taxed upon the disposal of shares.

The New Zealand Exchange Limited and the Securities Industry Association have submitted that it would make the rules clearer if the criteria in subsection (1)(a) were deleted.

Officials agree that the criteria in subsection (1)(a) are a duplication of other provisions in the Act which tax disposals of revenue account property. As such, it should not be necessary to specifically refer to these criteria in section CX 44B. Removing subsection (1)(a) would simplify the rules, while still making it clear that a share supplier is not taxable on the sale of shares under a share-lending arrangement.

Reference to consideration received

Concerns have been raised about the reference to "consideration" in section CX 44B. The New Zealand Law Society considers that the reference is not consistent with the concept of a share-lending arrangement as there is no "consideration" in the sense of cash movements when the shares are lent. Instead, they recommend amending the proposed rules so that the disposal and acquisition of shares under a share-lending arrangement is ignored for tax purposes.

Officials disagree with the idea of ignoring the disposal and acquisition for tax purposes. In general, the tax rules follow the actual transaction (a disposal and reacquisition). Officials consider that the share-lending rules should continue to adopt this approach, only switching off those few provisions needed to ensure consistency with the economic substance of these transactions.

The issue raised by the New Zealand Law Society could be dealt with by amending section CX 44B to treat the collateral received in respect of the shares as excluded income. This would eliminate the need to have a specific carve-out for share-lending fees and replacement payments.

Capital vs revenue account

The Securities Industry Association and New Zealand Institute of Chartered Accountants have submitted that the proposed share-lending rules should clarify whether a taxpayer who undertakes multiple lending arrangements will be in the business of trading in shares. The Securities Industry Association is particularly concerned about share-lending arrangements tainting treatment of shares otherwise held on capital account.

The share-lending rules are not intended to determine whether a share supplier is on revenue or capital account as there are other provisions in the Act which tax disposals of revenue account property. The capital or revenue account status of a share supplier in relation to particular shares will be determined by applying existing law to the facts in each case.

Returning shares

The Securities Industry Association and the New Zealand Law Society have submitted that the proposed rules need to clarify the tax treatment of returning borrowed shares.

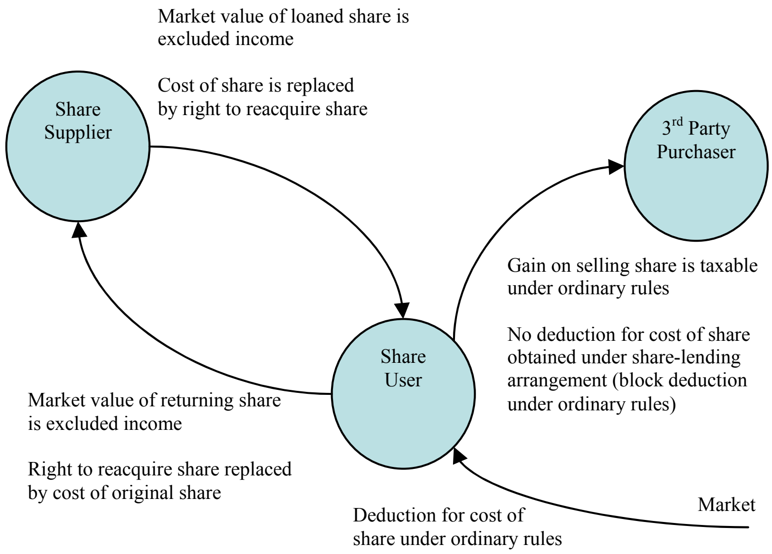
Section CD 44 deems a share user who transfers a replacement share to a share supplier to derive assessable income "equal to the market value of the original share at the date of acquisition by the share user".

The Securities Industry Association has submitted that section CD 44 should clarify when income is derived (in the income year in which the shares are transferred back to the share supplier), at what time market value should be determined (when the shares were transferred from the share supplier to the share user) and how the section links to section DB 12C (which allows a share user a deduction for acquiring a share under a share-lending arrangement). The industry is also concerned about the ability of participants to determine if shares are original or replacement as the draft legalisation is silent on returning original shares to a share supplier.

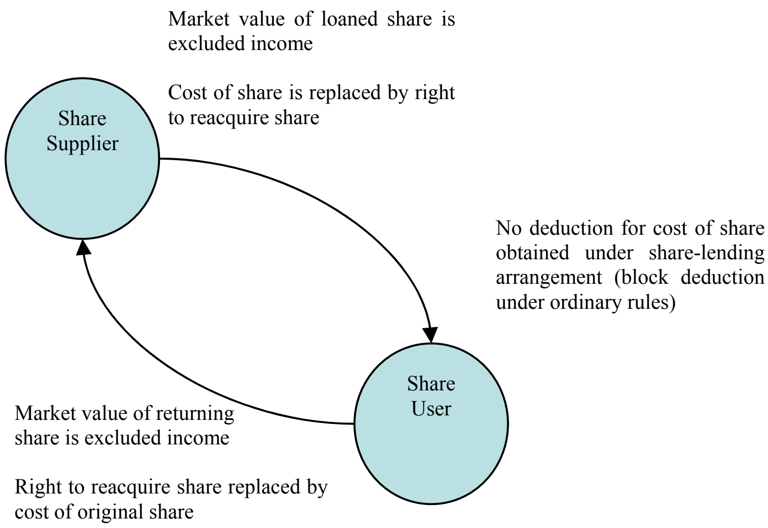
In response to submissions, officials have reviewed the relationship between the proposed rules and existing revenue account property provisions. To tax these transactions like loans, a number of existing provisions need to be switched off.

The following diagrams summarise the proposed interrelationship between the share-lending rules and existing revenue account property provisions. This is a simpler approach to that taken in the draft bill.

Proposed structure: where borrowed shares are on-sold to a third party



Proposed structure: where borrowed shares are returned to supplier



Following this proposed structure, officials recommend deleting section CD 44. Instead, a deduction should be denied for shares borrowed under a share-lending arrangement. This will be matched by treating the value of lent and returned shares as excluded income.

These changes will resolve problems with the derivation of deemed income (timing and calculation) and remove the need for participants to track whether they are dealing with original or replacement shares.

Officials also recommend deleting section DB 12C, as deductions for the cost of borrowed shares should already be available under the revenue account property rules. This will resolve problems raised about the links between sections CD 44 and DB 12C.

Market value

The Securities Industry Association and New Zealand Institute of Chartered Accountants have submitted that it would be helpful to clarify what is meant by "market value" (whether it is the weighted average price traded on the market, closing market price, the price agreed by the parties or some other price).

The Securities Industry Association is concerned that the current wording does not take into account the normal commercial practice of adopting a valuation date three days before the actual transfer of the shares. Specifically, they have suggested that the rules be amended to use the price agreed by the parties as the price for tax purposes, provided this has relevance to market value at the time.

The proposed changes to the interrelationship between the proposed share-lending rules and the revenue account property provisions will make this a much less significant issue. The revenue account property provisions use the terms "amount derived" and "cost". Parties to a share-lending arrangement should be able to apply normal commercial practice in determining the "market value", "amount derived" and "cost" of shares under a lending arrangement. This will be highlighted in any Inland Revenue *Tax Information Bulletin* article on these rules.

Recommendations

Officials recommend that:

- The submission on removing the revenue account criteria be accepted as these are already established under existing rules.
- The submissions on the reference to "consideration" and ignoring the disposal and acquisition for tax purposes should be declined. Instead, the collateral received in respect of the shares should be excluded income. This would eliminate the need to have a specific carve-out for share-lending fees and replacement payments.
- The submission that the proposed share-lending rules should clarify whether a taxpayer who undertakes multiple lending arrangements will be in the business of trading in shares should be declined. Instead, Inland Revenue will provide guidance in a *Tax Information Bulletin* article which will follow enactment of any amending legislation.

- The submissions on clarifying what happens when a share user returns shares, and participants being required to track shares, should be accepted. These submissions should be addressed by amending the interrelationship between the proposed rules and the revenue account property rules. Section CD 44 should be deleted. Instead, a deduction should be denied for the cost of shares borrowed under a share-lending arrangement. This will be matched by treating the value of lent and returned shares as excluded income. Section DB 12C should also be deleted, as deductions for the cost of borrowed shares are already available under the revenue account property rules.
- The submission on amending the proposed rules to clarify the meaning of the term "market value" be declined. However, any Inland Revenue *Tax Information Bulletin* on the proposed rules will highlight that parties to a share-lending arrangement should be able to apply normal commercial practice in determining the "market value", "amount derived" and "cost" of shares under a lending arrangement.

Submissions
(40 – Securities Industry Association, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

Submissions have been made about the interrelationship between the proposed share-lending rules and the existing timing and deduction rules for excepted financial arrangements, in particular that:

- The trading stock amendments should apply only to property held on revenue account.
- The concept of a "right to acquire a share" should be dispensed with.
- The reference to the end of a share-lending arrangement should be removed from subsection DB 12B.
- The timing and value of deductions should be clarified and aligned with the share-lending income sections.

Comment

Trading stock amendments and the right to acquire a share

The Securities Industry Association is concerned about the interrelationship between the proposed share-lending rules and the trading stock rules. They have submitted that the amendments to sections CH 1 and EA 1 should apply only to property held on revenue account.

Section EA 1 applies to a person who holds excepted financial arrangements that are revenue account property under subpart ED. The year-end value of such property is included as income under section CH 1. Similarly, the opening value of such property is allowed as a deduction under section DB 40. The values for these adjustments are determined under section ED 1.

The amendments to sections EA 1 and CH 1 are intended to ensure that there will be no tax implications for the share supplier in lending shares under a share-lending arrangement.

The New Zealand Law Society considers that the concept of a "right to acquire a share" (which is included in sections EA 1 and CH 1 as a result of these amendments) is artificial and unnecessarily complex. The Society considers that it should be dispensed with by ignoring the disposal of the share for tax purposes. As discussed previously, officials consider that, as far as possible, the proposed share-lending legislation should follow the actual transaction. As such, it is not appropriate to simply "ignore" the disposal of the shares.

As the lending of shares is a disposal, it will affect the opening and closing value of excepted financial arrangements. To counter this, the amendments replace the value of the original shares with the right to obtain the original or replacement share. However, a taxpayer is only required to recognise this right if the original shares were revenue account property under subpart ED. As such, the amendments already apply only to revenue account property.

The "right to acquire a share" will be extinguished when shares are returned to the share supplier or the share-lending arrangement comes to an end. The share supplier will normally replace the value of this right with the value of the replacement shares. The rules should ensure that this equates to the cost of the original shares.

Section DB 12B

The Securities Industry Association has submitted that the reference to the end of a share-lending arrangement should be removed from section DB 12B.

Officials have reviewed the interrelationship between the proposed share-lending rules and the revenue account property provisions, and consider that section DB 12B is unnecessary as deductions are already available under existing provisions.

Timing and value of deductions

A number of submitters have raised the need to clarify and align the timing and value of deductions under the share-lending rules. In particular, the value of the deduction under section DB 12C should be the same as the income under section CD 44(2) (market value), that the timing of the deduction should be clarified, and that the wording of the various share-lending sections should be aligned.

Officials have reviewed the interrelationship between the proposed share-lending rules and the revenue account property provisions, and consider that section DB 12C should be deleted. As the lending and returning of borrowed shares will be treated as excluded income, there should be no tax deduction for obtaining shares under a share-lending arrangement. There will be no deemed income arising under section CD 44 on returning borrowed shares. A deduction for purchasing replacement shares should be available under the normal revenue account property provisions.

In adopting this revised treatment of share-lending arrangements, officials agree that the wording of the various share-lending sections should be aligned.

Recommendations

Officials recommend that:

- The submission on the trading stock amendments and revenue account property be accepted. No changes are required to the proposed share-lending rules to achieve this result.

- The submission on replacing the concept of a “right to acquire a share” by ignoring the disposal of the share for tax purposes should be declined.
- The submissions recommending clarification and alignment of the share-lending deduction sections be accepted in general. As a result of reviewing the interrelationship between the proposed share-lending rules and the revenue account property provisions, officials consider that sections DB 12B and DB 12C should be deleted. In adopting this revised treatment of share-lending arrangements, officials agree that the wording of the various share-lending sections should be aligned.

REPLACEMENT PAYMENTS

Submissions
(40 – Securities Industry Association, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

A number of amendments should be made to the tax treatment of replacement payments, including that:

- Only dividend substitutes should be captured in the definition of a replacement payment.
- Unnecessary duplication around the definition of "replacement payment" should be removed from the proposed rules.
- Any amounts netted against replacement payments should not be subject to the same tax treatment.
- The requirement to transfer rights and options to the share supplier should be removed.
- Share users should not be required to determine the tax status of an unrelated third party in relation to deductions for replacement payments.
- The rules should address the treatment of taxable and non-taxable bonus issues.
- Section CX 44C needs to be re-examined.

Comment

Definition of replacement payment

A replacement payment is defined in section OB 1 as "a transfer of value, including any imputation credits, made under the returning securities transfer that satisfies paragraph (d)(ii) of the definition of returning securities transfer''.

Paragraph (d)(ii) of the definition of returning securities transfer requires a share user to make to the share supplier, transfers of value "intended to be economically equivalent in value to rewards of ownership to which the holder of the original share would be entitled during the term of the arrangement''.

The Securities Industry Association and the New Zealand Institute of Chartered Accountants are concerned that the current definition of replacement payment may capture payments which are not dividend substitutes. For example, this may include payments for movements in the share price and cash compensation for rights or options received on the underlying shares. They have submitted that the proposed rules should be amended to exclude amounts which are not dividend substitutes from the definition of replacement payments.

Officials agree that the definition of "replacement payment" is intended to capture dividend substitutes. As such, the definition should be amended to ensure that other payments made under a returning securities transfer are not treated as replacement payments – for example, cash compensation for rights and options and payments for movements in share price.

In amending the definition of "replacement payment", the duplicate references to replacement payments being "economically equivalent to a reward of ownership", in sections CD 43, CX 44C, DB 12D(2)(b) and DB 12D(2)(a)(ii) should also be removed as it is unnecessary and potentially confusing.

Net payments

Under some share-lending arrangements, the parties will net dividend replacement payments on the original shares against collateral-related payments. It is important that any amounts netted against replacement payments are not subject to the same tax treatment.

Officials agree that the rules should specify what happens when amounts are netted off under a share-lending arrangement. This could be achieved by amending the definition of "pay" to make it clear that an amount will still qualify even when it has been bundled with, or netted off, against other amounts.

Transferring rights and options

The definition of a "share-lending arrangement" requires a share user to transfer "to the share supplier the rights and options that the holder of the original share would be entitled to receive during the term of the financial arrangement, or rights and options that are equivalent to those rights and options".

The Securities Industry Association has submitted that some share-lending arrangements require the share user to make cash payments to the share supplier for rights and options issued on the underlying shares. As such, they have submitted that the requirement to transfer rights and options to the share supplier should be removed so that these arrangements will qualify for the proposed share-lending rules.

Officials agree with this submission. Rights and options are not taxed as a dividend. Therefore, it is not necessary to include the requirement to transfer rights and options in the definition of a share-lending arrangement.

Non-taxable distributions and bonus issues

Under section DB 12D, a share user must know the tax status of the share supplier in order to determine the deductibility of a replacement payment. The Securities Industry Association has submitted that share users should not be required to determine the income tax status of an unrelated third party in order to determine the tax deductibility of their own replacement payment expenditure.

The Securities Industry Association is also concerned that the denial of a deduction for the whole of the replacement payment seems an overly harsh punishment for what in principle is an attempt to collect NRWT on these payments.

There are two parts to section DB 12D. Subsection DB 12D(2)(a) is part of the anti-avoidance rules introduced to protect the tax base by preventing taxpayers from using securities lending transactions to trade imputation credits and circumvent the NRWT rules. As discussed later on pages 148 to 149 of this report, officials are recommending that the NRWT anti-avoidance rule is removed until the NRWT treaty rates review has been completed.

Section DB 12D(2)(a) relates to the tax treatment of bonus issues. A taxable bonus issue is any bonus issue that the company elects to treat as a dividend or a bonus issue in lieu. A non-taxable bonus issue (which is not a dividend for income tax purposes) occurs when no election is made (other than a bonus issue in lieu).

As discussed above, replacement payments should only include those amounts which are dividend substitutes (such as taxable bonus issues). Officials therefore recommend deleting sections CX 44C, DB 12D and the words from "if the replacement payment … derived by the person" in section CD 43.

Recommendations

Officials recommend that:

- The submissions on limiting replacement payments to dividend substitutes and removing unnecessary duplication from the definition be accepted.
- The submission on ensuring that any amounts netted against replacement payments should not be subject to the same tax treatment be accepted.
- The submission on removing the requirement to transfer rights and options to the share supplier be accepted.
- The submissions on determining the tax status of an unrelated third party in relation to deductions for replacement payments, bonus issues and re-examining CX 44C be accepted. Replacement payments should only include those amounts which are dividend substitutes (such as taxable bonus issues). Sections CX 44C, DB 12D and the words from "if the replacement payment … derived by the person" in section CD 43 should be deleted.

Officials also consider that the following amendments would help clarify what is meant by the term "replacement payment", and provide increased certainty for taxpayers:

- Transferring the requirements for a replacement payment to the definition of a replacement payment.
- Replacing the term "transfer of value" with the word "amount".
- Adopting concepts similar to those in the Australian definition of "replacement payment"[13] to ensure that all forms of dividend substitute are captured.

[13] The Australian legislation includes a detailed definition of what is meant by "related payment":
- causing a payment(s) to be made to, or in accordance with the directions of, the other person(s); or
- causing an amount(s) to be credited to, or applied for the benefit of, the other person(s); or
- causing services to be provided to, or in accordance with the directions of, the other person(s); or
- causing property to be transferred to, or in accordance with the directions of, the other person(s); or
- allowing any property or money to be used by the other person(s) or by someone nominated by the other person(s); or
- causing an amount(s) to be set off against, or to be otherwise applied in reduction of, a debt(s) owed by the person(s) to the taxpayer or associate; or
- agreeing to treat an amount(s) owed to the other person(s) by the taxpayer or associate as having been increased.

Submission
(40 – Securities Industry Association, 48 – New Zealand Institute of Chartered Accountants)

The following amendments should be made relating to tax credits attached to replacement payments:

- Replacement payments should be treated as surrogates for dividends, with the resulting imputation and withholding tax implications.
- The resident withholding tax (RWT) and imputation rules should not apply to replacement payments.
- Participants should be able to use exemption certificates for RWT on replacement payments.
- Share users should be able to pass RWT deductions on borrowed shares through to share suppliers.
- The reference to RWT in the definition of a share-lending arrangement should be clarified.
- The Australian certification approach should be adopted for dealing with tax credits on borrowed shares.

Comment

Resident withholding tax

Under the proposed rules, transactions will be subject to RWT at a rate of 33% if the share user has not received a fully imputed dividend on the borrowed shares. The RWT will be converted into imputation credits which are attached to the replacement payment.

The Securities Industry Association and New Zealand Institute of Chartered Accountants have submitted that replacement payments should be treated as surrogates for dividends, with the resulting imputation and withholding tax implications. They do not agree with the imposition of the RWT rules proposed in the bill.

RWT on replacement payments is required to match the tax deduction available to the share user when they make a replacement payment. Officials agree with the general proposition that the share-lending rules should leave share suppliers in no worse position than if they had maintained their investment in the original shares. However, in applying this principle, it is important to ensure that the New Zealand tax base is protected.

For example, if replacement payments paid to non-residents were treated as non-resident withholding income they would be taxed at 30% (or 15% if covered by a double tax treaty). However, the share user would be entitled to a tax deduction for making the replacement payment at 33% (assuming they are a company). The differential in these two rates would be a cost to the New Zealand tax base. Therefore, officials do not support exempting replacement payments from RWT.

Exemption certificates and passing on RWT credits

The Securities Industry Association has submitted that the RWT rules as they apply to replacement payments should be amended to allow for RWT exemption certificates and the passing on of RWT credits. They are concerned that there will be a requirement for share users to fund the RWT on replacement payments until they can either use the RWT credits attached to dividends received or claim a refund of surplus RWT credits.

As discussed above, the purpose of the share-lending RWT is to counter the tax deduction available to the share user in making the replacement payment. While there will be a timing difference between the payment of RWT under section NF 2(1)(g) and the ability to claim a tax deduction for the replacement payment, this can be reduced by factoring the tax deduction into provisional tax payments.

Officials therefore decline the submissions that RWT exemption certificates should apply for share-lending RWT and that share users should be able to pass through RWT credits.

RWT under section NF 2(1)(g)

To qualify as a share-lending arrangement, it is necessary that "the amount of resident withholding tax given by section NF 2(1)(g)" is paid by the share user. The Securities Industry Association has submitted that the proposed rules should be amended to clarify that it is RWT payable under the wider regime that needs to be paid and not the amount specifically calculated under section NF 2(1)(g).

RWT is only required to be paid under section NF 2(1)(g) if the share user has not received and passed on fully imputed dividends. RWT is required to be paid so that the share user does not benefit from obtaining a tax deduction for the replacement payment. The RWT payable is specific to share-lending transactions and is separate from any other RWT obligations in respect of the borrowed shares.

Tax credit transfers

The Securities Industry Association is concerned about the compliance costs and risks for share users related to receiving, tracking, and paying tax credits. They consider that replacement payments should be exempt from the imputation rules and that a certification approach should be adopted to transfer tax credits.

Officials disagree with exempting replacement payments from the imputation rules. Requiring a share user to attach imputation credits to a replacement payment is intended to put the share supplier in the same position as if they had retained the shares. A share supplier should not be able to exchange imputation credits for a cash replacement payment.

Officials would, however, support the introduction of a voluntary tax credit transfer system as part of the proposed share-lending rules. This would be based on the Australian system whereby relevant tax credits would continue to be derived by the share supplier if the share user and share supplier notified Inland Revenue of the share-lending arrangement.

The system would operate only between share users and suppliers and should not impose any obligations on share issuers since they are unlikely to have knowledge of the share-lending arrangement. This differs from the system described in the Securities Industry Association submission.

Recommendations

Officials recommend that:

- The submissions on treating replacement payments as surrogates for dividends, with the resulting imputation and withholding tax implications, and removing the RWT rules proposed in the bill be declined.
- The submissions on amending the proposed rules to allow for RWT exemption certificates and passing on RWT credits should be declined.
- The submission that the proposed rules should be amended to clarify that it is RWT payable under the wider regime that needs to be paid be declined.
- The submission on exempting replacement payments from the imputation rules be declined.
- The submission on introducing a tax credit transfer system be accepted. The system should be voluntary and should not impose any obligations on share issuers.

TREATMENT OF NON-FULLY IMPUTED DIVIDENDS

Submission
(28W – New Zealand Exchange Limited, 40 – Securities Industry Association)

A share user should not have to withhold RWT of 33% from a replacement payment made to the share supplier for unimputed or partially imputed dividends paid on the borrowed securities.

Comment

If a distribution is paid on a borrowed share during the term of a share-lending arrangement, the share supplier must receive a "replacement payment" from the share user. This is a normal commercial requirement for these transactions. The purpose of the replacement payment is to place the share supplier in the same position (as far as possible) as if they had received the actual distribution.

When an unimputed or partially imputed New Zealand dividend is paid to a non-resident investor, the dividend will have NRWT of 15% (or 30% if there is no applicable double tax agreement) withheld from the payment. For example, on a $100 unimputed dividend, the non-resident investor will receive $85 in the hand.

Under the proposed rules, when the non-resident lends those shares to a New Zealand resident share user, the dividend will have RWT of 33% withheld from that payment. When the share user makes a replacement payment to the non-resident lender, they will be required to fully impute this payment and pay RWT of 33% to fund these credits.

The New Zealand Exchange Limited, while noting that the majority of New Zealand dividends are fully imputed, is concerned that this could mean that a non-resident share supplier may not be in the same position as if they had held the original shares throughout the period of the share-lending arrangement.

The share-lending rules have been designed to ensure that the benefit of a dividend is received by the economic owner of the borrowed shares. The rules therefore require a share user to pay RWT to counter the tax deduction available for making a replacement payment. However, the proposed rules do not specify the amount of the replacement payment to be made, only that it is "intended to be economically equivalent in value to rewards of ownership to which the holder of the original share would be entitled". Therefore, a share user is able to adjust the cash amount of the replacement payment to ensure this is equivalent to what the share supplier would have received as the recipient of the actual dividend. While increasing the amount of the cash replacement payment means more RWT is paid, the tax deduction available also increases by an equal amount.[14]

[14] For example, for a $100 unimputed dividend, the share user could make a cash replacement payment of $85. Under the proposed share-lending rules, the share user will be required to attach imputation credits of $42, generated by paying RWT of $42. However, they can obtain a tax deduction on the entire value of the replacement payment of $127 (worth $42).

This means that the non-resident investor will be in the same tax position as if they had received the actual distribution, assuming that they are unable to use the imputation credits. The requirement to fully impute the dividend (and pay the associated RWT) will be offset by a tax deduction for an equivalent amount. While there will be a timing difference between the payment of RWT and the ability to claim a tax deduction for the replacement payment, this can be reduced by factoring the tax deduction into provisional tax payments.

Recommendation

That the submission be declined.

Submissions
(28W – New Zealand Exchange Limited, 31W – Goldman Sachs JBWere (NZ) Limited, 40 – Securities Industry Association, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

Amendments should be made so that non-resident share users can participate under the proposed rules, including:

- that the requirement for share users to operate an ICA be removed; and
- that a mechanism is introduced to allow non-resident share users to maintain an ICA for the purposes of share-lending arrangements.

Comment

As currently drafted, the share-lending rules allow only New Zealand-resident share users or borrowers to undertake share-lending arrangements. This is because a share user must operate an ICA. Non-resident companies are specifically prohibited from establishing and maintaining an ICA. This effectively means that only New Zealand-resident companies can be share users for the share-lending rules.

Officials consider that the requirement to maintain an ICA is an important part of the proposed rules. To place the share supplier in the same tax position (as far as possible) as if they had received the actual distribution, a share user must be able to pass on imputation credits when these have been attached to the underlying dividend. This is only possible if the share user can maintain an ICA.

If there was no requirement to ensure that a replacement payment mirrored the form of the underlying dividend, shareholders (non-residents or tax exempts) who were unable to use imputation credits would enter into a share-lending arrangement in order to "sell" these imputation credits. This would be contrary to the policy intent of the imputation rules.

One possibility would be to allow non-residents who wanted to borrow shares from a New Zealand share supplier to maintain an ICA on a limited basis. However, this raises concerns about the ability of Inland Revenue to monitor the use of this account. Officials have been careful in designing the share-lending rules to counter possible avoidance risks and have agreed to closely monitor the implementation of the amendments for any unintended outcomes. The need to monitor non-resident borrowers would make this difficult.

A second solution proposed by the New Zealand Exchange Limited and the New Zealand Institute of Chartered Accountants is for a separate "securities lending account" to be created, either just for non-residents or for all share-lending arrangements. This account could operate identically to an ICA, but could be operated by a non-resident to allow them to attach credits to replacement payments. Officials did consider the use of a separate memorandum account. However, this had significant administrative and compliance costs.

As a compromise, officials recommend the requirement to maintain an ICA be limited to those transactions which cross a dividend distribution date. Participants will also be able to make use of the credit transfer mechanism discussed earlier in this report.

Recommendation

That the submissions on removing the requirement to operate an ICA or allowing non-resident share users to maintain an ICA be declined. Instead, officials recommend that the requirement to maintain an ICA be limited to those transactions which cross a dividend date.

Future consideration could be given to further expanding the rules to non-resident companies if the implementation of the current proposals is successful and does not give rise to any unintended outcomes.

NON-RESIDENT SHARE SUPPLIERS

Submission
(31W – Goldman Sachs JBWere (NZ) Limited, 40 – Securities Industry Association, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

The proposed rules should be amended to allow for the payment of a supplementary dividend (or equivalent) so that that non-resident share suppliers can participate.

Comment

A general aim of the proposed share-lending rules is to keep share lenders in the same tax position they would have been in if they had not disposed of the underlying shares.

Normally a non-resident shareholder would be subject to NRWT on any New Zealand dividend but could receive a supplementary dividend of the same value. Under the proposed share-lending rules, a non-resident share supplier is instead not subject to NRWT.

Submitters have requested that the proposed share-lending rules be amended to allow for the payment of a supplementary dividend.

Officials agree that, prima facie, non-resident share suppliers should be entitled to receive the equivalent of a supplementary dividend if this would have been available on the borrowed securities. However, the availability of a supplementary dividend is tied to a liability for NRWT. New Zealand is currently reviewing its position on NRWT treaty rates. Given the complexity of building supplementary dividends into the proposed rules, and the possibility that New Zealand's NRWT treaty rates could change, officials recommend that this submission be declined at this stage.

Recommendation

That the submission on allowing for the payment of supplementary dividends be declined.

Submission
(40 – Securities Industry Association, 47 – New Zealand Law Society)

The proposed rules should be amended to eliminate double taxation as a result of the dividend withholding payment (DWP) rules also applying to a share-lending arrangement.

Comment

The Securities Industry Association and the New Zealand Law Society are concerned about the relationship between the DWP rules and the proposed share-lending rules. Under the proposed rules, if a share supplier lends foreign shares to a New Zealand resident, dividends received would be subject to DWP. The replacement payment made to the share supplier would also be subject to RWT.

Officials have modelled a variety of scenarios under the proposed share-lending rules. In the majority of situations these put the lender in the same tax position as if they had continued to hold the shares as well as ensuring that the same amount of New Zealand tax is collected pre and post any share-lending arrangement. However, officials agree that this is not achieved for all scenarios.

The specific issue could be reviewed if the industry and officials come up with a workable alternative in the future.

Recommendation

That the submission be declined but that the legislation should provide for the transfer of DWP credits.

Submissions

(31W – Goldman Sachs JBWere (NZ) Limited, 40 – Securities Industry Association, 48 – New Zealand Institute of Chartered Accountants)

Submitters have suggested changes to the definition of replacement shares, including that:

- the requirement to return identical shares should be waived in certain limited circumstances;
- the Commissioner of Inland Revenue should be given the discretion to approve transactions as still qualifying under the share-lending rules;
- there should be greater certainty to cover situations when a share-lending arrangement cannot be completed.

Comment

The definition of a "share-lending arrangement" requires identical shares to be returned to the share supplier upon termination of the transaction. In general, the industry agrees with this requirement. However, submitters have suggested that share-lending arrangements affected by certain events such as the receivership or insolvency of the share user, receivership of the share issuer, the share issuer being subject to corporate action or shares being no longer listed or traded, should continue to qualify under the proposed rules (and there should be no disposal for tax purposes).

The intention of the proposed share-lending rules is to keep the share supplier in the same tax position as if they had retained the shares. For corporate events such as the amalgamation, liquidation or takeover of the issuer, which would have affected the share supplier if they had continued to hold the shares, the same tax treatment should apply. Therefore, a disposal should arise (at the time that the event occurs) where these shares are part of a share-lending arrangement.

Recommendations

That the submissions on the definition of a replacement share be declined. Officials consider that further consultation is required on the treatment of share-lending transactions where it is not possible, due to default of the share user or a corporate action, to return replacement shares.

12-MONTH RESTRICTION

Submission
(31W – Goldman Sachs JBWere (NZ) Limited, 40 – Securities Industry Association)

The 12-month time limit for returning shares should be removed.

Comment

A share-lending arrangement is defined as a returning securities transfer that meets a number of further requirements, including that the term of the transfer is 12 calendar months or less.

The Securities Industry Association and Goldman Sachs JBWere (NZ) Limited have submitted that the 12-month restriction is arbitrary, will prevent participants from adopting longer term hedging or trading strategies, and could lead to reduced liquidity. They consider that the 12-month restriction should be removed.

The 12-month restriction is consistent with the rules adopted in Australia. As the rule allows a special treatment outside the ordinary tax rules, it is important to clearly identify those transactions which qualify. The majority of share-lending transactions have terms of less than one year. Officials therefore consider that this is an identifying characteristic of these transactions and that the limitation should be retained. For those taxpayers wishing to adopt longer term strategies, the rules permit the roll-over of qualifying transactions.

Recommendation

That the submission be declined.

COLLATERAL

Submission

(31W – Goldman Sachs JBWere (NZ) Limited, 40 – Securities Industry Association)

The tax treatment of collateral provided as part of a share-lending arrangement should be clarified.

Comment

It is normal commercial practice for share-lending arrangements to require the share user to post collateral with the share supplier. This collateral may take the form of cash or other securities.

The Securities Industry Association and Goldman Sachs JBWere (NZ) Limited have submitted that the tax treatment of collateral provided as part of a share-lending arrangement should be clarified. In particular, the transfer of, or changes in, collateral provided by the share user to the share supplier should not be a taxable event.

Officials agree that the provision (and returning) of collateral as part of a share-lending arrangement should not be a taxable event. Similarly, changes in the level or make-up of that collateral should not be subject to tax.

Recommendation

That the recommendation be accepted.

Submissions
(47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

Submissions have been made about the proposed share-lending anti-avoidance rules, in particular that:

- The securities lending and anti-avoidance parts of the proposals should be separately considered.
- The anti-avoidance rules should be referred for wider consultation.
- Only one anti-avoidance measure should apply to any returning securities transfer.

Comment

Introduction of the proposed share-lending rules

The New Zealand Institute of Chartered Accountants has submitted that the securities lending and anti-avoidance proposals should be separately considered and that the anti-avoidance rules should be referred for wider consultation.

Officials disagree with this submission (subject to the subsequent comments on the NRWT anti-avoidance rule). Any change to the tax treatment of share-lending must simultaneously address the risk to the tax base of adopting an economic substance over legal form approach. The strengthening of associated anti-avoidance measures as part of introducing special tax rules for share-lending is consistent with the approach taken in other international jurisdictions, such as Australia and the United Kingdom. The anti-avoidance rules are also needed to counter existing transactions which are using the lack of rules to trade imputation credits and circumvent the NRWT rules. It is estimated that tax lost to date from such transactions is in excess of $100 million.

The proposed anti-avoidance rules were included in the November 2003 government discussion document on securities lending and have been subject to the full generic tax policy process.

Single anti-avoidance measure

The New Zealand Law Society has submitted that only one anti-avoidance measure should apply to any returning securities transfer.

The proposed anti-avoidance rules are primarily aimed at the trading of imputation credits. However, the draft legislation also contains measures to prevent taxpayers using share-lending to circumvent the NRWT rules.

Officials agree, that based on the draft legislation, it is possible that both the imputation and NRWT anti-avoidance rules could apply to a single transaction (cancelling the imputation credits and denying a deduction for the replacement payment). This would put the taxpayer in a negative rather than neutral position which was not the intention of the proposed rules.

Given these technical difficulties, officials recommend the removal of the NRWT anti-avoidance rule until the government's NRWT review has been completed.

NRWT avoidance is not seen as a significant risk for share-lending transactions. The estimated $100 million of tax lost to date from these transactions relates solely to the trading of imputation credits.

Recommendation

Officials recommend that:

- The submission on separately considering the securities lending and anti-avoidance proposals be declined.
- The submission that only one anti-avoidance measure should apply to any returning securities transfer be accepted. The NRWT anti-avoidance rule should be removed at least until the government's NRWT review has been completed.

DRAFTING

Submission
(40 – Securities Industry Association, 48 – New Zealand Institute of Chartered Accountants)

Several drafting references should be corrected or clarified, including:

- That the reference to share user at the end of section CD 44(1)(b) be changed to share supplier.
- That subparagraph (1)(b)(ii) be deleted from section DB 12B.

Comment

Section CD 44

Officials agree with the Securities Industry Association submission that the reference to "share user" at the end of section CD 44(1)(b) is incorrect. However, if officials' recommendations with respect to the relationship between the proposed share-lending rules and revenue account property provisions are accepted, this section will be removed.

DB 12B(1)(b)(ii)

The Securities Industry Association has submitted that the reference to an original share or replacement share acquired "when the share-lending arrangement ends" should be deleted as it is inconsistent with the wording of other sections (sections CX 44B(1)(c) and DB 12C(1)(b)) and could cause confusion.

Officials agree. However, if officials' recommendations with respect to the relationship between the proposed share-lending rules and revenue account property provisions are accepted, this provision will be removed.

Recommendation

Officials agree with both submissions. However, if officials' recommendations with respect to the relationship between the proposed share-lending rules and revenue account property provisions are accepted, these provisions will be removed.

OFFICIALS' RECOMMENDATIONS

Officials also recommend making the following amendments to clarify the proposed share-lending rules and ensure they operate as intended:

- Amending the references to "a party" in the proposed share-lending rules to also cover associated persons of that party. Officials are concerned taxpayers may be able to structure their affairs around the proposed rules as currently drafted by using associated persons.
- Amending the definition of a "returning securities transfer" to deal with arrangements utilising options. The current wording implies upfront agreement regarding the future transfer of the shares, which may not be satisfied when the shares are subject to an option.
- Clarifying the definition of a "returning securities transfer" by referring to key terms directly rather than putting these in brackets. For example, share supplier, share user, original share, replacement share and replacement payment.
- Deleting the reference to "substitute" in the definition of original share. The current wording could imply that a share in some other company could be returned as a substitute.
- Removing the words "receives" and "acquires" at the beginning of paragraphs (a) and (b) (respectively) in the definition of replacement share as they are redundant.
- Amending the definition of "replacement share" to make it clear that a share user can have a replacement share.
- Including the requirement for the replacement share to confer the same rights and impose the same obligations on the holder in the definition of a replacement share (currently in the definition of a returning securities transfer).
- Deleting clause 64 as section EW 32 is no longer relevant to the proposed share-lending rules.
- Including a specific anti-avoidance provision in the share-lending rules to target arrangements structured to defeat the application of the rules.
- Replacing the term "replacement share" with "identical share".

Allocation of research and development tax deductions

OVERVIEW

The amendments in the bill will allow taxpayers to allocate certain research and development (R&D) tax deductions to income years after the year in which the related expenditure (including a depreciation loss) is incurred. This new tax treatment will be optional. However, those who choose this approach must allocate R&D deductions against income resulting from R&D expenditure.

The result is a better matching of income and expenditure for taxpayers who opt in. In particular, the tax benefit of a taxpayer company's R&D expenditure will not be lost as a result of a significant change in their shareholding.

Technology companies, in particular, often have a long lead-in period in which they incur major expenditure before realising income from it. Under current law they can lose R&D tax deductions if they bring in new investors after their initial development stage. The changes in the bill will better suit the growth cycle of these companies. Most of the pre-commercial production expenditure of start-up technology companies will qualify for the new treatment.

The amendments will apply from the 2005–06 income year.

Four submissions were received on these amendments. All the submissions supported the general principle of the amendments, which is to achieve a better matching of the timing of tax deductions for R&D expenditure with the timing of income resulting from that expenditure. The submissions also proposed a number of technical amendments.

Submission
(46 – PricewaterhouseCoopers)

A person should be entitled to also allocate to a later income year research and development (R&D) expenditure that is deductible under the general deductibility provisions in subpart DA. In some circumstances, a person will be entitled to a deduction for R&D expenditure on the basis that R&D is an ordinary part of the person's business and hence is not of a capital nature. In these circumstances, the taxpayer does not need to rely on section DB 26 to obtain a deduction for the R&D expenditure as the capital prohibition in section DA 2(1) does not apply. The new rules should apply to all deductible expenditure on R&D regardless of the provision under which the primary entitlement to the deduction arises.

Comment

Officials consider the proposed amendment to be unnecessary because all R&D expenditure on revenue account (and therefore not of a capital nature) would still come within the main R&D deduction provision in section DB 26 of the Income Tax Act 2004. Any deduction allowed under section DB 26 will qualify under the new rules and can be allocated to future income years. Section DB 26 allows taxpayers a deduction for R&D expenditure if the expenditure does not satisfy all the asset recognition criteria contained in Financial Reporting Standard 13 (FRS-13).

The main group of persons that section DB 26 applies to are those who recognise R&D expenditure as an expense for financial reporting purposes under paragraph 5.1 or 5.2 of FRS-13. Entities which qualify for exemption in accordance with the framework for differential reporting are not required to comply with paragraph 5 of FRS-13 – for example, small companies. However, it is still possible for any entity which qualifies for differential reporting to have their R&D expenditure covered by section DB 26. All they need to do is to recognise the expenditure as an expense for financial reporting purposes under paragraphs 5.1 or 5.2 of FRS-13. In other words, although such entities are not required to apply FRS-13 they are not prevented from doing so and therefore coming within the ambit of section DB 26. Section DB 26 also automatically applies to persons who incur expenditure of $10,000 or less on R&D in a tax year. This is a minimum threshold provision for small taxpayers who would often qualify for differential reporting.

Recommendation

That the submission be declined.

Issue: Depreciation of assets used for market development

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The allocation rules should apply to depreciation of assets used for market development as well as to assets used for R&D. It is likely that some assets used in the market development of a product will not be used in carrying out the R&D for the product. The policy intent is that depreciation deductions for assets used in all activities covered by the proposed allocation rules should be covered by the new rules.

Comment

Officials agree that depreciation deductions for assets used for R&D and for market development of products resulting from R&D should both be covered by the new allocation rules.

Recommendation

That the submission be accepted.

Issue: Loss on sale of an asset

Submission
(46 – PricewaterhouseCoopers)

It should be clarified that the deduction for any loss suffered on the sale or disposal of a depreciable asset should be able to be allocated to a later income year in the same way that the depreciation on that asset can be allocated to a later year.

Comment

Officials consider that the proposed amendment is unnecessary because it is already clear that a loss on disposal of a depreciable asset comes within the definition of "depreciation loss". In particular, the legislation provides that:

- A "depreciation loss" is defined in section OB 1 of the Income Tax Act 2004 as a loss that a person has in the circumstances set out in section EE 1(2).
- Section EE 1(2) provides, inter alia, that the amount of depreciation loss is calculated under sections EE 9 to EE 11.

- Section EE 11(4) provides that a person has an amount of depreciation loss calculated under section EE 41(2) for a disposal or event to which that provision applies.
- Section EE 41(2) allows an amount of depreciation loss to the extent that the consideration received from the disposal is less than the item's tax book value.

Officials therefore consider that the legislation is sufficiently clear on this point.

Recommendation

That the submission be declined.

MARKET DEVELOPMENT EXPENDITURE REQUIREMENTS

Submission
(46 – PricewaterhouseCoopers, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

The requirement in proposed section EJ 20 that market expenditure must be incurred before the person first derives assessable income from the use of the R&D product to qualify for the new treatment should be omitted. The reason for the inclusion of these criteria is to ensure that regular advertising expenditure cannot qualify for the new treatment. However, this requirement is not necessary to achieve this objective and will exclude some expenditure that should be covered by the rules. This is because some income may be earned during the development phase – for example, from the sale of prototypes. The best indication that market development is completed is the start of commercial production, which is another requirement in section EJ 20. *(PricewaterhouseCoopers)*

The requirement in proposed section EJ 20 that the expenditure be incurred before commercial production of the R&D product starts should be omitted. A deduction should not depend on whether commercial production development has begun. *(New Zealand Institute of Chartered Accountants)*

Proposed section EJ 20 should be amended by deleting the reference to "market development". It is possible that the words "market development" will create difficulties in interpretation. There appears to be a significant reason for the rule relating to the allocation of expenditure by a start-up entity to be restricted to market development expenditure. New section EJ 20 should apply to all expenditure incurred by a company in relation to a product that has resulted from R&D expenditure in the period until commercial production is commenced. The proposed section EJ 21(2) could also result in interpretation difficulties if proposed section EJ 20 applies only to market development expenditure. It will be difficult to prove that assessable income "would not have been derived but for" the market development expenditure. The linkage between market development expenditure and assessable income may not be a clear one. *(New Zealand Law Society)*

Alternative submission
(46 – PricewaterhouseCoopers)

The words "the use of" in proposed section EJ 20(1)(b) should be deleted since income may be derived from the sale of the product rather than its use.

Comment

Officials agree that proposed section EJ 20(1)(b), requiring market development expenditure to be incurred before the person first derives assessable income, may exclude some market development expenditure that should be covered by the new rules. This is because some income, such as from the sale of prototypes, may be earned during the development phase. However, the other requirement in proposed section EJ 20(1)(c) that the expenditure is incurred before the start of commercial production of the R&D product would only cater for situations involving the sale of goods. It would not cater for the situation where the R&D product is a service.

Officials therefore consider that while proposed section EJ 20(1)(b) should be omitted, proposed section EJ 20(1)(c) should be amended so it applies to both goods and services. This will ensure that general advertising expenditure does not qualify under the new rules.

The proposed requirement that the market development expenditure must be incurred before the person begins commercial production of the R&D product is a timing provision only. The deductions for market development must already be allowed under the deduction enabling provisions in Part D of the Income Tax Act 2004. Proposed section EJ 20 is concerned only with whether certain deductions for market development of a product resulting from R&D expenditure should qualify for the new allocation treatment.

The proposed requirement that the market development expenditure must be incurred before the person begins commercial production of the product to qualify for the new treatment is consistent with FRS-13, which the main R&D production provision in section DB 26 is based on. FRS-13 allows expenditure on market research activities undertaken prior to the beginning of commercial production to establish the usefulness of a product or the existence of a potential market, to be treated as development costs to which the standard applies. The fact that commercial production has started therefore operates as an objective indication that the market development stage of an R&D product is completed. Expenditure incurred on promoting a product after its commercial production has started should be treated as a regular advertising expense and subject to normal income tax timing rules (that is, it should be recognised in the year the expenditure is incurred).

The reference to “market development” in proposed section EJ 20 has been developed in consultation with representatives from relevant technology sector groups. “Market development” has a generally accepted commercial meaning and should not create difficulties in interpretation. New section EJ 20 would be inappropriately wide if it applied to all expenditure (not just market development expenditure) incurred by a company in relation to a product resulting from R&D expenditure until commercial production has started. As noted above, the reference to “market development” is also consistent with FRS-13.

Recommendation

That the primary submissions be accepted to the extent of omitting proposed section EJ 20(1)(b) and amending section EJ 20(1)(c) to ensure it applies to both goods and services.

Issue: Ordering of deductions

Submission
(46 – PricewaterhouseCoopers)

The effect of the ordering rule in proposed section EJ 21(3) is that deferred expenditure must be deducted from gross income before any deduction is claimed for expenditure which has not been deferred. To achieve the full policy intent, the proposed ordering rule should be reversed so that deferred expenditure should be deducted only after all current year expenditure and depreciation has been deducted.

After commercial production has begun, a company may still require additional equity injections which may result in shareholder continuity being breached during the commercial production phase. If it takes five years to deduct all the deferred R&D expenditure, for those five years, the current year expenditure will result in losses that must be carried forward. In the event that a breach in shareholder continuity occurs (for example, in year three of commercial production because further capital is required) those losses will be forfeited. This result is inappropriate because it does not match the current year expenditure to the income derived from that expenditure and may result in deductions for current year expenditure being forfeited even though income will continue to be derived from the product. The most appropriate way to resolve this is to allow current year expenditure to be deducted before deferred R&D expenditure.

Comment

Officials do not consider it would be consistent with the policy underlying the reform to require current year expenditure to be deducted before deferred R&D expenditure. The amendments are based on achieving a better matching of the timing of tax deductions for R&D expenditure with the timing of income resulting from that expenditure. This treatment recognises that taxpayers in the development period of an R&D project are developing assets for the purpose of earning income in future periods instead of incurring economic losses in the initial development stage.

The current tax treatment results in R&D expenditure being recognised too early in relation to when the resulting income is recognised. The current mismatch in the early recognition of expenditure and the later recognition of income means that the deductions for R&D expenditure of a company may be inappropriately lost when there is a shareholding change in the company. This is particularly problematic for technology companies whose growth cycle typically has a long lead-in period and significant expenditure is incurred before any income is realised. It is part of the normal financing process for such companies to bring in additional equity investors after the initial development work has been successful, but before commercial production has started.

It is appropriate for deferred R&D expenditure from earlier years to be offset first against any current year income resulting from that expenditure based on the application of a first-in, first-out principle.

Normal income tax rules should otherwise apply once commercial production has started. As described earlier, the primary objective of the reform is to achieve a better matching of R&D expenditure with resulting income and to ensure that shareholding changes occurring before commercial production starts, and income is earned, do not result in R&D deductions being forfeited.

It is not a particular objective of the reform to mitigate the effect of shareholding changes on the carry-forward losses after a company has begun commercial production of an R&D product. Instead, normal income tax rules should apply, which is the case under the proposed amendments.

The proposed amendment to require deferred expenditure to be deducted only after all current year expenditure and depreciation has been deducted would also significantly increase the complexity of the rules because the deferred deduction would be treated more like an available net loss than another current year deduction in the year of recognition. In particular, the amendment would require the calculation of an interim net income figure (gross income less all expenditure and depreciation incurred in the current year), something which the Act does not currently provide for. It is also noted that any current year R&D expenditure qualifies for the new treatment.

Recommendation

That the submission be declined.

Issue: Allocation against resulting R&D income

Submission
(47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

There should be no requirement that the R&D expenditure can only be offset against income resulting from that expenditure. There are serious compliance costs in tracking the expenditure and trying to identify which income arises from the expenditure. There are also apportionment problems where the expenses of the business have to be apportioned between R&D producing income and non-R&D producing income. A single purpose R&D business is fine under these rules but a start-up business with a mix of projects is a problem. The submission expresses concern that taxpayers will not use the provisions as they are currently drafted. It requires differentiation between successful and non-successful R&D projects. *(New Zealand Institute of Chartered Accountants)*

Draft section EJ 21(2)(a) should be amended to refer to "assessable income derived from the use or disposal of the product that has resulted from the expenditure incurred by the person on research and development". The proposed section currently uses a "but for" test. There may be considerable difficulties in establishing the link to this standard. An example is when expenditure is incurred in developing a market from which no revenue is ultimately generated. The wording in the bill will not allow this expenditure to be allocated to a year after that in which it is incurred. *(New Zealand Law Society)*

Alternative submission
(48 – New Zealand Institute of Chartered Accountants)

An alternative approach that merits consideration is a rule where it is possible to have a special-purpose subsidiary that has full deductibility for R&D expenditure.

Comment

The proposed requirement that taxpayers must allocate their deferred tax deductions against income resulting from R&D expenditure is necessary as a tax base protection measure to ensure that taxpayers do not use their R&D tax deductions to shelter their non-R&D income. The requirement is also consistent with the policy underlying the new treatment of achieving a better matching of deductions for R&D expenditure with the income resulting from that expenditure.

This requirement has been developed in consultation with representatives from relevant technology sector groups. Overall, the design of the new rules for allocating R&D tax deductions is simple, and officials consider that the proposed rules will be able to be applied in practice.

The rules do not require differentiation between successful and non-successful projects. In particular, expenditure incurred on unsuccessful R&D projects can be matched against income resulting from successful R&D projects.

Most R&D expenditure is already fully deductible so the alternative approach suggested is already possible. It would not be appropriate to fully exempt a special-purpose subsidiary engaged in R&D from the shareholder continuity rules because the policy reasons for these rules are of general application. The policy underlying the proposed reform, which is to achieve a better matching of deductions for R&D expenditure with income resulting from that expenditure, is not inconsistent with the policy underlying the shareholder continuity rules.

Recommendation

That the submissions be declined.

Issue: Further options for the timing of the deferred deduction

Submission

(48 – New Zealand Institute of Chartered Accountants)

Proposed section EJ 21(2), which governs the timing of the deferred deduction, should be amended to include the following options:

- allowing a continuity of business test as exists in a number of jurisdictions overseas, limited only to the R&D expenditure aspect;
- allowing all R&D expenditure to be carried forward regardless of shareholding changes.

Comment

The government has previously considered and rejected a general business continuity test for the following reasons:

- It is contrary to the main policy underlying the loss carry forward rules, which is to prevent the trading of losses between unrelated parties.
- It is the experience of other countries that the test is difficult to apply in practice, creating both complexity and uncertainty.
- A general business continuity test could potentially lock companies into businesses that are only marginally profitable and do not represent the best use of capital.
- A general business continuity test could have significant revenue implications.

Many of these reasons for not favouring a general business continuity test will also apply to a business continuity test limited to R&D expenditure.

There are also no grounds for giving a separate exemption from the shareholding continuity rules to R&D expenditure. Such an exemption would not be based on the sound policy principles underlying the proposals in the bill which is to achieve a better match between the timing of tax deductions for R&D expenditure and the timing of income resulting from that expenditure.

Recommendation

That the submission be declined.

Issue: Extending the rules to all start-up expenditure

Submission
(48 – New Zealand Institute of Chartered Accountants)

The reform should be extended beyond R&D to all start-up expenditure. The rules are too subjective. Section DB 26 allows other expenditure types such as overheads to be allocated to R&D, which seems to support a broader approach.

In particular, all small companies should be able to elect for all significant start-up expenditure to be allocated to a memorandum account. This could apply to, say, the first five years of business. They could then elect for this expenditure to be allowed as a deduction once taxable profits are made. This would then allow the start-up expenditure to be allocated to income irrespective of the continuity of a shareholding.

Alternative submission
(48 – New Zealand Institute of Chartered Accountants)

Small businesses should be exempt from the shareholder continuity rules. The compliance costs for conforming to the shareholder continuity rules are onerous for small business.

Comment

It would not be consistent with the policy underlying this reform to extend it to all start-up expenditure.

The amendments in the bill are based on achieving a better matching of the timing of tax deductions for R&D expenditure with the timing of income resulting from that expenditure. The current tax treatment results in R&D expenditure being recognised too early in relation to when the resulting income is recognised. This current mismatch in the early recognition of expenditure and the later recognition of income means that deductions for R&D expenditure of the company may be inappropriately lost when there is a shareholding change in the company.

However, this mismatch rationale for the proposed amendments does not apply to all start-up expenditure. There is no mismatch under current timing rules in the recognition of some start-up expenditure and income resulting from that expenditure. For example, in the case of a rental property there is no mismatch in the timing of the relevant expenditure and rental income.

Officials do not agree that the proposed rules are too subjective. For example, the main type of expenditure covered by the proposed rules comes within section DB 26, which is the main R&D deduction provision in the Income Tax Act 2004. This provision, in turn, is based on the application of the objective criteria in FRS-13.

R&D expenditure covered by section DB 26, and therefore by the proposed allocation treatment may include overhead costs (other than interest) such as rent and power.

There is no policy justification for generally exempting small businesses from the shareholding continuity rules for carrying forward tax losses. Such an exemption would be contrary to the main policy underlying these rules, which is to prevent the trading of losses between unrelated parties. The proposal is also not appropriate because it would require a hard to define boundary between small businesses and other businesses.

Recommendation

That the submissions be declined.

Issue: Extension of proposals to petroleum mining

Submission
(2 – Petroleum Exploration and Production Association of New Zealand, 47 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The proposed new rules should be extended to petroleum prospecting and exploration expenditure. Like technology companies, petroleum exploration companies are faced with long lead-in times in which they incur significant prospecting and exploration expenditure before they realise income from that expenditure. The current tax treatment results in such expenditure being recognised considerably in advance of the resulting income being derived. For new companies in particular the prospecting and exploration expenditure is often funded by new equity investors. The introduction of these new investors may breach the shareholder continuity requirements for carrying forward tax losses.

Comment

The proposals in the bill are concerned only with achieving a better matching of the timing of tax deductions for R&D expenditure with the timing of income resulting from that expenditure. Although R&D expenditure may not be the only type of expenditure when these timing issues arise, extending the proposed treatment to other types of expenditure is outside the scope of this bill. Also, there may be other significant issues concerning these other types of expenditure which need to be properly considered. Proper consideration of all relevant issues is best achieved through the generic tax policy process. This process places a major emphasis on consultation at each of the main stages of the process with taxpayers, their advisors and professional and industry bodies.

Recommendation

That the submissions be declined.

Issue: Recommendations for a *Tax Information Bulletin* article

Submission

(46 – PricewaterhouseCoopers)

The *Tax Information Bulletin* article on these amendments should make it clear that if a company incurs R&D expenditure on a number of projects, some of which are successful and some of which are not, all of the expenditure, including the expenditure that does not result directly in a product, can be allocated under proposed section EJ 21.

Comment

Officials agree it is the intention of the proposed amendments that R&D expenditure incurred on unsuccessful projects can be allocated against income from successful R&D projects. Officials will reiterate this aspect in the *Tax Information Bulletin* article on these amendments.

Recommendation

That the submission be accepted.

Issue: Need to address "black hole" R&D expenditure

Submission

(48 – New Zealand Institute of Chartered Accountants)

There is still a need to address the "black hole" issue for R&D expenditure. "Black hole" expenditure is simply any expenditure that is capital (other than land) that does not result in a depreciable asset. Such expenditure should be available as a deduction, one way or the other (depreciable or expensed).

Comment

The issue of black hole R&D expenditure is on the tax policy work programme for consideration.

Since the enactment of the new R&D expenditure tax rules in 2001 (now contained in sections DB 26 and DB 27 of the Income Tax Act 2004) there would be less R&D black hole expenditure for which no deduction is available. This is because under the current tax rules R&D costs that do not satisfy all the asset recognition criteria in FRS-13 can be deducted immediately. Theoretically, some R&D expenditure may result in an asset (and therefore cannot be deducted under section DB 26) but the asset is not a depreciable asset for income tax purposes. After the 2001 rules were enacted, officials consulted with the private sector to identify any specific remaining examples of black hole expenditure. As a result, legislation was enacted in the Taxation (Venture Capital and Miscellaneous Provisions) Act 2005 to ensure that expenditure on failed patent and failed Resource Management Act consent applications could be immediately deducted as an expense. Officials do not believe that a "catch-all" R&D black hole expenditure provision is needed and are not aware of further examples of R&D black hole expenditure. However, taxpayers and their advisers are welcome to bring further examples to officials' attention, and the issue does merit further consideration.

Recommendation

That the submission be noted.

Corporate migration

OVERVIEW

The bill introduces amendments to ensure that migrating companies pay tax on their worldwide income earned while resident in New Zealand, and that the rules are consistent with the tax rules that apply on liquidation. The changes are intended to remove incentives for companies to migrate for tax reasons.

A company resident in New Zealand is liable for New Zealand tax on its worldwide income. However, a company is currently able to migrate without having necessarily paid tax on income that was earned while it was resident.

Under the changes in the bill, a migrating company will be treated as if it had realised all assets, liquidated, and fully distributed its proceeds to shareholders prior to migration.

The changes will apply to companies migrating on or after 21 March 2005, the date these changes were announced by the government.

Six submissions were received on the corporate migration amendments. The main issues concerned the application date of the amendments and the treatment of capital gains. Officials are recommending a limited grandparenting provision for companies that had done everything within their control to migrate by 21 March 2005, but had not yet become non-resident.

While realised capital gains will generally be excluded from the distribution that is taxed, a consequence of alignment with the liquidation rules is that they will be included for non-resident related corporate shareholders. Officials do not support changing this aspect of the reform. However, it is proposed that this issue be separately reviewed.

WITHDRAW PROPOSED LEGISLATION

Submission
(29 – Corporate Taxpayers Group)

The proposed changes for the taxation of migrating companies are incorrect from a policy perspective and should not be enacted. The government should consider withdrawing the proposed legislation.

Comment

New Zealand wishes to tax its residents on their worldwide income. However, companies are currently able to migrate without having paid tax on some of their worldwide income that was earned while they were resident in New Zealand. For example, any increase in the value of offshore revenue account property,[15] such as a forest, that accrued during their New Zealand residence is not taxed in New Zealand if the company migrates and the property is then sold. Similarly, reserves generated during residency may not be entirely captured in New Zealand's tax base. Distributions to resident shareholders would still be subject to tax, although offset to some extent by credits for tax paid on the distribution in the company's new country of residence. However, distributions made to non-resident shareholders would not be taxed in New Zealand at all as the company is no longer a New Zealand-resident company.

On the liquidation of a New Zealand company, distributions of retained earnings to shareholders are treated as a dividend subject to income tax. Distributions of capital profits as well as retained earnings to non-resident related companies are treated as a dividend subject to NRWT. Therefore a higher portion of economic income is captured in the New Zealand tax base when a New Zealand company liquidates compared with when it migrates. This creates an avenue for obtaining a tax advantage as companies may choose the option with the lighter tax. For example, a company wishing to liquidate may first migrate before doing so. While migration and liquidation are not exact substitutes, they are close equivalents for tax purposes; both involve the taxpayer leaving the New Zealand tax base so neutrality between them is desirable.

Almost all OECD countries have some form of exit tax on migration so New Zealand is simply moving closer to the treatment in comparable jurisdictions. The proposed changes can therefore be seen as filling an anomalous gap in New Zealand's tax laws. The changes will remove incentives for companies to migrate for tax reasons.

Recommendation

That the submission be declined.

[15] Other than financial arrangements that are generally taxed on an accrual basis.

APPLICATION DATE

Issue: Application date: grandparenting provision

Submissions
(46 – PricewaterhouseCoopers, 13 – Pacific Hydro, 48 – New Zealand Institute of Chartered Accountants)

The application date of the proposed rules should be amended to exclude companies that were committed to migrating before 21 March 2005. *(Pacific Hydro, PricewaterhouseCoopers)*

A company could have committed itself to the migration process as early as approval has been given by the board of directors, and should not be caught with the new rules. It should not be necessary for the company to have progressed the migration to the stage that an application has been made to a foreign registrar for registration. *(New Zealand Institute of Chartered Accountants)*

Alternative submission
(46 – PricewaterhouseCoopers)

The application date of the proposed rules should be amended so that the rules do not apply to companies that became non-resident on or before 21 March 2005.

Alternative submission
(48 – New Zealand Institute of Chartered Accountants)

Any company that had an application for approval for a corporate migration with Inland Revenue on 21 March 2005 should be excluded from the new rules.

Comment

Officials agree that a grandparenting provision should apply to companies that, before 21 March 2005, completed the statutory requirements for migrating companies relating to public notification, shareholder approval, Inland Revenue clearance and solvency, and that have applied to a foreign registrar for registration.

These objective criteria are based on a company having completed all steps within its control before 21 March 2005 to migrate a company out of New Zealand. A company committed to migrating before 21 March 2005 that satisfies these criteria would be excluded from the new corporate migration rules.

Officials do not agree that a company has committed itself to migrating merely by its board of directors passing a resolution to that effect. This is only an initial step and there are many others that are within its control, such as public notification and obtaining shareholder approval.

Recommendation

That the submissions seeking a grandparenting provision along the lines described in the comment above be accepted.

Issue: Prospective application date

Submission
(29 – Corporate Taxpayers Group, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

Any new legislation affecting migrating companies should only have a prospective application date so that non-resident investors can plan future investment into New Zealand.

Comment

The proposals should apply on or after 21 March 2005 (the date of their announcement) to minimise the risk of companies migrating before the legislation is enacted to obtain the tax advantages under the current law. The application date of 21 March 2005 means there is no window of opportunity to exploit the weaknesses in the current law before amendments are enacted.

If the proposals applied only to future investment, a number of concerns would arise:

- Investment patterns would be distorted through the use of existing companies as opposed to new companies as a vehicle for new investment.
- There would be significant loss of tax revenue should existing companies choose to migrate.
- Distinguishing existing and new companies would lead to comparable investments facing different tax consequences, undermining the neutrality benefits of the proposal.

Alternative submission
(47 – New Zealand Law Society)

The amendments should only have effect from the date on which the bill was introduced.

Comment

The concerns discussed under the previous submission also apply if the amendments applied from the date of the bill's introduction.

Recommendation

That the submissions be declined.

Issue: Unapproved applications

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

Companies that have applied for, but have not yet received, Inland Revenue approval to migrate should be entitled to have their application put "on hold" pending finalisation of the legislation. This will provide companies with the opportunity to fully consider the tax implications of migrating from New Zealand before deciding whether to proceed with their proposed migration.

There should be transitional rules to allow companies in the middle of a migration to be reinstated to their pre-migration status.

Comment

There is nothing to preclude companies seeking to put their application to migrate on hold or to withdraw their application from making a request to the Inland Revenue staff member considering the application.

Recommendation

Note that companies are currently entitled to put their application for Inland Revenue clearance to migrate on hold.

TAXATION OF CAPITAL GAINS TO NON-RESIDENTS

Submissions
(29 – Corporate Taxpayers Group, 42W – Ernst & Young, 46 – PricewaterhouseCoopers, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

Submissions seek removal of what they regard as a current anomaly whereby capital gains can be distributed tax-free to New Zealand shareholders but are subject to non-resident withholding tax when paid to non-resident corporate shareholders that are related.

Alternatively, as submitted by Ernst & Young, the capital dividend exclusion should be extended to those foreign corporate investors which can demonstrate that any tax paid in New Zealand on capital dividends would not be creditable against any tax payable in their home country.

Ernst & Young also submit that if the current proposal proceeds then taxing capital gains to non-residents should be subject to consultation as a separate matter.

Submissions suggest that the different tax treatment between distributions paid to New Zealand-resident shareholders and non-resident shareholders is contrary to the non-discrimination articles in many of New Zealand's double tax agreements. These broadly require that residents of the relevant country are not subject to tax in New Zealand, which is more burdensome than taxes imposed on a New Zealand resident in the same circumstances.

The proposals are likely to entrench further a preference towards other investment vehicles into New Zealand such as trusts and branches. The existing rules are clearly inequitable for those foreign investors that cannot, in terms of their own corporate or home tax rules, invest abroad other than through a subsidiary of their foreign parent company.

Comment

The existing liquidation rules generally exempt from tax the capital gains component of dividend distributions received by all shareholders – with the exception of related non-resident corporate shareholders. The proposed new corporate migration rules follow this approach. Under the current dividend rules, all distributions of capital gains outside liquidation are taxable as dividends.

Most companies potentially affected by the corporate migration proposal face a choice between liquidation and migration. By matching the approach taken on liquidation, the corporate migration proposal goes some way towards ensuring that similar investments face similar tax consequences.

Officials have previously reported on these issues and will raise them again with the government as part of the new tax policy work programme.

Officials do not agree that these rules are contrary to non-discrimination articles. The submission refers to Article 24 of the New Zealand/Indian DTA. However, paragraph 4 of the article expressly allows both countries to have different rules for residents and non-residents.

It is an acknowledged feature of our tax system that different tax rules can apply to different investment vehicles. For example, because a branch of a foreign company is not a separate legal entity, its tax treatment does differ significantly from that of a New Zealand-resident company. In particular, NRWT cannot apply on distributions of profit from a branch to its overseas head office as any payment is within the same company. The different treatments are not significantly worsened by the proposal.

Ernst & Young submitted that the capital dividend exclusion be extended to those foreign corporate investors which can demonstrate that any tax paid in New Zealand on capital dividends would not be creditable against any tax payable in their home country. Officials consider that New Zealand's tax treatment should not be governed by the particular tax laws in the non-resident shareholder's home country. Also, some countries deny foreign tax credits in cases where the tax laws of foreign countries impose tax on non-resident investors only if a credit for the tax is available in their home country.

Officials estimate that the amount of tax foregone if capital gains were excluded from the dividend that is taxed for non-resident related corporate shareholders would be, on average, about \$20 – \$30 million per annum.

Recommendation

That the submission be declined, but note that officials will report to the government on the distinction in the liquidation and migration rules between non-resident related corporate shareholders and other shareholders.

TECHNOLOGY COMPANIES AND VALUATION OF ASSETS

Submission
(46 – PricewaterhouseCoopers)

The progress of the proposals should be deferred until further work is undertaken, in consultation with industry bodies and other interested parties, to determine the possible implications of the proposed rules for high technology industries in New Zealand.

Comment

There is no ground for exempting a particular industry sector from the corporate migration rules. The reasons for the corporate migration rules have general application and should apply to any New Zealand-resident company that migrates regardless of the type of activity it is involved in.

New Zealand has recently introduced or announced a number of tax measures to reduce barriers to technology investment in New Zealand. For example:

- Since late last year, gains from the sale of shares in unlisted companies held on revenue account have been exempt from tax for certain non-resident investors.
- Proposed legislation in this bill will exempt non-resident investors from tax on the sale of shares in companies that they have invested into alongside the New Zealand Venture Investment Fund Limited.
- Proposed legislation in this bill improves access to tax deductions for research and development expenditure for companies that bring in new equity investors after their initial development stage.
- A limited partnership regime is also to be introduced into New Zealand. It will have separate legal personality and a flow-through (partnership) tax treatment.
- Investment tax changes are to be introduced that will remove the current disincentive for New Zealanders to save via investment funds. This should increase the level of domestic private equity available from funds for use in New Zealand. This will send an important profitability signal to potential non-resident investors.

Recommendation

That the submission be declined.

EXTENT OF APPLICATION OF RULES

Issue: Breadth of proposed rules

Submission
(46 – PricewaterhouseCoopers)

The proposed rules are significantly broader than required to achieve the stated policy objective of removing the incentives for companies to migrate rather than liquidate for tax reasons. Instead of the proposed rules, a targeted anti-avoidance provision should be introduced that applies in circumstances when the primary purpose of a company ceasing to be New Zealand tax resident is tax avoidance.

Comment

The proposed changes will fill an anomalous gap in New Zealand's tax laws by ensuring that migrating companies pay tax on their worldwide income earned while resident in New Zealand. Therefore, they should have general application to any New Zealand-resident company that migrates rather than be limited to avoidance cases only.

Any limitation to avoidance cases would also create uncertainty as it would be difficult to define when a migration had occurred for tax avoidance reasons.

Recommendation

That the submission be declined.

Issue: Limiting amendments to change of place of incorporation

Submission
(48 – New Zealand Institute of Chartered Accountants)

The rules should apply only to corporate migrations occurring by a change in the place of incorporation, and not to companies that change their residence.

Comment

New Zealand loses the right to tax a company's worldwide income earned while resident in New Zealand whenever the company becomes non-resident, and not just when its place of incorporation is shifted from New Zealand to another country. For example, any increase in the value of a forest situated outside New Zealand that accrued when a company was resident in New Zealand is not currently subject to New Zealand income tax if the company ceases to be a New Zealand resident and the forest is then sold.

Recommendation

That the submission be declined.

Issue: Tax credits for non-resident shareholders

Submission

(46 – PricewaterhouseCoopers, 42W – Ernst & Young)

Further work should be undertaken by officials on the potential impact that the proposed corporate migration rules will have on non-resident investors, in particular on tax credits for non-resident shareholders.

Imposing a more onerous tax burden on non-residents is generally a disincentive to encourage foreign investment.

Comment

The ability for non-residents to claim tax credits in a foreign jurisdiction for New Zealand tax paid is determined by the foreign jurisdiction. New Zealand's tax treatment should not be governed by the particular tax laws in the non-resident shareholder's home country.

Officials consider that a corporate migration exit tax that would apply at a modest rate only on previously untaxed income is not likely to be a big factor in a company's decision to make a long-term permanent investment in New Zealand. Also, such an exit tax is a common feature of tax systems in comparable jurisdictions.

Recommendation

That the submission be declined.

TIMING OF DISTRIBUTION

Submission
(46 – PricewaterhouseCoopers)

Any distribution treated as being paid by a migrating company pursuant to proposed subpart FCB should be deemed to be paid six months after the date the company becomes non-resident.

Comment

Officials do not agree with shifting the time of the deemed distribution as it could affect the effectiveness of the rule changes. A company needs to be a New Zealand resident, and therefore fully within our taxing jurisdiction at the time of the deemed distribution. This is currently achieved under proposed section FCB 2, which treats the distribution as occurring immediately before the company becomes a non-resident.

Officials acknowledge the amount of work involved in calculating the amount of tax payable under the corporate migration rules and consider the submitter's concerns can be resolved by allowing a three-month extension of time for the payment of NRWT and RWT (and associated filing) relating to the corporate migration. This would not affect the timing of the distribution under proposed section FCB 2.

Recommendation

That the submission be accepted to the extent of allowing a three-month extension of time for the payment of NRWT and RWT (and associated filing) relating to the corporate migration.

PROPOSED EXEMPTIONS

Issue: Exemption for non-New Zealand sourced income derived before migration

Submission
(48 – New Zealand Institute of Chartered Accountants)

The retained earnings that arose prior to migration from non-New Zealand sourced income should be exempt from these rules.

Comment

The retained earnings of a company relating to its worldwide income earned while resident in New Zealand are part of the New Zealand tax base and should therefore be subject to the corporate migration rules.

Recommendation

That the submission be declined.

Issue: Exemption for retained earnings with no imputation credits

Submission
(48 – New Zealand Institute of Chartered Accountants)

Retained earnings with no attached imputation credit arising through a group loss claim should be exempt from the corporate migration rules.

Comment

If no tax is paid, and therefore no imputation credits are generated because of the use of losses, then subsequent dividends will be unimputed. This is a general feature of our tax system and is not special to the corporate migration rules. The submission is therefore inconsistent with the structure of New Zealand's corporate tax system.

Recommendation

That the submission be declined.

Issue: Exemption for assets remaining in New Zealand

Submission
(46 – PricewaterhouseCoopers)

Assets which are owned by a company that ceases to be New Zealand-resident, and which remain in New Zealand following the migration and continue to be subject to tax in New Zealand, should be excluded from the proposed rules.

Comment

An exclusion for assets that remain in New Zealand is unnecessary as the corporate migration rules provide that the assets are deemed to be re-acquired in New Zealand at the current market value. This will establish a new cost base to apply in the event of a subsequent disposal and remove any double taxation.

In addition, it would be very complex to separately identify assets that remain in the New Zealand tax base and exclude them from the corporate migration rules.

Recommendation

That the submission be declined.

Issue: Exemption where parent company remains a New Zealand resident

Submission
(48 – New Zealand Institute of Chartered Accountants)

There should be an exemption from these rules when the ultimate parent company is still a New Zealand resident.

Comment

Even when the ultimate parent company remains a New Zealand resident, New Zealand still potentially loses some taxing rights – for example, if a company migrates to a grey list country. Therefore, it is still necessary to apply the corporate migration rules in this case to ensure that the company pays New Zealand tax on its worldwide income earned while resident in New Zealand, which is the primary objective of the new corporate migration rules.

Recommendation

That the submission be declined.

Issue: Inward migration exemption

Submission

(46 – PricewaterhouseCoopers)

The retained earnings of a company that migrates into New Zealand should be deemed to be an amount paid in consideration for the subscription of shares and should therefore form part of a company's "available subscribed capital".

Comment

New Zealand obtains full taxing rights over dividends paid out of retained earnings of a New Zealand-resident company whether or not the retained earnings accrued while the company was a New Zealand resident. New Zealand does not have comprehensive cost basis rules which apply when a non-resident becomes a New Zealand resident. For example, if a person holding shares in a company with retained earnings migrates to New Zealand, New Zealand has full taxing rights to any dividends subsequently received.

The submission is therefore inconsistent with other features of New Zealand's tax system.

Recommendation

That the submission be declined.

INTERACTION WITH DOUBLE TAX AGREEMENTS

Submission
(46 – PricewaterhouseCoopers, 47 – New Zealand Law Society)

Retained earnings of a migrating company that have not been taxable in New Zealand under a double tax agreement (DTA) should be deemed to be an amount paid in consideration for the subscription of shares, and should therefore form part of a company's "available subscribed capital". *(PricewaterhouseCoopers)*

Enactment should be accompanied by a Public Ruling, Interpretation Statement or other public comment (such as commentary in the *Tax Information Bulletin*) confirming that the proposals to treat corporate migrations as liquidations under New Zealand domestic law are not seeking to override the effect of the DTAs that New Zealand has concluded, nor deprive migrating companies (or shareholders of migrating companies) of the ability to claim relief from the impost of NRWT that may be available under a DTA. *(New Zealand Law Society)*

Comment

The corporate migration rules apply only to companies that cease to be resident under domestic rules.

The migration rules do not apply to dual-resident companies because the application of the rules would be too uncertain because it is difficult to ascertain the effect of other countries' residence rules. Therefore there should be no increase to available subscribed capital to take account of the effect of a DTA. A dual-resident company is still resident in New Zealand and is treated as non-resident only for the purposes of the DTA. A DTA may limit certain taxing rights, but New Zealand still retains full taxing rights otherwise.

There will be some discussion of the interaction between DTAs and the corporate migration rules in the *Tax Information Bulletin* item on the new law. Officials consider that the corporate migration rules are not inconsistent with DTAs.

Recommendation

That the submission to amend the rules be declined, and note there will be some discussion of the interaction between DTAs and the corporate migration rules in a *Tax Information Bulletin* item on the new law.

Issues: Retrospective attachment of imputation credits to deemed dividends

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The proposals should be amended to clarify that a company is not required to be an imputation credit account company after the date of migration.

Comment

A company cannot be an imputation credit account company once it has migrated. However, a company must be an imputation credit account company to apply proposed section ME 6(2) and retrospectively attach imputation credits to dividends arising under the corporate migration rules.

Section ME 6(2) should be amended so that it applies to migrating companies that were imputation credit account companies immediately before becoming non-resident.

Recommendation

That the submission be accepted.

Issue: Conduit tax relief account debits

Submission
(48 – New Zealand Institute of Chartered Accountants)

The liability arising under section MI 5(1)(f), (g) or (h) (debits arising to conduit tax relief account) should arise (or be calculated) after the deemed distribution arising under subpart FCB. There is a risk that the debit will be overstated if the migrating company is required to have regard to the balance in the conduit tax relief account prior to the time the deemed dividend arises and prior to the attachment of relevant credits to the deemed distribution.

Comment

Officials consider that the suggested amendment is unnecessary because conduit tax relief account credits cannot be used to impute the deemed distribution arising under subpart FCB. Imputation credits, including those generated from tax paid on the deemed disposition under section FCB 3, may be retrospectively attached to dividends arising under the corporate migration rules.

Companies have the ability to clear out credits from their conduit tax relief accounts at any time before migration.

Recommendation

That the submission be declined.

Issue: Timing of imputation credit account credits

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The proposed rules should be amended to clarify that all income tax paid on income derived before migration, including tax that is attributable to income derived under subpart FCB, be treated as being paid immediately before the migrating company becomes a non-resident.

Comment

Proposed new section ME 6(2) will allow a company to retrospectively attach imputation credits to a dividend arising from the migration. Tax paid that is attributable to the migration will be treated for imputation purposes as being paid immediately before the company ceases to be a New Zealand resident.

Officials consider it is appropriate, for imputation credit timing purposes, to treat tax paid on income derived to the date of migration the same as tax paid that is directly attributable to the migration. In both cases the tax should be treated as being paid immediately before the migrating company becomes a non-resident (and therefore ceases to be entitled to maintain an imputation credit account). A migrating company will be able to attach imputation credits available immediately before it ceases to be a New Zealand resident to the deemed dividend resulting from the migration.

Recommendation

That the submission be accepted.

Issue: Reference to dividends

Submission
(46 – PricewaterhouseCoopers)

The phrases “as a dividend” and “as dividends” should be removed from proposed subpart FCB. The phrases could be interpreted as deeming a distribution under proposed section FCB 2 to be a taxable dividend, notwithstanding that it may be paid out of available subscribed capital or capital gains. This interpretation is unintended and could lead to unplanned results.

Comment

Officials consider it is already clear under proposed section CD 18 that available subscribed capital or capital gains are not taxed as a dividend. Referring to the term “dividend” ensures the corporate migration rules link directly to the dividend rules which makes the law clear and accessible to users.

Recommendation

That the submission be declined.

Issue: Calculation of distribution

Submission
(46 – PricewaterhouseCoopers)

Proposed section FCB 2 should be amended to clarify that the amount of the distribution deemed to be paid is the market value of the property owned by the company, less all known and contingent liabilities.

Comment

The legislation refers to “the amount that would be available for distribution”. Therefore, liabilities are already taken into account and the suggested amendment is unnecessary.

The liquidation rules refer only to “an amount paid to a shareholder in relation to a share”. Specifying the various types of liabilities to be excluded from the taxable amount of the distribution on migration would therefore also be inconsistent with the liquidation rules.

Recommendation

That the submission be declined.

Issue: 20% loading on assets remaining in New Zealand

Submission

(46 – PricewaterhouseCoopers)

Assets treated under proposed section FCB 3 as being disposed of and reacquired by a migrating company should continue to be eligible for the 20% loading available on New Zealand-new assets under section EE 26 of the Income Tax Act 2004.

Comment

Officials agree that because actual ownership of the property does not change, the disposition and re-acquisition deemed to occur under the corporate migration rules should be disregarded for depreciation loading purposes.

Recommendation

That the submission be accepted.

Issue: Mitigation of double taxation on dividends paid subsequent to migration

Primary submission

(46 – PricewaterhouseCoopers)

All dividends paid by a non-resident company that was previously New Zealand-resident should be exempt from tax in New Zealand to the extent that dividends arose to shareholders when the company migrated.

Alternative submission

The definition of "available subscribed capital" should be amended to clarify that available subscribed capital is increased by the amount of the deemed dividend.

Comment

The primary submission would require shareholders to record the amount of the distribution made under the corporate migration rules and match it to a subsequent dividend. Such tracking rules are complex and increase compliance costs.

Under the proposed approach, the amount of the distribution is added to a company's available subscribed capital which can be measured and monitored by the company and distributed tax-free to shareholders in certain circumstances. This removes the need for each shareholder to record and track the amount of the distribution and is the better approach because it reduces complexity and compliance costs.

The draft legislation in the bill amends the definition of available subscribed capital to include the amount of the deemed distribution under section FCB 2 "that is assessable income of the shareholders". The alternative submission considers that these words should be changed to "that is a dividend".

It is possible that some "dividends" may be exempt income but should also be added to available subscribed capital. Secondly, some distributions which are excluded from dividends may be assessable income (for example, a capital return to a revenue account shareholder) and should not be added to available subscribed capital.

Officials agree with the alternative submission.

Recommendation

That the primary submission be declined.

That the alternative submission be accepted.

Issue: Meaning of migration time

Submission
(48 – New Zealand Institute of Chartered Accountants)

It is not clear what the relationship is between "emigration time" and the point in time at which a company ceases being resident in New Zealand. This should be clarified.

Comment

Draft legislation in the bill amends section OB 1 of the Income Tax Act 2004 to define "emigration time" as "the time at which the emigrating company becomes a non-resident".

Officials therefore consider that the legislation is already clear on this point, and does not need to be amended.

Recommendation

That the submission be declined.

Temporary exemption from tax on foreign income for new migrants and certain returning New Zealanders

OVERVIEW

The bill introduces a number of amendments to remove the tax barriers inhibiting international recruitment to New Zealand.

A two-tiered exemption will be introduced. The first tier proposes a five-year exemption for employees and the second tier a three-year exemption for all new migrants. In both cases the exemption would be from all foreign income except dividends, interest, employment income and business income relating to the supply of services. To qualify, the individual must not have been tax resident in New Zealand for at least ten years.

Six submissions were received on these changes. While all submissions welcomed the overall proposal, they considered that some proposals did not go far enough or were compliance intensive. In particular, it was argued that the scope and length of the exemption should be extended. As a result, officials recommend that the scope of the exemption be extended to cover dividends, interest and amounts connected to employment exercised outside New Zealand while non-resident. However, no change should be made to the length of the exemption.

In addition, it was argued that the certification regime is overly complex and compliance intensive. After further consideration, officials recommend the removal of the certification process. An individual would then be required to "self-assess" their eligibility.

RESIDENCE DEFINITION

Clause 22

Submission

(46 – PricewaterhouseCoopers, 29 – Corporate Taxpayers Group)

The exemption period for a new recruit should begin on the first day of arrival for work in New Zealand.

Comment

The definition of "residence" under New Zealand law is based on a physical presence in New Zealand test. If a person is present in New Zealand for more than 183 days in any 12-month period, they are deemed to be resident from the first date they were present in New Zealand.

This may mean that, as a technical matter, for some new migrants or returning New Zealanders, their first date of residence may be backdated to a previous visit prior to 1 April 2006. Therefore, they will be ineligible for the exemption. Or, the period of exemption will begin before the new migrant or returning New Zealander actually moves permanently to New Zealand.

Officials acknowledge that this result would be counter to the policy objectives of the exemption and have therefore recommended an amendment to ensure that the exemption period begins on the first day of arrival for work in New Zealand. This will be achieved by disabling the 183-day test and relying on the permanent place of abode test in section OE 1.

Recommendation

That the submission be accepted. Changes will be made to the application of the residence rules for the purposes of the exemption. The effect of this change will be to "turn off" the 183-day test. Therefore, residence will be based on the permanent place of abode test.

LENGTH OF THE EXEMPTION

Issue: Extending the length of the exemption

Clause 170

Submission
(46 – PricewaterhouseCoopers, 11W – Business New Zealand, 48 – New Zealand Institute of Chartered Accountants)

The length of the exemption should be extended from the proposed 5-year exemption to a seven-year exemption.

If this is not accepted, then an extension of an additional four years should be available on request by the employer. *(New Zealand Institute of Chartered Accountants)*

Comment

The scope of the proposed exemption of five years represents a compromise between having an exemption that is lengthier but narrower in application versus an exemption that is shorter and wider in application. These were the two potential options advanced in the government discussion document, *Reducing tax barriers to international recruitment to New Zealand*, released in November 2003.

Officials have a general concern that any exemption on foreign-sourced income would encourage taxpayers to disguise onshore income as offshore income. We are therefore concerned to keep the period of exemption as short as practicable, to minimise this risk. Further to this, the five-year time limit strikes a balance between achieving the desired policy objectives while not unnecessarily conceding revenue. Officials consider that the proposed five-year exemption period is the appropriate policy response.

Recommendation

That the submission be declined.

Issue: Commissioner discretion to extend the exemption

Clause 22

Submission
(46 – PricewaterhouseCoopers)

The Commissioner of Inland Revenue should be granted a discretion to extend the exemption for a limited period of time in certain circumstances.

Comment

The submitter argued that in some circumstances, there would be an unreasonable compliance burden on an individual who is required to comply with domestic legislation for a short period of time. For example, a person due to repatriate within six months of the exemption ending will have to account for an interest in a foreign investment fund for that six-month period before he or she leaves New Zealand.

Officials believe that the five-year time limit provides the best balance between the policy objectives of the amendment and revenue conceded. Providing such discretion to the Commissioner of Inland Revenue would in effect be creating a further exemption with associated boundary issues. This would result in uncertainty and further compliance costs in trying to determine eligibility to the extension. Officials consider that it would be inappropriate to provide the Commissioner with discretion to allow for an extension of the exemption.

Recommendation

That the submission be declined.

Issue: Tax years

Submission
(48 – New Zealand Institute of Chartered Accountants)

Section 91K (1)(c)(ii) should state “one of the next three tax years”.

Section 91K (2)(d)(ii) should state “in the next five years”.

Comment

The submitter argues that the period of time permitted for the exemption could potentially be restricted to two years. This is because the exemption is tied to tax years. A situation could arise where a person becomes New Zealand resident on 29 March 2006 with the exemption expiring on 31 March 2008. Therefore, the submitter advocates an exemption for a minimum of three years and up to four years.

The current wording in the bill is consistent with the intentions of the proposed legislation. Changing it in the way this submission suggests could give rise to adverse tax planning opportunities that would have the effect of lengthening the exemption. This would give rise to equity issues.

To avoid any confusion, officials intend to explain the effect of the exemption being tied to tax years, and not a 12-month period in an article in the *Tax Information Bulletin*.

Recommendation

That the submission be declined.

NON-RESIDENCE PERIOD

Clause 170

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The requirement that new and returning residents must not have been tax-resident for at least ten years is too long, and should be reduced to five years. *(PricewaterhouseCoopers)*

The proposed ten-year qualification should be reduced to seven. *(New Zealand Institute of Chartered Accountants)*

Comment

The ten-year non-residence rule targets New Zealanders who have emigrated from New Zealand on a permanent basis and have, therefore, the same status as a new migrant relating to New Zealand tax on foreign-sourced income. It is accepted that reducing the ten-year exemption may have advantages in attracting mobile New Zealanders because of their familiarity with New Zealand culture and business practices.

However, officials do not agree that the period of non-residence should be reduced. It is critical to have robust rules restricting the extent to which former New Zealand residents can access the relief provided by the exemption. Such rules also reduce the risk that New Zealanders will be incentivised to emigrate to access the exemption in future.

Recommendation

That the submissions be declined.

SCOPE OF THE EXEMPTION

Issue: Extending the exemption to all foreign-sourced income

Submission
(11W – Business New Zealand, 29W – Corporate Taxpayers Group)

The exemption should be extended to other types of foreign-sourced income.

Comment

It was submitted that further sources of income should be considered for the exemption. The Corporate Taxpayers Group submitted that the exemption should be extended to all foreign-sourced income.

Officials have reconsidered whether dividends and interest should remain taxable. It has always been an "on balance" call whether to include dividends and interest in the exemption. In essence, it is necessary to trade off the benefits of continuing to tax income that is generally taxable in all countries (and so should not be a deterrent to migrants) against the beneficial effects of signalling an across-the-board exemption.

Australia recently announced details of a similar proposal. Under the Australian proposals, dividends and interest would be exempt. It has been argued that this would encourage people to repatriate their income, allowing individuals to rearrange their affairs in light of international tax rules, without being penalised by tax. There is some advantage in harmonising our proposed exemption with Australia's.

Excluding interest and dividends from the exemption could pose a risk to the tax base – particularly in relation to wholly owned companies. Individuals would be eligible for deductions for the interest on their borrowing to fund investments in overseas companies. The deferral of repatriation of dividends/interest could result in a timing advantage. Indeed, the income may never be repatriated during the period of the exemption – or prior to the departure of the migrant. These issues do not arise if dividends and interest are exempt.

Recommendation

That the exemption be extended to cover dividends and interest.

Issue: Bonus payments

Submission
(25W – Deloitte, 29 – Corporate Taxpayers Group)

The exemption should cover bonus payments from employment performed overseas before coming to New Zealand.

Comment

It is not uncommon for individuals who arrive in New Zealand to receive bonus payments from overseas employment. Officials accept that it would be inappropriate to tax bonus payments simply because they are often not determined until after the individual has arrived in New Zealand.

Recommendation

That the submission be accepted. However, as the Income Tax Act 2004 does not define a bonus payment, all amounts derived in connection with employment exercised outside New Zealand before an individual's arrival will be exempt.

Issue: Death and asset transfer rules

Submission
(48 – New Zealand Institute of Chartered Accountants)

The new rules should exclude temporary residents from the death and asset transfer rules for interests in property outside the tax base.

Comment

The death and asset transfer rules do not by themselves bring any income into the tax base. What they do is deem assets to be sold upon death or an in specie or "in kind" distribution, and any tax consequences follow. If the assets are not in the tax base, then there can be no adverse tax consequences.

Recommendation

That the submission be declined.

ELIGIBILITY CRITERIA

Issue: Available more than once in a lifetime

Clause 170

Submission
(25W – Deloitte, 29 – Corporate Taxpayers Group, 48 – New Zealand Institute of Chartered Accountants)

The eligibility to receive the exemption should be extended to twice in an individual's lifetime. *(Deloitte, Corporate Taxpayers Group)*

The exemption should be made available more than once, but restricted to four years. *(New Zealand Institute of Chartered Accountants)*

Comment

It was submitted that allowing individuals to receive the benefit of the exemption more than once better recognises the work patterns of people who are truly mobile and continuously shift their residence for employment. Many international entities place people in New Zealand in management positions who often return later in a more senior role because of their association with, and knowledge of, New Zealand.

However, a multiple exemption rule may adversely affect public perceptions of equity. It also gives rise to the concern that skilled individuals would have an incentive to leave New Zealand to keep refreshing their exemption.

Recommendation

That the submission be declined.

Issue: One class of exemption

Submission
(47 – New Zealand Law Society, 29 – Corporate Taxpayers Group, Issue raised by the Specialist Tax Advisor to the Finance and Expenditure Committee)

There should be only one class of new-resident certificate, which should apply to all migrants and returning New Zealanders. *(New Zealand Law Society)*

The two-tiered proposal is unnecessarily compliance cost intensive and a more simplistic and workable approach could be adopted. *(Corporate Taxpayers Group)*

The different treatment could send an adverse signal that New Zealand is more interested in attracting employees than the self-employed. *(Specialist Tax Advisor to the Finance and Expenditure Committee)*

Comment

Submitters argue that there should be no distinction between individuals who come to New Zealand for employment and those who come to New Zealand as contractors, investors, or business owners in their own right. This will encourage people to come to New Zealand to undertake employment, engage in entrepreneurial activities, or work as independent contractors.

The original proposal was to exempt employees only. However, during consultation it became evident that it would be desirable to cover independent contractors as well, to achieve the aims of the proposal. The problem is that it is difficult to develop laws to target only independent contractors. Legislative boundaries can be structured around (even by persons who are essentially retirees) and are difficult to enforce. Moreover, they can produce arbitrary results for taxpayers.

In order to include independent contractors, it was necessary to extend the proposal to all new migrants. Our preference is to provide a shorter exemption period of three years for all new migrants who have not been resident in New Zealand for at least ten years. A shorter exemption will accommodate independent contractors – who are generally in New Zealand for a shorter period of time than migrant employees – while mitigating any concern with retirees receiving a tax exemption.

Therefore, if we were to align the exemption periods, this would mean that individuals outside the target group of skilled workers will receive a longer period of exemption.

Officials acknowledge the concerns expressed by submitters and by the Specialist Tax Advisor to the Committee. However, aligning the periods would increase the fiscal cost of this proposal. We do not consider the benefits of alignment would outweigh these costs.

Recommendation

That the submission be declined.

Issue: Eligibility criteria – full time work test

Clause 170

Submission
(46 – PricewaterhouseCoopers, 25W – Deloitte, 29 – Corporate Taxpayers Group, 47 – New Zealand Law Society (alternative submission if submission above is not accepted), 48 – New Zealand Institute of Chartered Accountants)

An individual can receive an employed resident certificate if the individual is engaged in full-time employment 94 percent of the time. This allows three weeks to find employment. This is insufficient and the threshold should be lowered. The manner in which the test is to operate should also be clarified.

Comment

Some submitters viewed the 94 percent threshold as being too high because it creates a bias in favour of those with prearranged employment.

Officials acknowledge that a 94 percent test may be overly strict. On the other hand, it is still important to keep the threshold reasonably high to ensure the exemption applies to genuine employment cases. The concern is that if the threshold were lowered, the employee exemption would be much more widely available than intended. Ensuring this boundary is robust is important to maintain the integrity of the new rules. Also, it recognises the wider availability of the three-year general exemption.

In line with submissions, officials now recommend that the 94% threshold be reduced to 85%. This will give new migrants up to 54 days to find employment on arrival in New Zealand.

Recommendation

That the submission be accepted and the threshold be reduced to 85%.

Issue: Eligibility criteria – part-time work test

Submission
(47 – New Zealand Law Society; alternative submission if main submission is not accepted)

A person can receive an employed resident certificate if they are working part-time only if they earn $70,000 per annum, pro rata. This threshold is too high and should be reduced to $40,000.

Comment

The submission states that the threshold is such that persons who come to New Zealand seeking only part-time work in areas where there are skill shortages, such as nursing, would be ineligible for the five-year exemption.

Officials believe it is important to keep the threshold reasonably high to ensure the exemption is appropriately targeted. If the threshold were dropped, the employee exemption would be much more widely available than intended.

Recommendation

That the submission be declined.

Issue: Associated persons

Submission
(48 – New Zealand Institute of Chartered Accountants)

The employment exemption should be available to individuals who are associated with the employer.

Comment

The condition that the migrant employee cannot be associated with their employer is an anti-avoidance measure. It ensures that an individual cannot establish a fictional employment situation in order to receive the benefit of the longer exemption. It is difficult to draw legislative and administrative lines between legitimate and fictional employment situations where the employee is associated with their employer.

Legitimate business people will still be eligible for the general exemption.

Recommendation

That the submission be declined.

Issue: Exemption for dependent spouses

Clause 170

Submission
(46 – PricewaterhouseCoopers, 25W – Deloitte, 29 – Corporate Taxpayers Group, 48 – New Zealand Institute of Chartered Accountants)

Dependent spouses should be eligible for the exemption if the working spouse can obtain the exemption.

Comment

Not allowing an exemption for a dependent spouse could result in inequitable and complex treatment where assets may be jointly held. Therefore, officials agree that the exemption should be extended to dependant spouses. This is also consistent with the treatment of dependent children under the amendments.

Recommendation

That the submission be accepted.

Issue: Existing New Zealand residents and application date

Clause 22

Submission
(46 – PricewaterhouseCoopers, 25W – Deloitte, 29 – Corporate Taxpayers Group)

The exemption should apply to individuals who are already in New Zealand, who would otherwise be eligible for the exemption. *(PricewaterhouseCoopers, Deloitte)*

The exemption should apply from 1 April 2006 to all individuals who arrive in New Zealand after the date the bill was introduced (19 May 2005). *(Corporate Taxpayers Group)*

Comment

The submitters argue that the amendments provide no incentive for current migrants to stay. Therefore, consideration should be given to extending the amendments to migrants already in the country if they would otherwise have been eligible. The employee would be entitled to the exemption for the balance of the five years from 1 April 2006.

Officials do not consider that retrospective application of the exemption can be justified. It is not desirable to signal that the exemption will apply prior to the legislation being enacted, because of potential changes to the design of the exemption that may occur during the legislative process.

It is our understanding that new and returning New Zealanders would prefer a set application date and a set date of arrival for certainty of treatment. Furthermore, those who arrive in New Zealand before 1 April 2006 will not be sensitive to New Zealand tax, as they had already chosen to come to New Zealand.

Recommendation

That the submission be declined.

Issue: Changing exemptions

Submissions
(48 – New Zealand Institute of Chartered Accountants, 25W – Deloitte, 29 – Corporate Taxpayers Group)

Individuals should be able to qualify for the employed temporary resident exemption after they have qualified for the general resident exemption, providing they meet the criteria. *(New Zealand Institute of Chartered Accountants)*

New migrants who are eligible only for the general three-year certificate should be able to apply for an extension of two years if they meet the employment test. *(Deloitte, Corporate Taxpayers Group)*

Comment

The submissions are inconsistent with the policy objective of maintaining the distinction between the two exemptions. The employee five-year exemption accommodates individuals with long employment contracts. The general three-year exemption is designed for individuals who are in New Zealand on short-term contracts, as independent contractors.

Recommendation

That the submission be declined.

CERTIFICATION PROCESS

Clause 170

Submissions

(46 – PricewaterhouseCoopers, 11W – Business New Zealand, 48 – New Zealand Institute of Chartered Accountants, 47 – New Zealand Law Society)

It should be possible for the application for a certificate to be made up to one month before the due date for the tax return to be filed. *(PricewaterhouseCoopers)*

The level of complexity that is involved in applying for the exemption is of concern. Inland Revenue should take steps to ensure that the changes are clearly advertised and explained to all prospective applicants. *(Business New Zealand)*

The new resident certification process should be done away with entirely. Individuals should be able to "self-assess" their eligibility on their tax return. *(New Zealand Institute of Chartered Accountants)*

Sections 91L to 91O inclusive should be omitted entirely. *(New Zealand Institute of Chartered Accountants)*

The words "for a time" and "at a time" in new section 91L of the Tax Administration Act 1994 are not necessary. *(New Zealand Law Society)*

Comment

There is some concern around the certification process and its complexity. Officials have reviewed the need for a certification process.

Individuals who rely on the exemption should comply with New Zealand's tax laws once the period of exemption expires. To this end, a certification requirement was included in the proposed legislation. An individual would apply for a certificate of exemption, and Inland Revenue would issue a certificate confirming that the individual met the residence criteria for the exemption. However, this process requires unnecessary contact by taxpayers with Inland Revenue.

After further consideration, officials believe Inland Revenue's current risk management approach in identifying and profiling those eligible for the exemption will be adequate.

Recommendation

That the submissions are noted and the certification process is removed from the bill.

SHARE OPTIONS

Clause 14

Submissions
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The legislation should be clarified to state whether it is the date the option is granted or the vesting period that is relevant for the exemption. *(PricewaterhouseCoopers)*

A rule will be required to apportion gain attributable to periods when the person is a non-resident if the gain is derived over both periods. *(New Zealand Institute of Chartered Accountants)*

Comment

Submitters are uncertain about the effect of this clause. Clause 14 refers to "the period of employment that gives rise to the benefit or part of the benefit" when non-resident. This means that when a share option is granted in relation to employment while the individual is non-resident, and the individual chooses to exercise the option while claiming the exemption, there will be no New Zealand tax impost.

However, when the employment services to which a share option relates have been provided both overseas and in New Zealand, an allocation rule is required. The allocation method would simply be a straight-line day counting test.

Recommendation

That the submission be noted and the drafting clarified.

Submission
(48 – New Zealand Institute of Chartered Accountants)

Section CE 2 should be amended to include all tax residents who derive an employee share option benefit, not just those categories of temporary residents that are eligible for the exemption.

Comment

Individuals coming to New Zealand will be eligible for the general exemption provided they have not been tax-resident in New Zealand for at least ten years.

The submission says that the issue of share option schemes held offshore and exercised when the individual is resident in New Zealand for tax purposes should be addressed.

The submission is outside the scope of this policy initiative of relieving tax on foreign sourced income.

Recommendation

That the submission be declined.

TRUSTS

Clause 86

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

The wording of clause 86 does not make it clear to whom the concession applies and the position of returning New Zealanders with foreign trusts should be clarified. *(PricewaterhouseCoopers)*

Section HH 2 should be amended to better deal with returning residents. *(New Zealand Institute of Chartered Accountants)*

Comment

Currently, new migrants who have settled a trust offshore have 12 months to elect to make the trust a qualifying trust for New Zealand tax purposes. Clause 86 defers the election until 12 months following the end of the exemption.

It has been submitted that a New Zealander who settles a foreign trust while tax non-resident cannot elect into the qualifying trust regime upon their return to New Zealand.

Officials disagree with these submissions. The changes in clause 86 extend the election period to returning New Zealanders. Under the proposed rules, when a New Zealander who is eligible for the exemption settles a trust prior to their return, that trust will be deemed to be a foreign trust up until the date that they elect into the qualifying trust regime.

Recommendation

That the submission be declined. However, officials will clarify the application of this section in the *Tax Information Bulletin.*

Submission
(48 – New Zealand Institute of Chartered Accountants)

The 12-month election rule in section HH 2 should be changed to 24 months.

Comment

This submission is outside the scope of this policy initiative of relieving tax on foreign-sourced income.

Recommendation

That the submission be declined.

Submission
(48 – New Zealand Institute of Chartered Accountants, matter raised by officials)

Section EW 5(15B) should apply to a financial arrangement with a non-resident that was entered into after the person became a resident.

Comment

It was submitted that if individuals vary their financial arrangements after becoming resident, the exclusion should cover these arrangements also.

Officials believe that this is a consequential change that needs to happen if the scope of the exemption is extended to cover interest.

Recommendation

That the submission be accepted.

Submission
(48 – New Zealand Institute of Chartered Accountants)

Removing the requirement to withhold non-resident withholding tax on foreign mortgages should be extended to the removal from the agency rules as well.

Comment

An amendment to section NG 2(1)(b) removes the requirement for non-residents to be liable for non-resident withholding tax on foreign mortgages – provided that the interest payment is paid by a certified resident. The submitter asks whether we need to turn off the agency rules in sections HK 16–26 for individuals who are eligible for the exemption.

Even though the individual will technically remain an agent of the mortgagee, the liability to pay non-resident withholding tax will be removed by the amendment to section NG 2(1)(b).

Recommendation

That the submission be declined.

FAMILY ASSISTANCE IMPLICATIONS

Submission
(48 – New Zealand Institute of Chartered Accountants)

The rebate apportionment rules should also apply in addition to the definition of "qualifying person" in section KD 3 and in section OB 1.

Comment

After clarification with the submitter, it is submitted that individuals eligible for the exemption should not be eligible to receive the low income rebate in section KC 1. Although this will be desirable, systematically it would be difficult to achieve.

Recommendation

That the submission be declined.

Submission
(Matter raised by officials)

The bill amends the definition of "qualifying person" for the purpose of section KD 3. The effect of these amendments is intended to be that an individual who has a new-resident certificate will be ineligible to receive family assistance payments. The bill should also amend the definition of "principle caregiver".

However, it appears that after the current amendment has been enacted, an individual who is eligible for the exemption may still be eligible to receive an in-work payment. To be eligible to receive an in-work payment, a person must be a "principal caregiver" and not necessarily a "qualifying person", as required for the other forms of family assistance.

Currently the bill does not amend the definition of "principal caregiver" and it is arguable that a new resident can be a "principal caregiver" and meet other requirements for obtaining an in-work payment.

Recommendation

That the submission be accepted.

IMMIGRANTS' FOUR-YEAR EXEMPTION FROM CERTAIN FIF INTERESTS

Submission
(46 – PricewaterhouseCoopers)

The new provisions outlined in clause 72 should be added to, rather than replace, section EX 35.

Comment

Currently section EX 35 provides relief from the foreign investment fund rules for individuals resident in New Zealand who will not be eligible for the exemption. Under clause 72 this will no longer apply and individuals with a foreign superannuation fund or foreign life insurance policy will no longer be able to rely on the four-year exemption.

Recommendation

That the submission be accepted. However, the current section EX 35 will expire on 1 April 2010, and clause 72 will apply.

DISCLOSURE

Submission
(48 – New Zealand Institute of Chartered Accountants)

There do not need to be specific exclusions, apart from the specific exclusion from disclosure.

Comment

The submitter argues that as the changes to section EX 16 and section EX 35 effectively mean that an individual eligible for the exemption will not have an interest in a CFC or a FIF, they will have no disclosure requirement under section 61 of the Tax Administration Act. Consequently no changes are required to section 61.

Officials agree with this submission and recommend that the changes to section 61 in the bill be removed.

Recommendation

That the submission be accepted.

OTHER

Submission
(48 – New Zealand Institute of Chartered Accountants)

The *Tax Information Bulletin* should highlight that rental losses on property owned offshore and rented will not be deductible in New Zealand.

Recommendation

That the submission be accepted.

Submission
(46 – PricewaterhouseCoopers)

A "living away from home" allowance should be introduced so that New Zealand is more competitive internationally.

Comment

The proposals do not address other costs incurred by New Zealand businesses to attract international recruits such as "tax-free" packages. These packages often include housing allowances, reimbursement or contributions to utility expenses, return airfares home and continued contributions to home-country superannuation/pension plans. New Zealand businesses usually incur the tax costs of such benefits.

The submission requested that the government should introduce a "living away from home" allowance to become more competitive with Australia. The Australian concession allows for tax-free accommodation, together with assisted tax-free food costs and provides concessions for those who are truly working away from home on a temporary basis.

The proposal is outside the scope of this policy initiative of relieving tax on foreign-sourced income. However, the broad direction of tax reform in recent times has been to remove exemptions of this sort.

Recommendation

That the submission be declined.

DRAFTING ISSUES

Submission
(47 – New Zealand Law Society)

The concept of a "period of time" has the potential to create unnecessary confusion.

Comment

The proposed removal of the certification process removes the need for this phrase.

Recommendation

That the submission be noted.

Submission
(47 – New Zealand Law Society)

The concept of "last becoming a New Zealand resident" causes confusion.

Comment

The phrase "last becoming a New Zealand resident" arises because the legislation needs to deal with a person who becomes a New Zealand resident after having previously become a New Zealand resident and then being a non-resident. Officials recommend that the drafter be asked to consider whether the use of "last", or an equivalent, is necessary.

Recommendation

That the submission be noted and the drafter asked to consider whether the use of "last", or an equivalent, is necessary.

Submission
(47 – New Zealand Law Society)

The words "maintained as a member of the family" are confusing.

Comment

The phrase "maintained as a member of the ... family" is used in the current definition of "dependent child" in the Income Tax Act 2004. It is also used in the definition of "dependent child" in s30(5) of the Child Support Act 1991. We are unaware of any significant confusion the phrase has caused in the history of its use.

Recommendation

That the submission be declined.

Submission
(48 – New Zealand Institute of Chartered Accountants)

The term "certified resident" should be replaced by "temporary resident".

Comment

The term "certified resident" has been superseded, due to the removal of the certification process. However, the residency of the affected individuals is not "temporary". It is their proposed status that is temporary. Therefore, officials recommend that the term "certified resident" be replaced by a phrase that indicates the transitional nature of the exemption.

Recommendation

That the submission be declined. The term "certified resident" will be replaced by a phrase that indicates the transitional nature of the exemption.

Submission
(48 – New Zealand Institute of Chartered Accountants)

Section 91K should be split into three sections that respectively deal with general, employee and dependent temporary residents.

Comment

Section 91K, as it is, will no longer be needed if the certification process is removed. However, a new eligibility section, very similar to this, would be needed. However, officials feel that there is merit in asking the drafter to consider whether the replacement for section 91K should have a different structure.

Recommendation

That the submission be noted.

Submission
(48 – New Zealand Institute of Chartered Accountants)

Section 91K (6)(b) should state "has not been tax resident for at least ten years".

Comment

Officials consider that both formulations can be interpreted as a requirement that the person had been resident in New Zealand for less than ten years. The current formulation is not unambiguous.

Recommendation

That the submission be noted.

Submission
(48 – New Zealand Institute of Chartered Accountants)

Section 91K (2)(e) is cumbersome and needs rewriting.

Comment

The detail in this section arises from the width of the definition of "source deduction payment" and the policy requirements to limit the types of remuneration that qualify a person to have the proposed exemption. There is no suitable alternative to "source deduction payment" that has a narrower meaning.

Recommendation

That the submission be declined.

Submission
(48 – New Zealand Institute of Chartered Accountants)

The amendment to Part CW should include a general amendment that would cover all income types that these rules seek to exclude from the income of the temporary resident for the relevant period.

Comment

The approach of the Income Tax Act 2004 is to notify users of the relationship between related provisions, if possible. If a general exclusion was used, amendments to affected provisions would still be required. Officials therefore do not think that the result would be any simpler.

Recommendation

That the submission be declined.

Submission
(48 – New Zealand Institute of Chartered Accountants)

Section CW 22B doubles up by potentially exempting income arising under the FIF and CFC rules in addition to the amendment that treats these people as not holding FIF or CFC interests, and in addition to the amendments that exclude CFC and FIF income and losses arising.

Comment

Section CW 22B is required as the section exempts foreign-sourced amounts that are not CFC or FIF income.

Recommendation

That the submission be declined

Submission
(48 – New Zealand Institute of Chartered Accountants)

The amendments to sections EX 16 and EX 35 mean that the person is not regarded as holding an interest in a CFC or a FIF if they are a qualifying person under these rules. There is no need to further amend the CFC or FIF rules.

Comment

This submission suggests that the amendments to sections such as CQ 2 and CQ 5 and the loss rules are unnecessary.

These amendments are necessary as they are consistent with the current drafting approach of the Income Tax Act 2004.

Recommendation

That the submission be declined.

Submission
(48 – New Zealand Institute of Chartered Accountants)

An exemption method should be considered for the accrual rules.

Comment

The amendments to the financial arrangement rules extend the approach that the rules currently adopt towards non-residents who are parties to financial arrangements. It is logical to adopt the same approach towards residents who qualify for the exemption. In addition, it would be unnecessary for the financial arrangements rules to require a resident to calculate a figure that would be treated as exempt income.

Recommendation

That the submission be declined.

Information-reporting and record-keeping requirements for foreign trusts

OVERVIEW

Clauses 87, 155(2), (12) and (14), 156, 162 and 182

The bill introduces new information-reporting and record-keeping requirements for foreign trusts that will enable New Zealand to meet its exchange of information obligations with its double tax agreement (DTA) partners, especially Australia. These requirements will also ensure that New Zealand is better placed to meet its international obligations as a member of the international community and organisations such as the Organisation for Economic Co-operation and Development (OECD).

A foreign trust is a trust that has had no New Zealand-resident settlor from the later of 17 December 1987 or the date that the first settlement was made to the trust. Under current tax law, a New Zealand-resident trustee of a foreign trust that receives foreign-sourced income (a "targeted" trust) is not required to provide information to Inland Revenue or keep records for New Zealand tax purposes about that foreign income.

Information relating to foreign income of foreign trusts may be requested by foreign tax authorities under the exchange of information provisions in New Zealand's DTAs. As targeted foreign trusts are not required to provide that information to Inland Revenue, there is a risk that New Zealand may be unable to provide foreign tax authorities with the information requested.

While the size of the problem is not readily definable, failure to provide information will impact negatively on New Zealand's relationship with its DTA partners. Australian authorities, in particular, are concerned that foreign trusts are being established in New Zealand that have the effect of causing Australian tax to be avoided.

The OECD has recently developed minimum standards to improve greater transparency and exchange of information between foreign tax authorities and to encourage international co-operation on tax matters. Unless New Zealand is in a position to exchange information on the foreign income of foreign trusts that are administered by New Zealand-resident trustees, New Zealand will not be compliant with these standards.

The requirements introduced in the bill impose obligations on New Zealand-resident trustees of foreign trusts to disclose limited information to Inland Revenue and to keep financial and other records relating to each foreign trust for New Zealand tax purposes. Failure to comply with these requirements may result in a New Zealand-resident trustee being subject to sanctions, such as prosecution for failure to keep or provide information. In limited circumstances, the foreign trust may be treated as being taxable in New Zealand on its worldwide income.

Eight submissions were made relating to the new requirements for foreign trusts. Most submissions were critical of the new requirements, in particular, submitters complained that the requirement for each foreign trust to have at least one qualifying New Zealand-resident trustee was too onerous and that the sanctions for non-compliance were illogical, misdirected and unfair. The majority of officials' recommendations are aimed at dealing with these concerns by improving the overall fairness and balance of the foreign trust requirements. The requirements as amended by the recommendations in this report are briefly explained below.

The Finance and Expenditure Committee has heard two submissions that questioned the legality of automatically providing foreign trust information to Australia and whether New Zealand has a current legal obligation to provide foreign trust information in response to an exchange of information request under its DTAs. These submissions were of particular concern to the Committee. It is the view of officials that the new foreign trust requirements are consistent with current tax law, the exchange of information provisions in New Zealand's DTAs, and international standards of transparency and effective exchange of information between foreign tax authorities. Officials' analysis and views on these submissions are set out in the chapter, "Validity of the new requirements" on page 227.

New requirements as amended

The new requirements for foreign trusts, as amended by the recommendations of this report, take into account the need to create the right incentives for New Zealand-resident trustees to comply with the requirements, while protecting those trustees who genuinely do not have knowledge of these requirements from potentially onerous tax and compliance costs.

Under the requirements originally proposed in the bill, a New Zealand-resident trustee would have been required to disclose limited information and keep certain financial and other records and provide these records to Inland Revenue, if requested. The foreign trust was also required to have at least one qualifying New Zealand-resident trustee. If the trustee did not comply with the requirements, sanctions would have applied and, in some instances, the foreign trust would have been subject to tax on its worldwide income.

These requirements would have been particularly harsh for non-professional trustees of family trusts or private estates or for trustees who are not in the business of providing trustee services. For example, a person who migrated to New Zealand from the United Kingdom before 1 April 2006 (the proposed date the new requirements come into effect), and who is also a trustee of his or her parents' estate would have been caught by the new requirements. Most people in this situation would not have been aware that the new requirements applied to them.

Under the new requirements as amended by the recommendations in this report, there will be no requirement for a trustee to become a qualifying New Zealand-resident trustee and a New Zealand-resident trustee will be subject to sanctions only if he or she "knowingly" fails to disclose information or keep or provide records to Inland Revenue, as required under the law. Whether the trustee is aware of his or her tax responsibilities is a question of fact to be determined on a case-by-case basis, although it will be assumed that "professional" trustees or those trustees who are in the business of providing trustee services will be aware of the new requirements.

If a New Zealand-resident trustee knowingly does not comply with the new requirements, Inland Revenue can prosecute the trustee under section 143A of the Tax Administration Act and, if convicted, the trustee will be subject to a monetary fine and/or a term of imprisonment. Additionally, the world-wide income of the foreign trust will be subject to tax in New Zealand. The penalty for non-compliance and the taxing penalty are considered necessary to deal with serious recalcitrant trustees.

If the New Zealand-resident trustee is a "qualifying New Zealand-resident trustee", or a co-trustee that meets the qualifying status has been appointed to the trust, the trust will never be subject to tax on its worldwide income. These trusts will effectively enjoy a safe-harbour treatment from the taxing penalty. New Zealand-resident trustees can become a "qualifying New Zealand-resident trustee", or appoint a co-trustee who meets the qualifying New Zealand-resident trustee criteria, at any time to qualify for the safe-harbour treatment.

The possibility of conviction under section 143A of the Tax Administration Act should provide sufficient incentive for qualifying New Zealand-resident trustees to comply with the new requirements. If a qualifying New Zealand-resident trustee is convicted of the above offence, it will become a matter of public record and Inland Revenue will bring the matter to the attention of the trustee's professional body. It will be left to the professional body to determine what action should be taken against its members.

The new requirements as amended by the recommendations in this report were developed in response to the submissions and in consultation with the Committee's specialist tax advisor, Ms Therese Turner.

APPLICATION DATE FOR NEW REQUIREMENTS

Submission
(Matter raised by officials)

The application date for the new requirements should be 1 October 2006, rather than 1 April 2006. This change would allow more time for the new requirements to be implemented.

Comment

The current application date of 1 April 2006 does not give sufficient time for Inland Revenue to publicise the new requirements, implement internal procedures to support the requirements or publish guidelines for organisations seeking "approved organisation" status. In addition, existing trustees of foreign trusts will need to develop an appreciation of the new obligations, decide whether the trust should continue to be administered in New Zealand and, if so, make the required disclosure to Inland Revenue within 60 days of the date of the commencement of the new requirements. For trustees appointed on or after 1 April 2006, they will have 30 days to make the required disclosure. Officials recommend, therefore, that the new requirements apply from 1 October 2006.

Recommendation

That the submission be accepted.

VALIDITY OF THE NEW REQUIREMENTS

Issue: No current obligation to collect foreign trust information

Submission
(47 – New Zealand Law Society)

The new requirements should not be imposed, as they are predicated on the misconception that New Zealand requires information about certain foreign trusts to be in a position to meet its international commitments and obligations under its double tax agreements.

Comment

The submission provides technical arguments that there is no current obligation under New Zealand's double tax agreements to obtain foreign trust information. As such, the submission contends that the entire predication on which the amendments are based is invalid.

The rationale for the amendments was the need "to ensure that New Zealand can meet its international obligations, such as satisfying requests for information from countries with which New Zealand has a double tax agreement". The emphasis on "international obligations" refers primarily to new minimum standards of transparency and effective exchange of information adopted by both the European Union and the OECD. Such standards of transparency and effective exchange of information are reflected in the 2002 OECD *Model agreement on exchange of information in tax matters* and the revised "Exchange of Information" Article inserted in the 2005 update of the OECD *Model tax convention on income and on capital*.

In addition, in 2003 the New Zealand Minister of Finance, Hon Dr Michael Cullen, and the Australian Treasurer, Hon Peter Costello, agreed to New Zealand and Australia entering into a partnering arrangement for jointly negotiating Tax Information Exchange Agreements (TIEAs) with jurisdictions identified by the OECD as meeting the criteria of a "tax haven". New Zealand has commitments both as an OECD member and because of its political relationship with Australia to support the new standards of transparency and effective exchange of information and to encourage the adoption of those standards by other countries. New Zealand should also take seriously Australia's concerns that New Zealand-based foreign trusts with Australian settlors have the effect of avoiding Australian tax.

The technical argument that New Zealand's current double tax agreements do not require the collection of information on foreign trusts does not take these factors into account. The NZLS's argument is based on the current wording of the Exchange of Information Article in the DTA between New Zealand and Australia.

The current wording of Article 26 of the New Zealand/Australia DTA provides that:

> (1) The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Agreement or of the domestic law of the Contracting States concerning the taxes to which this Agreement applies insofar as the taxation under that law is not contrary to this Agreement…
>
> (2) In no case shall the provisions of paragraph 1 be construed so as to impose on the competent authority of a Contracting State the obligation:
>
> (a) to carry out administrative measures **at variance with the law or administrative practice** of that or the other Contracting State;
>
> (b) to supply information which is not obtainable **under the law or in the normal course of the administration** of that or of the other Contracting State; or
>
> (c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or to supply information the disclosure of which would be contrary to public policy."
>
> [Emphasis added]

An amendment to the wording of Article 26 of the New Zealand/Australia DTA has been negotiated, formally signed by the two respective governments, and is due to come into force early this year. The new wording follows that made by the OECD to the "Exchange of Information" Article in the OECD *Model tax convention on income and on capital*. It therefore adopts the new OECD standards.

The NZLS also argues that at present New Zealand does not have any obligation to provide information concerning New Zealand-based foreign trusts to any of its treaty partners. This is because providing such information would be "at variance with the law or administrative practice" of New Zealand and would not be able to be obtained "under the law or in the normal course of the administration" of New Zealand. In other words, New Zealand has no interest in obtaining information concerning New Zealand-based foreign trusts unless those foreign trusts derive New Zealand-sourced income.

Officials do not agree with the NZLS view. Officials note that the commentary on the OECD *Model tax convention on income and on capital* (at paragraph 16) states that information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination.

The new Article 26 of the New Zealand/Australia DTA provides that:

> (1) The competent authorities of the Contracting States shall exchange such information as is forseeably relevant for carrying out the provisions of this Agreement or to the administration or enforcement of the domestic law concerning taxes referred to in Article 2, insofar as the taxation thereunder is not contrary to the Agreement. The exchange of information is not restricted by Article 1.

(2) Any information received under paragraph 1 by a Contacting State shall be treated as secret in the same manner as information obtained under the domestic law of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, the determination of appeals in relation to, the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

(3) In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the law and administrative practice of that or of the other Contracting State;

(b) to supply information which is not obtainable by the competent authority under the law or in the normal course of the administration of that or of the other Contracting State;

(c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

(4) If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

(5) In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

The main rule concerning the exchange of information is contained in the first sentence of paragraph 1. It provides that information may be exchanged not only for the purposes of the provisions of the DTA but for the “administration or enforcement of the domestic law”. On this basis, officials consider that New Zealand will be obliged to provide information to Australia for the purposes of administering or enforcing their tax laws, which would extend to information concerning Australian residents who use trusts with New Zealand-resident trustees to undertake their income earning activities. The information would be used to determine whether these people are being correctly taxed in Australia.

Paragraph 4 of the new Article provides that the reasons contemplated in paragraph 3 for denying a request cannot “be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information”. This directly answers the NZLS’ concern that New Zealand has no domestic tax interest in the information concerning New Zealand-based foreign trusts and that paragraph 3 can therefore be relied upon to deny any request from Australia to provide that information. The fact that New Zealand does not tax certain foreign trusts is of no relevance and cannot be used to decline a request.

Furthermore, paragraph 3 states that the Article should not be construed as imposing an obligation "to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State". On the enactment of the proposed requirements, obtaining information on New Zealand foreign trusts is not at variance with domestic law.

The new exchange of information Article is now the model that New Zealand will use in all current and future DTA negotiations with other countries.

Recommendation

That the submission be declined.

Issue: Automatic provision of information to Australia – "unlawful"

Clause 162

Submission
(4 – NZ Trustee Companies Association Ltd and the Society of Trust and Estate Practitioners)

The automatic exchange of information with Australia in connection with all New Zealand foreign trusts which have an Australian settlor would appear to be a blatant breach of international tax law principles and the provisions of the Tax Administration Act 1994 and the provisions of the current Australian/New Zealand DTA.

Comment

As proposed, if information provided by a trustee indicates that a settlor of a trust is an Australian resident, Inland Revenue would request further information from the trustee on an annual basis (such as financial records, details relating to distributions to beneficiaries and the identity of the settlor). This information would be provided automatically to the Australian Tax Office (ATO) on an annual basis. The ATO has indicated that the provision of this information by Inland Revenue would satisfy its requirements.

Officials do not agree that the automatic exchange of information with Australia is unlawful. The recently updated commentary on the OECD *Model tax convention on income and on capital* explains that paragraph 1 of the exchange of information Article allows information to be exchanged in three different ways:

- upon request, with a special case in mind;
- spontaneously, when a Contracting State has acquired information which it supposes to be of interest to another Contracting State;

- automatically, when information received by a Contracting State meets certain criteria agreed with another Contracting State and is provided to that State on a systematic basis.

The new requirements would merely put New Zealand in a position to exchange certain information automatically with Australia.

The OECD commentary also states that the Article does not restrict the possibilities of exchanging information to these three methods and that Contracting States may use other techniques to obtain information, such as simultaneous examinations, tax examinations and industry-wide exchanges of information.

Any information provided by a trustee would be subject to the existing tax confidentiality provisions. Section 81 of the Tax Administration Act prevents Inland Revenue from providing information to a foreign jurisdiction except as permitted by section 88 of that Act – under a DTA. Therefore, the automatic provision of information concerning New Zealand-based foreign trusts with Australian settlors to Australia would not contravene the provisions of the Tax Administration Act.

Recommendation

That the submission and officials' views be noted.

Issue: Valid information requests under a TIEA or DTA

Submission
(4 – NZ Trustee Companies Association Ltd and the Society of Trust and Estate Practitioners)

The bill should specifically provide that information requests made by Inland Revenue in relation to New Zealand foreign trusts should be made only in response to valid information requests made under a DTA or Tax Information Exchange Agreement (TIEA). This would prevent Inland Revenue from going on "fishing expeditions" at the behest of foreign tax authorities by making blanket requests for information that are not related to specific taxpayers.

Comment

Officials do not consider that such a provision is necessary. As noted in the commentary to the bill, information will be provided to New Zealand's DTA partners on a case-by-case request basis except for Australia, when Inland Revenue considers there are valid grounds for requesting the information.

The 2002 OECD *Model agreement on exchange of information in tax matters* (for TIEAs) is explicitly limited to information on request and prohibits fishing expeditions.

The revised "Exchange of Information" Article in the 2005 update of the OECD *Model tax convention on income and on capital* is not limited to information on request as noted in the previous comment. The OECD commentary explains that the revised Article is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to engage in fishing expeditions or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer.

Recommendation

That the submission be declined.

SANCTIONS FOR NON-COMPLIANCE

Issue: Proposed sanctions are "illogical", "misdirected" and "unfair"

Submissions

(4 – NZ Trustee Companies Association Ltd and the Society of Trust and Estate Practitioners, 47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

New section HH 4(3BB) of the Income Tax Act 2004, which imposes tax on the worldwide income of a foreign trust, is not supported. Imposing New Zealand tax on the worldwide income of a foreign trust is illogical, inconsistent with the scheme and purpose of New Zealand's tax legislation, discriminatory and unconstitutional. *(NZ Trustee Companies Association Ltd and the Society of Trust and Estate Practitioners, New Zealand Law Society, New Zealand Institute of Chartered Accountants)*

Non-compliance with the new requirements should be dealt with by the application of penalties to the New Zealand-resident trustee, as presently provided for in new section 143(1)(d) of the Tax Administration Act 1994, as well as the existing provisions of that Act. *(NZ Trustee Companies Association Ltd and the Society of Trust and Estate Practitioners, New Zealand Institute of Chartered Accountants)*

Penalties or tax should arise when a trustee fails to provide information, as this is when the mischief arises, not merely because a New Zealand-resident trustee does not qualify, or because the foreign trust has no qualifying New Zealand-resident trustee. There is no automatic connection between a trust that has no qualifying New Zealand-resident trustee and that trust failing to provide information. Therefore, the sanctions should apply to the failure to provide information only. The requirement to have a qualifying New Zealand-resident trustee is discriminatory as it presumes that people who do not belong to certain professions can be less trusted to meet their tax obligations (as a trustee) than non-professionals. If new section HH 4(3BB) is enacted, the new requirements should be redrafted to impose a tax liability or penalty only if a New Zealand-resident trustee does not comply with the record-keeping requirements in section 22 of the Tax Administration Act or the disclosure requirements in new section 59B(1) of the Tax Administration Act. *(New Zealand Law Society)*

Comment

As proposed in the bill, the sanctions for failing to comply with the new information-reporting and record-keeping requirements are:

- If a qualifying New Zealand-resident trustee does not disclose information or keep or provide records as required by law, the trustee will commit an offence under section 143 or 143A of the Tax Administration Act and, if convicted, will be subject to a monetary fine.

- If a New Zealand-resident trustee is not a qualifying New Zealand-resident trustee, the trustee will commit an offence under new section 143(1)(d) of the Tax Administration Act and, if convicted, will be subject to a monetary fine. If the trustee does not become a qualifying New Zealand-resident trustee (or have a co-trustee appointed who satisfies this requirement) within 30 days of receiving notice from Inland Revenue of its intention to prosecute (for failure to be a qualifying New Zealand-resident trustee), the worldwide income of the foreign trust will be subject to tax.
- If the New Zealand-resident trustee is not a qualifying New Zealand-resident trustee and the records requested by Inland Revenue are not produced, the worldwide income of the foreign trust will be subject to tax for the income years for which the records cannot be produced. The trustee may also be prosecuted for failure to keep or provide records or for failure to be a qualifying New Zealand-resident trustee.

The qualifying New Zealand-resident trustee requirement is intended to ensure that there is local accountability and that there is a person located in New Zealand who has the necessary expertise and incentive to maintain records of the required standard and who will comply with the law.

Officials believe the current proposed sanctions can be amended to address the concerns raised in submissions without compromising the stated policy objectives of the new requirements. This result can be achieved by:

- removing the criminal penalty that applies to New Zealand-resident trustees for failure to be a "qualifying New Zealand-resident trustee";
- restricting the sanctions for non-compliance to the knowledge offence in section 143A of the Tax Administration Act, which would apply if a New Zealand-resident trustee "knowingly" fails to disclose information or keep or provide records, as required by law; and
- limiting the taxing penalty in new section HH 4(3BB) to serious recalcitrant trustees who are not qualifying New Zealand-resident trustees and who do not provide the information requested.

The effects of these changes on the new requirements are outlined below.

The requirement that at least one New Zealand-resident trustee must be a qualifying-resident trustee will no longer apply. Therefore, non-professional trustees may act as a trustee for a foreign trust and, as long as they comply with the new requirements, sanctions will not apply to them.

Sanctions will only begin if a New Zealand-resident trustee "knowingly" fails to comply with the new requirements. The criminal penalty for failure to disclose information or maintain records as required by law in section 143 of the Tax Administration Act will not apply to New Zealand-resident trustees of foreign trusts. It is now recognised that had this penalty applied it would have created unfair results, especially for non-professional trustees of family trusts or estates and those trustees who are not in the business of providing trustee services.

If a New Zealand-resident trustee has failed to comply with the new requirements but was not aware of these requirements, sanctions will not apply. As a matter of practice, Inland Revenue will notify the trustee of his or her tax responsibilities as a trustee of a foreign trust, seek the required limited information disclosure and outline the record-keeping requirements. Whether the trustee is aware of his or her tax responsibilities will be a question of fact to be determined on a case-by-case basis, although it can be reasonably assumed that "professional" trustees and those trustees in the business of providing trustee services will be aware of the new requirements.

If a New Zealand-resident trustee has failed to comply with the new requirements and the trustee ought to have known about his or her tax responsibilities as a trustee of a foreign trust, the trustee will be in breach of section 143A of the Tax Administration Act and, if convicted, will be subject to a monetary fine and/or imprisonment. When the non-compliance is first detected, Inland Revenue will notify the trustee of its intention to prosecute for the breach if the requirements are not met. If the trustee fails to comply with the terms of the notification, Inland Revenue will commence prosecution proceedings.

If a non-compliant New Zealand-resident trustee is not a qualifying New Zealand-resident trustee and the trustee has been convicted of an offence under section 143A of the Tax Administration Act and has not provided the requested information, the world-wide income of the foreign trust will be subject to tax in New Zealand. This tax liability ceases when the New Zealand-resident trustee has provided the required information.

If a non-compliant New Zealand-resident trustee is a "qualifying New Zealand-resident trustee", the sanctions for non-compliance will be limited to the penalty in section 143A of the Tax Administration Act. Therefore, foreign trusts that have at least one qualifying New Zealand-resident trustee will never be subject to tax on their worldwide income – they will effectively enjoy a safe-harbour treatment. Because qualifying New Zealand-resident trustees may be subject to disciplinary action by their professional bodies, officials consider that this will create sufficient incentive to comply.

Officials consider that the proposed changes will improve the overall fairness and balance of the sanctions for non-compliance by targeting the actual mischief when it arises. The retention of the tax penalty, however, is considered necessary to deal with serious recalcitrant trustees.

Recommendation

That the submissions be accepted in part.

Officials recommend that:

- the taxing penalty in new section HH 4(3BB) of the Income Tax Act 2004 apply to New Zealand-resident trustees but not qualifying New Zealand-resident trustees. The taxing penalty ceases to apply when the New Zealand-resident trustee provides the required information;

- the criminal penalty in section 143 of the Tax Administration Act 1994 not apply to New Zealand-resident trustees of foreign trusts;
- the criminal penalty in section 143A of the Tax Administration Act 1994 apply to New Zealand-resident trustees who knowingly fail to disclose information or maintain financial records as required by law;
- the criminal penalty in new section 143(1)(d) of the Tax Administration Act be removed.

Issue: Penalties should not apply if a foreign trust has a qualifying New Zealand-resident trustee

Submission
(48 – New Zealand Law Society)

New section HH 4(3BB) of the Income Tax Act 2004 and new section 143(1)(d) of the Tax Administration Act 1994 should be amended to ensure that they will not impose tax or penalties as long as the foreign trust has at least one qualifying New Zealand-resident trustee.

Comment

If the recommendations on pages 235–236 are accepted, a qualifying New Zealand-resident trustee who complies with the new requirements will not be subject to the proposed penalties, nor will the foreign trust be subject to tax on its worldwide income.

Recommendation

That the submission be accepted.

Issue: Penalties should apply to the corporate trustee – not their employees

Submission
(30 – NZ Trustee Association)

Penalties for non-compliance should apply to corporate trustees and not their employees. The bill should provide that corporate trustees, and not their employees, should be penalised for non-compliance with the new requirements. The Association is concerned that corporate trustees could nominate their in-house accountants or lawyers for the purposes of meeting the criteria of a "qualifying New Zealand-resident trustee" even though they might not be subject to the full jurisdiction of their respective professional bodies.

Comment

The policy intention is to impose sanctions for non-compliance on the New Zealand-resident trustee. If the trustee is a corporate trustee, it is intended that sanctions also apply to the New Zealand-resident directors or managers of the corporate trustee.

If a corporate trustee has committed an offence against section 143A of the Tax Administration Act, an employee, officer or agent of the corporate trustee would be liable to sanctions under section 147 of the Tax Administration Act. This would occur if the section 143A offence was caused by an act done, or carried out by, or by an omission of, or through knowledge attributable to the employee, officer or agent. Although the sanctions in section 147 are not intended to apply to non-managerial employees such as clerical staff, this is not clear.

Officials recommend that if the New Zealand-resident trustee is a corporate trustee, penalties for non-compliance should apply to the corporate trustee, and the New Zealand-resident directors and managers of the corporate trustee, but not to non-managerial employees.

Furthermore, the proposed amendment to remove the penalty for failure to be a "qualifying New Zealand-resident trustee" should address the concern relating to in-house accountants and lawyers being nominated as the "qualifying New Zealand-resident trustee".

Recommendation

That the submission be accepted in part. The bill should clarify that New Zealand-resident directors and managers of a corporate trustee, and not non-managerial employees, should be subject to the existing sanction in section 147 of the Tax Administration Act.

Clauses 155(2) and (12)

Issue: Exclusion of certain trustees from the new requirements

Submission
(9W – Inter Church Working Party on Taxation, 12W – the Salvation Army of New Zealand, Fiji and Tonga Territory, 25W – Deloitte, 46 – PricewaterhouseCoopers)

The proposed definition of "New Zealand-resident trustee" should be amended to exclude New Zealand-resident trustees of charitable foreign trusts. The new requirements will impose additional compliance costs on charitable foreign trusts since many of their trustees are not likely to be members of an "approved organisation". The compliance costs relate to amendments to the constitutions and trust deeds to include an additional acceptable trustee, recruitment and paying ongoing fees to these trustees, and the actual information disclosures and record-keeping. *(The Inter Church Working Party on Taxation and the Salvation Army of New Zealand, Fiji and Tonga Territory)*

The proposed definition of "approved organisation" should be amended to include executors of private estates. The compliance costs would be too onerous for these trustees. *(Deloitte)*

Foreign trusts with non-professional trustees should not be subject to the new requirements as these trusts are typically created for asset protection or asset management and inheritance purposes rather than for tax avoidance or evasion. It would be unfair and unreasonable to subject these types of trusts to the new requirements and related penalties. *(PricewaterhouseCoopers)*

The effect of these submissions would be to exclude certain trustees from the ambit of the new requirements.

Comment

If officials' recommended changes to the current proposed sanctions for non-compliance are accepted (see pages 235–236), the requirement that all foreign trusts must have at least one qualifying New Zealand-resident trustee will be removed. This change should reduce compliance costs for charitable foreign trusts and foreign trusts with non-professional trustees.

Officials consider it may be appropriate to exclude certain foreign trusts from the new requirements if Inland Revenue is able to obtain information about those trusts from another government authority or other body that requires similar information-disclosure and record-keeping. On this basis, officials consider there is a case for excluding charitable foreign trusts from the new requirements.

New Zealand has recently introduced a charities registration system. Organisations seeking charitable recognition may apply to the Charities Commission. Upon application, certain information is required to be lodged with the Commission, including a copy of the constitution or trust deed of the organisation and a set of annual accounts. If Inland Revenue were permitted to obtain this information for the purposes of satisfying a valid request for information from a foreign tax jurisdiction, this would meet New Zealand's exchange of information obligations. There is currently provision for Inland Revenue to obtain information from the Charities Commission.

Recommendation

That the submissions be accepted in part. Charitable foreign trusts should be excluded from the new requirements if they are registered with the Charities Commission.

APPROVED ORGANISATION

Clause 155(2)

Issue: Eligibility criteria

Submission
(30 – NZ Trustees Association)

The NZ Trustee Association (NZTA) should be an "approved organisation". Unless the Association is an approved organisation its members who are in the business of providing trustee services would not be eligible for "qualifying New Zealand-resident trustee" status. This is likely to disadvantage NZTA members in the provision of trustee services in New Zealand.

Comment

If the recommendation to remove the requirement that a foreign trust must have at least one qualifying New Zealand-resident trustee is accepted, the perceived disadvantage between NZTA members and non-members in the provision of trustee services for the administration of foreign trusts in New Zealand should be minimised.

Whether the NZTA is an "approved organisation" depends on whether it meets the eligibility criteria. An "approved organisation" is an organisation that is acceptable to Inland Revenue, whose members include individuals who are subject to a code of conduct and disciplinary procedures intended to enforce compliance with this code, and who typically provide trustee services in the course of their business activities. The code of conduct and the disciplinary processes are considered important factors in providing appropriate incentives for such trustees to comply with the new requirements. If the submission on page 241 is agreed, organisations will also be required to comply with other criteria set by the Commissioner of Inland Revenue.

Once the legislation is enacted, organisations including the NZTA would be invited to apply to Inland Revenue for consideration as an "approved organisation". Inland Revenue also proposes to issue administrative guidelines regarding the type of bodies that are likely to be found acceptable.

Recommendation

That the submission be noted. The NZTA will be invited to apply to Inland Revenue for consideration as an "approved organisation".

Issue: Commissioner to set further eligibility criteria

Submission

(Matter raised by officials)

The Commissioner of Inland Revenue should have the discretion to consider other suitable criteria in determining an "approved organisation".

Comment

It is the view of officials that providing the Commissioner of Inland Revenue with the discretion to consider other suitable criteria in determining an "approved organisation" should provide greater certainty and a more streamlined approval process. It will also avoid the difficulties that arose with the recently enacted "approved advisor group" approval process in relation to the non-disclosure rights rules.

Examples of other criteria that the Commissioner may consider include:

- whether the organisation's activities require its members to have certain qualifications;
- whether the organisation has a minimum number of members.

The Commissioner will have the discretion to allow bodies to be approved as an "approved organisation". District Law Societies and the New Zealand Institute of Chartered Accountants are expected to apply. Other organisations may also apply, and approval will depend upon those organisations fulfilling the eligibility criteria of the definition of "approved organisation".

Recommendation

That the submission be accepted.

Issue: Professional code of conduct

Submission

(Matter raised by officials)

The reference to a "code of conduct" in the proposed definition of "approved organisation" should be replaced with a reference to a "professional code of conduct".

Comment

This amendment would be consistent with similar criteria in the current definition of "approved advisor group", which relates to non-disclosure rights for tax advisors. It also sets a higher threshold for organisations seeking "approved organisation" status.

Recommendation

That the submission be accepted

Issue: Publishing the names of "approved organisations"

Submission
(Matter raised by officials)

Section 81(4) of the Tax Administration Act 1994 should be amended to allow Inland Revenue to publish names of organisations that have "approved organisation" status.

Comment

To ensure that New Zealand-resident trustees know which organisations have been approved by Inland Revenue, the names of these organisations should be published by Inland Revenue on its website and/or in an appropriate publication.

Recommendation

That the submission be accepted.

QUALIFYING NEW ZEALAND-RESIDENT TRUSTEE

Clause 155(14)

Issue: Exclusion of "manager"

Submission
(4 – NZ Trustee Companies Association Ltd and the Society of Trust and Estate Practitioners)

The proposed definition of "qualifying New Zealand-resident trustee" should be amended to exclude the reference to a "manager". The term "manager" has no specific definition in any of the Revenue Acts or any precise meaning from a commercial or legal perspective and could be open to abuse. The "manager", despite being properly qualified, may have little role or obligation in the management or administration of the corporate trustee. The requirement for a New Zealand-resident individual to be a director of a corporate trustee would ensure a much greater level of accountability given the onerous obligations imposed upon directors under the Companies Act 1993.

Comment

The policy intention of including a "manager" in the definition of "qualifying New Zealand-resident trustee" is to ensure that there is someone in a position of responsibility who can be held accountable under the new requirements, if there are no New Zealand-resident directors of the corporate trustee.

The term "manager" is intended to cover administrators or officers of the company who are responsible for the day-to-day management of the company or who carry out the duties and responsibilities of the non-resident director. Officials accept, however, that the term "manager" should be defined for the purposes of the definition of "qualifying New Zealand-resident trustee" to avoid doubt.

Furthermore, officials will monitor corporate trustees that use New Zealand-resident managers to satisfy the qualifying New Zealand-resident trustee status for any abuse.

Recommendation

That the submission be declined.

Officials recommend that the term "manager" be defined for the purposes of the definition of "qualifying New Zealand-resident trustee".

INFORMATION-DISCLOSURE REQUIREMENTS

Clause 162

Issue: Timing of disclosure

Submission
(46 – PricewaterhouseCoopers)

New section 59B of the Tax Administration Act 1994 should be amended to ensure that disclosure is not required until after the trustees have arrived in New Zealand and their residency status has been determined.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Foreign trusts with more than one New Zealand-resident trustee

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

New section 59B should be amended to provide that if a foreign trust has more than one New Zealand-resident trustee, only one trustee should be required to make the required disclosure.

Comment

It is accepted that if a foreign trust has more than one New Zealand-resident trustee that only one trustee should be required to make the required disclosure to Inland Revenue under new section 59B.

To clarify this matter, officials recommend the bill provides that the requirements in new section 59B will be met if one of the New Zealand-resident trustees of a foreign trust makes the required disclosure. The bill should also provide that if a foreign trust has more than one New Zealand-resident trustee, the trustees must decide who is to make the required disclosure.

To ensure that the initial disclosure is made and that the trustees have nominated a "responsible" trustee to make the initial disclosure, each of the New Zealand-resident trustees will be subject to the penalties for any breach of the disclosure requirement.

Recommendation

That the submission be accepted. In addition, officials recommend that each New Zealand-resident trustee should be subject to the penalty for any breach of the disclosure requirement.

Issue: Overlap with existing disclosure requirements

Submission
(46 – PricewaterhouseCoopers)

New section 59B of the Tax Administration Act 1994, which contains information disclosure requirements for foreign trusts, should be redrafted having regard to the existing disclosure requirements of section 61 of the Tax Administration Act 1994.

Comment

A review of the information disclosures required under new section 59B and section 61 indicates some overlap. However, the common information collected would be insufficient for New Zealand to meet its exchange of information obligations relating to foreign trusts.

Officials consider that if a New Zealand-resident trustee complies with the new information-reporting requirements in new section 59B, the trustee should be exempt from the existing disclosure requirements in section 61.

Recommendation

That the submission be accepted in part. The bill should provide for an exemption from the disclosure requirements in section 61 of the Tax Administration Act 1994 for New Zealand-resident trustees of foreign trusts who have complied with the disclosure requirements in new section 59B of the Tax Administration Act 1994.

Issue: Limit disclosure requirements to foreign trusts whose settlors reside in a DTA country

Submission

(46 – PricewaterhouseCoopers)

If the above submission is not accepted, the additional information-reporting and record-keeping requirements should apply only to New Zealand-resident trustees of foreign trusts where the settlor is resident in a country with which New Zealand has a DTA. This limitation would alleviate the burden and costs of the new requirements on foreign trusts from non-DTA countries and would also be consistent with the stated purpose of the new requirements and current tax law.

Comment

Officials consider that limited information should be collected from all foreign trusts with a New Zealand-resident trustee, irrespective of the country of residence of the settlor. As a New Zealand-resident trustee might not know the country of residence of a settlor or a settlor might move between jurisdictions, it might be unclear, without analysis, where a settlor resides. Also, a beneficiary of a trust, rather than a settlor, could be of interest to a foreign tax authority.

As New Zealand is currently working in partnership with Australia to negotiate Tax Information Exchange Agreements (TIEA) with non-DTA countries, it is also possible that valid requests for information on foreign trusts could in future be received from countries with which New Zealand has no full DTA, but a TIEA.

Recommendation

That the submission be declined.

RECORD-KEEPING REQUIREMENTS

Clause 156

Issue: Foreign trusts with more than one New Zealand-resident trustee

Submission
(46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

New section 22 should clarify that if a foreign trust has more than one New Zealand-resident trustee, only one trustee should be required to maintain the records and provide these to Inland Revenue, if requested.

Comment

It is accepted that the new record-keeping requirements will be met if at least one New Zealand-resident trustee maintains the required records in accordance with new section 22. Officials consider that this requirement should be clarified in the bill. The bill should also provide that if a foreign trust has more than one New Zealand-resident trustee, the trustees must decide who is to keep the required records. This will avoid any arguments that the other trustee was meant to comply with the record-keeping requirement.

To ensure compliance with the new record-keeping requirements, each New Zealand-resident trustee should be subject to the penalty for any breach of the record-keeping requirement.

Recommendation

That the submission be accepted. In addition, officials recommend that each New Zealand-resident trustee should be subject to the penalty for any breach of the record-keeping requirement.

Issue: Responsibility for maintaining the required records when no New Zealand-resident trustees remain in New Zealand

Submission
(46 – PricewaterhouseCoopers)

The amendments to section 22 of the Tax Administration Act 1994 should clarify who bears responsibility for maintaining the records relating to the foreign trust when the New Zealand-resident trustee leaves New Zealand and no New Zealand-resident trustees remain.

Comment

As proposed, if a New Zealand-resident trustee of a foreign trust leaves New Zealand and no New Zealand-resident trustees remain, the departing trustee can either seek Inland Revenue's approval to keep and retain the records of the foreign trust outside New Zealand, or maintain the records of the foreign trust in New Zealand. It is the responsibility of the departing trustee to ensure that the records are readily available and can be provided at minimal cost to Inland Revenue.

This matter will be clarified in Inland Revenue's *Tax Information Bulletin* that is issued when the legislation is enacted.

Recommendation

That the submission be clarified in the *Tax Information Bulletin*.

Issue: Record-keeping requirement too stringent

Submission
(4 – NZ Trustee Companies Association Ltd and the Society of Trust and Estate Practitioners, 48 – New Zealand Institute of Chartered Accountants)

The proposed record-keeping requirements for foreign trusts should not be enacted as they are unnecessary and inappropriate. *(NZ Trustee Companies Association Ltd and the Society of Trust and Estate Practitioners)*

New sections 22(7)(d)(iii)(B) and (C) should be deleted, and new section 22(7)(d)(iii) should be reworded as "a record of the assets and liabilities of the foreign trust". These proposed record-keeping requirements are too wide and will impose unnecessary obligations on the trustees of foreign trusts – especially family trusts or non-trading trusts with simple and infrequent transactions that are adequately administered on a manual basis. *(New Zealand Institute of Chartered Accountants)*

Comment

The policy intention of the record-keeping requirements is to ensure that appropriate records are being kept to enable the financial position of the trust to be determined.

The proposed record-keeping requirements reflect the current general record-keeping requirements that apply to businesses. Officials now recognise that the requirements may not be suitable for non-trading trusts such as family trusts or private estates. We therefore consider that the proposed record-keeping requirement should apply only to New Zealand-resident trustees of foreign trusts that are in business.

For non-trading foreign trusts, limited record-keeping should be required. The trustees of such trusts should not be required to maintain records relating to the charts and codes of accounts, the accounting manuals and the system and programme documentation which describes the accounting system used in the administration of the trust. However, the other records such as a record of the assets and liabilities of the foreign trust and the details of all sums of money received and expended by the trustee in relation to the trust should still be required to be kept. Such records are necessary to enable the financial position of the trust to be determined with reasonable accuracy at any time and financial statements to be prepared. This limited record-keeping should reduce the compliance costs for trustees of non-trading foreign trusts.

Recommendation

That the submission be accepted in part. The proposed record-keeping requirements should apply to foreign trusts that are in business only and lesser record-keeping requirements should apply to non-trading foreign trusts.

DRAFTING

Submission
(46 –PricewaterhouseCoopers)

In section 59B(3)(c) the term “resident” should be included after the words “that ends immediately before the trustee becomes a New Zealand”.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Submission
(Matters raised by officials)

New section 59B(4)(b) should be amended to replace the word “of” (where it first appears) with the word “after”. The suggested amendment clarifies that the date on which the relevant disclosure is required to be made is 60 days after new section 59B(4)(b) becomes effective.

Recommendation

That the submission be accepted.

Trans-Tasman imputation credit streaming

OVERVIEW

The changes deal with the inappropriate use of the trans-Tasman imputation rules to stream imputation credits.

The intention of the trans-Tasman imputation rules is that Australian and New Zealand shareholders of trans-Tasman companies can be allocated imputation credits representing New Zealand tax paid and franking credits paid, in proportion to their ownership of the company. However, each country's credits can be utilised only by its residents.

A problem has emerged in the form of imputation credit "streaming". Imputation credits are directed to the New Zealand owners of Australian-issued redeemable preference shares (RPS), where the proceeds of the share issue do not directly cause further New Zealand tax to be paid by the Australasian group. A particular feature of these arrangements is that under Australian tax law the RPS coupons are deductible as interest.

This streaming problem is being dealt with by not allowing the Australian issuer of shares to attach imputation credits to dividends if the payment of the dividends gives rise to an Australian tax-deductible amount. This automatically includes RPSs of the type discussed above.

This solution is not a "first principles" solution, but is based on the Australian characteristics of the mechanism being used.

JUSTIFICATION FOR CHANGES

Clauses 106, 107B and 143

Submission
(48 – New Zealand Institute of Chartered Accountants)

The perceived need for this change indicates that either the law as it currently stands, or the current policy settings are defective. If the law is defective, a planned and full change is the proper response. If policy settings are not correct, the proposed changes may not be required. This indicates that a proper review is required.

Comment

Officials acknowledge that the legislative amendments do not comprise a first principles solution that deals with the deficiency in the law. Different solutions are available (such as aligning the tax treatment of debt and equity between New Zealand and Australia) but would have wider implications, would take longer to consider, and may prove inappropriate or impractical.

However, given the market activity and in particular that the relevant transactions are being directed at the retail investment market, a timely response is required. Officials therefore considered that the legislation should be amended as soon as possible to deal with current transactions, rather than waiting for a full review to be carried out.

Recommendation

That the submission be declined.

TRANS-TASMAN IMPUTATION CREDITS

Clauses 106, 107B and 143

Submissions
(34W – Russell McVeagh, 39 – Commonwealth Bank of Australia)

Section ME 6(1B) should apply only to Australian imputation credit account companies.

Comment

The policy intention is that the new rule should apply if a company claims an Australian deduction for dividends paid on redeemable preference shares. Officials believe that nothing further is added by this submission, but will further clarify this in our response to the next submission.

Recommendation

That the submission be declined.

Submission
(47 – New Zealand Law Society)

The amendment should apply only to dividends which are paid by a company which is not New Zealand resident. New Zealand-resident companies which pay tax on their worldwide income should not need to consider whether proposed section ME 6(1B) applies to them or not.

Comment

The submission asks for more certainty. Officials have reservations about whether a further amendment is necessary. However, we accept that further certainty can be provided at no cost to the effectiveness of the rule. This can be achieved by including the requirement that the payment by the imputation credit account company be dealt with in an Australian tax return of the company.

Recommendation

That the submission be accepted.

Submissions
(34W – Russell McVeagh, 39 – Commonwealth Bank of Australia, 47 – New Zealand Law Society)

The new rule should apply only when the company can claim an interest deduction in Australia.

Comment

As currently drafted, the new rule may prohibit the attachment of imputation credits to dividends paid by one company in a “consolidated group” to another company within the same “consolidated group”, although under Australian tax rules no deduction is allowed for those dividends.

The intention is that the attachment of imputation credits should be prohibited if the dividends are paid to non-Australian residents. Therefore, officials consider that the provision should be amended by excluding from its application dividends paid between members of the same wholly owned group if the companies involved are not New Zealand resident.

Recommendation

That the tenor of the submission be accepted to the extent described above.

PROCEEDS USED TO GENERATE INCOME WHICH IS SUBJECT TO NEW ZEALAND TAX

Clauses 106, 107B and 143

Submission
(34W – Russell McVeagh)

The new rule should not apply when the proceeds of issuing shares are applied to generate income which is subject to New Zealand tax.

Comment

Conceptually, if the proceeds of the issue of the redeemable preference shares were directed back into the New Zealand activities of the Australasian group, and this caused additional New Zealand-sourced income and increased New Zealand tax payments, there would not be a streaming problem from a New Zealand perspective. However it is difficult, if not impossible, to trace the proceeds of an issue of redeemable preference shares through a group of companies to its end use. This is because money is fungible. In particular, the interest deductions for companies rules are based on this fungibility concept.

If Australasian groups have concerns about being denied imputation credits for dividends relating to redeemable preference shares where the proceeds of the shares were directed at New Zealand operations, they have the option of issuing the redeemable preference shares directly from their New Zealand subsidiaries. Imputation credits could then be allocated to the dividends in the normal way. Alternatively, the New Zealand operation could simply issue debt. This should yield an economically equivalent result to both parties.

Recommendation

That the submission be declined.

STREAMING CONCERNS

Clauses 106, 107B and 143

Submission
(34W – Russell McVeagh)

Streaming concerns should not be addressed by amending the imputation rules.

Comment

The arrangements targeted by the proposed new rule could cause significant loss to the tax base. The proposed amendment deals with the problem in a timely manner, rather than a more generic approach, which would have taken considerably longer to develop.

However, officials acknowledge that the proposed solution is not a "first principles" solution, and is based on the Australian characteristics of the mechanism being used. A more fundamental analysis of the use of imputation credits by shareholders, which could include an examination of the wider policy settings, is a matter for consideration in the context of the government's tax policy work programme.

Recommendation

That the submission be declined.

FURTHER “GRANDFATHERING” PROVISIONS

Clauses 106, 107B and 143

Submission
(39 – Commonwealth Bank of Australia)

Section ME 6(1C) should be extended to “grandfather” certain shareholdings by companies that are in the same imputation group of companies as the imputation credit account company.

Comment

Irrespective of when the share issue was made, the new rule will apply to dividends paid after 1 April 2006, if the imputation credit account company and the redeemable preference shareholders are part of the same group of companies (related party issues). This is less concessionary that the treatment of non-related issues. Non-related issues made before 21 July 2005 are not caught by the new rule.

The submission argues that further relief should be provided for related party issues, for shares that are held for business reasons, when:

- a share-broking company within a group acquires such shares as part of its share-broking business;
- security may be taken over such shares by a group company and that security may be enforced, resulting in the group company holding shares;
- an insurance company within the group may hold such shares as part of its investment portfolio; and
- a company within a group may hold such shares as trustee for non-related persons.

Officials agree that further relief is warranted if the shares were issued before 21 July 2005 and the decision that led to the acquisition of the shares was independent of the ownership of the subsidiary companies.

Recommendation

That the submission be mainly accepted, and the rule be amended so that it does not apply for shares issued before 21 July 2005, if the shares were acquired in the circumstances listed above in the ordinary course of business and the decision to acquire the shares was independent of the ownership of the subsidiary companies.

BINDING RULING APPLICATIONS

Clauses 106, 107B and 143

Submission
(15W – AXA)

Section ME 6(5B) should be extended to exclude from the rules the proposed issue of redeemable preference shares by AXA Asia Pacific Holdings Ltd, which is the subject of a binding ruling application. The application was made before 21 July 2005, the date of the announcement of the proposed changes.

Comment

Technically, the legislation that underpins binding rulings provides that any amendment to the tax law upon which a ruling is based effectively negates that part of the ruling, whether the ruling has been issued or merely applied for.

Section ME 6(5B) provides that the new rule applies to dividends paid on shares issued after 21 July 2005 (the date of the announcement) and subject to grandparenting, shares issued before this date.

In deciding to grandparent existing public issues, officials' main concern was the effect on public subscribers – hence the decision to restrict full grandparenting to instances where a public issue has already been made.

The current grandparenting provision is relatively generous. It would not be sustainable to extend this to those considering, or in the process of, making a public issue. A rulings application falls into this category.

Recommendation

That the submission be declined.

RESIDENT WITHHOLDING TAX DEDUCTIONS

Clauses 106, 107B and 143

Submission
(6W – Westpac)

The tax law should be changed so that Westpac Banking Corporation, an Australian company, is not required to deduct and account for resident withholding tax deductions from the dividends it pays to its New Zealand shareholders.

Comment

The rationale for the requirement for a non-resident company with a fixed establishment in New Zealand to deduct and account for resident withholding deductions was to address tax avoidance concerns that can arise where the non-resident company has no business operations in its home country, but has a branch operation in New Zealand. Officials now consider that it should be unnecessary for non-resident companies which have significant business interests in their home country as well as in New Zealand, such as Westpac, to deduct and account for resident withholding tax. In economic terms it is difficult to separate the New Zealand activities of Westpac (which is required to deduct RWT) and the other Australian banks that are not required to deduct.

The problem is the confirmation of significant home-country business interests. There are several ways this can be done. The present legislation allows an exemption when dividends are not paid in New Zealand dollars. Unfortunately, this provision no longer correctly targets such entities because Australian companies now frequently pay dividends to their New Zealand shareholders in $NZ. It is considered that if the companies' financial statements are not required by generally accepted accounting practice (GAAP) to be presented in $NZ, that is sufficient evidence that avoidance of resident withholding tax should not be a concern. If the company's activities are substantially or all denominated in $NZ, then GAAP will require that company to report in $NZ, which would correctly result in RWT being deducted from dividends.

Recommendation

That the submission be accepted by applying the anti-avoidance rule where the non-resident company has a fixed establishment in New Zealand and if the company's financial statements are required by GAAP to be presented in $NZ.

This amendment should apply to dividends paid after 1 April 2007. This will allow sufficient time for Westpac's New Zealand shareholders (and any others who may be affected) to be informed about the change.

IMPUTATION CREDITS AND RESIDENT WITHHOLDING TAX DEDUCTIONS

Clauses 106, 107B and 143

Submission
(6W – Westpac)

The tax law concerning resident withholding tax deductions should be amended to allow for a reduction in resident withholding tax deducted, to the extent that a dividend paid by a non-resident is imputed under the trans-Tasman rules.

Comment

The policy intention is that resident withholding tax should complement the imputation system, so that withholding tax is deducted from dividends at source only if there are insufficient imputation credits allocated to the dividend to cover its full tax liability.

When the trans-Tasman imputation rules were introduced a consequential amendment to the resident withholding tax rules, to allow for trans-Tasman imputation credits to be taken into account, seems to have been overlooked.

This anomaly should be corrected retrospectively to the introduction of the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003, to the extent the present law has not been complied with.

Recommendation

That the submission be accepted and the amendment made retrospectively to the introduction of the trans-Tasman imputation rules (1 April 2003) to the extent the present law has not been complied with by the dividend-paying company.

Foreign hybrids and foreign tax credits

OVERVIEW

A foreign hybrid is an entity that has the characteristics of both a company and a partnership. It is treated like a partnership (with a "flow-through" tax treatment) under another country's tax system.

The bill clarifies that foreign hybrids will be treated as a company for tax purposes. People who invest in "foreign hybrids" will then receive the benefits of grey list treatment or foreign tax credits for the foreign tax paid by them on income earned by a foreign hybrid. The changes will apply to foreign hybrids that are either a controlled foreign company or a branch-equivalent foreign investment fund.

Three submissions were received on the proposed amendments. Submissions were generally supportive of the proposed amendments. However, they stated that further technical changes are needed to achieve the purpose of the amendments. In particular, in relation to the amendment that reduces the amount of the dividend paid, submissions commented that it should apply to all other fiscally transparent entities and not just partnerships.

Submissions also suggested that the application date be made retrospective or a savings provision adopted.

Issue: Allowing a credit for foreign taxes paid by a New Zealand shareholder in a foreign hybrid

Submission
(48 – New Zealand Institute of Chartered Accountants)

A credit should be available against a dividend withholding payment (DWP) liability.

Comment

The legislation does provide a credit for foreign tax against DWP liabilities – when one would be available if the tax had actually been imposed on the foreign hybrid.

New section CD 10B applies only to determine the amount of the dividend on which a New Zealand shareholder in a foreign hybrid is taxable. It excludes from that amount the amount of any foreign income tax paid by the New Zealand shareholder on the company's income. This ensures that the overall tax result is the same as if the foreign hybrid had actually paid the tax instead of the shareholder.

Furthermore, subpart LF is being amended in the bill, which changes the underlying foreign tax credit that is deductible against the dividend withholding payment liability.

Recommendation

That the submission be declined.

Issue: Extending the reduction for foreign income tax paid by a New Zealand shareholder in a foreign hybrid

Submission
(48 – New Zealand Institute of Chartered Accountants, 46 – PricewaterhouseCoopers)

Section CD 10B(1)(a)(ii) is too restrictive. It should be extended to apply to a dividend from any fiscally transparent entity when the New Zealand taxpayer is liable for tax on the income of the entity – regardless of whether that entity is technically taxed as a partnership. *(PricewaterhouseCoopers)*

The approach taken in related provisions (clauses 70 and 71 of the bill) would be more suitable. *(New Zealand Institute of Chartered Accountants)*

Comment

In some situations, an entity which has a flow-through tax treatment in its country of organisation, is not treated as a partnership for tax law purposes in that country. For example, a limited liability company (or LLC) formed in the United States with only one member is technically taxed as a "branch" of the member rather than as a "partnership". We agree that such entities should be treated in the same fashion.

Recommendation

That the submission be accepted.

Submission
(46 – PricewaterhouseCoopers)

Section CD 10B(1)(a)(ii) should be extended to apply to a dividend from a foreign company that is treated as a fiscally transparent entity by the laws relating to income tax of the country or territory in which the company would otherwise be liable to pay tax.

Comment

Under the proposed rules, the amount of the dividend received from a foreign hybrid is reduced by the foreign income tax imposed on the New Zealand shareholder only if the hybrid is resident in the country or territory imposing the tax. This may be too restrictive.

For instance, when a foreign hybrid is organised in one jurisdiction – say the United Kingdom but is doing business in another jurisdiction – say the United States, the United States may treat the hybrid as a flow-through entity for tax purposes. Therefore, the New Zealand members of the hybrid will be liable to pay tax in the United States. But in this case the liability arises not because the foreign hybrid is resident in the United States but because the income is derived from sources in the United States. It would be consistent with the underlying policy of the reform to reduce the amount of the dividend for foreign tax imposed on the foreign hybrid on the basis of the source of the income.

Recommendation

That the submission be accepted

Submission
(46 – PricewaterhouseCoopers)

Section CD 10B should be extended to cover situations when there are two (or more) layers of hybrid entities and the foreign tax is imposed on the New Zealand shareholder of the lower-tier entity.

Comment

The proposed rules apply to foreign tax imposed on the New Zealand shareholder for the income of the hybrid entity. The income of the lower-tier entity will flow through to the upper-tier entity and therefore the tax will be imposed in respect of the income of the upper-tier entity rather than the lower-tier entity. Accordingly, no specific mention needs to be made to lower-tier entities. However, the legislation should be clarified to ensure that it refers to the tax liability arising under the laws of the foreign jurisdiction.

Recommendation

That the submission be declined, but the legislation will be clarified.

GREY LIST EXEMPTION FOR FOREIGN HYBRIDS

Clauses 70 and 71

Submission
(46 – PricewaterhouseCoopers)

The current proposal allows a New Zealand member of a foreign hybrid to treat its interest as a share in a grey list resident company (and therefore as exempt from attribution under the CFC or FIF rules) only if the foreign hybrid derives 80 percent or more of its income from the country under whose law it is organised. This is inconsistent with the application of the grey list exemption for non-hybrid investments. Also, other provisions in the proposed sections achieve the objective of ensuring the grey list country taxes the hybrid's income (albeit in the hands of the members).

Comment

The grey list exemption is given on the basis that the relevant entity is subject to tax in the grey list country on its worldwide income. A hybrid entity organised in grey list country X which derives income sourced from country Y often will not be subject to tax in country X on income derived from country Y that is attributable to members resident outside country X. That is because the income is treated by grey list country X as earned by a non-resident from sources outside country X.

The 80 percent rule is therefore necessary to ensure that grey list treatment is given to a hybrid entity only if the grey list country taxes most of the income earned by (or through) the hybrid entity. The threshold of 80%, as opposed to 100%, is intended to provide some flexibility where an insignificant amount of income is earned outside the jurisdiction.

Recommendation

That the submission be declined.

GREY LIST COMPANY UNDERLYING FOREIGN TAX CREDITS

Submission
(46 – PricewaterhouseCoopers)

The requirement that the foreign hybrid derives 80 percent of its income from the jurisdiction in which it is organised is inconsistent with the application of the underlying foreign tax credit to existing grey list companies.

Comment

The proposal is designed to extend the deemed underlying foreign tax credit. The credit would be extended to dividends paid by a foreign hybrid which is organised in a grey list jurisdiction and derives 80 percent of its income from that jurisdiction.

There is a sound reason for the 80 percent requirement being imposed in relation to hybrid entities. The grey list country would generally not impose tax on income sourced from another country which is attributable to an investor resident in another country. So, without this restriction, a deemed underlying foreign tax credit could be granted for income on which no grey list country taxation is payable by either the foreign hybrid or its investors. However, as the submission states, the restriction should require that 80 percent or more of the income of the foreign hybrid is from sources in the grey list jurisdiction.

Recommendation

That the submission be declined. However, proposed section LF 5(1)(b) should be amended by inserting the words “or more” after the figure “80%”.

Submission
(46 – PricewaterhouseCoopers, 47 – New Zealand Law Society)

The legislation requires further amendment to ensure a foreign hybrid will be a “grey list company” for the purpose of claiming deemed underlying foreign tax credits in subpart LF.

Comment

A deemed underlying foreign tax credit can be claimed only in respect of a dividend paid by a “grey list company” as defined in section OB 1. That definition, in turn, refers to the section OE 2 definition of a grey list company. As drafted, this definition may not apply to a foreign hybrid because it requires that the foreign hybrid is liable for tax in the grey list jurisdiction.

Recommendation

That the submission be accepted.

DEFINITION OF "COSTS"

Clauses 74

Submission
(46 – PricewaterhouseCoopers)

The proposed amendments to section EX 44(6) should also include foreign tax on the income of the foreign investment fund (FIF) for which the person is liable.

Comment

One of the options for calculating income from a FIF is the comparative value (CV) method. Under the CV method a person is allowed a deduction each year for the opening value of their FIF interest, plus any costs incurred during the year. The proposed amendments in clause 74 include in those costs any foreign tax paid by the shareholder in a foreign hybrid on the income of the company, but only if the tax is imposed by the jurisdiction in which the FIF is resident. The submission states that the costs should also extend to foreign tax paid by the shareholder because the income earned by the foreign hybrid is imposed on a source basis. (This is similar to the submission made in relation to section CD 10B.)

The submission also refers to clause 75 of the bill, where the amendment would be the same but the effect is different. In this case the effect of treating the amount of the foreign tax payment by the shareholder as a cost is to increase the amount of the dividend calculated under the deemed rate of return method (since that method determines income as a percentage of cost). A similar amendment should be made to this clause.

Recommendation

That the submission be accepted.

DIVIDEND WITHHOLDING PAYMENTS AND OTHER SUBMISSIONS

Submission
(46 – PricewaterhouseCoopers)

Subsection NH 2(2) should be amended to make it clear that the dividend amount (item "a") should be reduced by the amount of tax calculated under section CD 10B.

Comment

The proposed section CD 10B would reduce the amount of a taxable dividend subject to tax for a New Zealand resident who is not a company by the amount of foreign income tax on the income of that entity which is imposed on and paid by the New Zealand resident.

The reduction in the amount of a dividend subject to tax should also apply to sections NH 1 and NH 2. Proposed section CD 10B does not explicitly link to those sections, nor does it explicitly deny that it applies to them. However, consistent with the rewrite of the Income Tax Act, there is no general cross-reference to subpart CD. A specific cross-reference would be inconsistent with this approach.

Recommendation

That the submission be declined.

Submission
(46 – PricewaterhouseCoopers)

When a New Zealand shareholder calculates income from a foreign hybrid that is a FIF using the accounting profits method and pays foreign tax on the income of the FIF, that foreign tax should reduce the amount of FIF income.

Comment

Investors in FIFs that are widely held can use the accounting profits method of calculating income from the FIF. However, in most cases, a hybrid entity would not meet the requirements for applying the accounting profits method. In particular, it is unlikely that it would be quoted on the official list of a recognised exchange or offered widely to the public in more than one country. However, it is theoretically possible that it might occur.

Recommendation

That the submission be accepted.

Submission
(46 – PricewaterhouseCoopers)

Further consideration should be given to whether New Zealand income tax paid on the New Zealand income of a CFC hybrid should be claimable as a tax credit.

Comment

New Zealand will seek to tax the New Zealand sourced income of a CFC hybrid directly, as we do not "look-through" the CFC hybrid. Therefore, officials believe that this situation is covered by the existing credit provisions in LC 4.

Recommendation

That the submission be declined.

Submission
(48 – New Zealand Institute of Chartered Accountants, 46 – PricewaterhouseCoopers)

The amendments to sections EX 24, EX 33 and LC 4 should be made retrospective. *(New Zealand Institute of Chartered Accountants)*

If the submission to apply the amendments retrospectively is rejected then a "savings" provision should be included confirming returns already filed when the person has relied on hybrids being grey list residents, or on the ability to claim a foreign tax credit for foreign tax paid by New Zealand shareholders on a hybrid's income. *(New Zealand Institute of Chartered Accountants)*

A savings provision is appropriate in relation to the amendments to section LC 4 and subpart LF, and the starting date for some of the other provisions should be more clearly specified. *(PricewaterhouseCoopers)*

Comment

Taxpayers have interpreted and applied the law in a variety of ways. This would make retrospective legislation or a savings provision difficult to implement and apply.

Recommendation

That the submission be declined.

Submission
(48 – New Zealand Institute of Chartered Accountants, 46 – PricewaterhouseCoopers)

A different application date is appropriate for the amendments to the FIF and CFC rules (including the foreign tax credit against CFC income in section LC 4).

Comment

In relation to clause 8, there does not seem a need for a different implementation date. New section CD 10B will apply to dividends derived from 1 April 2006 onwards and will allow reduction for tax payments made by the shareholder at any time before receipt of the dividend (whether before or after 1 April 2006).

In relation to the proposed changes to the FIF and CFC rules, including section LC 4, officials agree that in line with the submission it would make sense for these changes to apply on an income year basis. Otherwise taxpayers with non-standard years would need to make an apportionment, treating the CFC/FIF as subject to the relevant rules for the period up to 31 March 2006, but not thereafter.

In relation to underlying foreign tax credits, there does not seem a need for a different implementation date. The amendments to subpart LF will apply to dividends received from 1 April 2006 onwards, and will allow a credit for tax payments by the shareholder made at any time before receipt of the dividend.

Recommendation

That the submissions be declined but that the amendments to the CFC and FIF rules apply for the 2006–07 income year.

Other changes to the Income Tax Act

DEDUCTIBLE DISTRIBUTIONS FROM CO-OPERATIVES

Clauses 7, 10, 47 and 220

Submissions were generally supportive of the proposal to exclude certain types of payouts from co-operatives to their members from being a dividend and to allow a deduction to the co-operative. There were, however, several technical submissions relating to the drafting of the new provisions, as well as submissions that the dividend exclusion apply to all distributions from co-operatives.

Issue: Support for amendments

Submission
(24 – Federated Farmers, 32W – Fonterra)

Federated Farmers and Fonterra note that they were consulted on the proposal and that their members support it.

Recommendation

That the submission be noted.

Issue: Election to treat a distribution as a dividend

Submissions
(8W – Foodstuffs (South Island Ltd), 44 – Foodstuffs (Auckland Ltd), 46 – PricewaterhouseCoopers)

Co-operatives should be allowed to elect whether a distribution to members is treated as a dividend, with an attached imputation credit, or as a deductible expense.

Comment

Currently, payouts from co-operatives to members may be treated either as a dividend under the general dividend provisions in subpart CD and the specific co-operative distribution provisions in ME 35, or as a deductible expense to the co-operative under the mutual association provisions in section HF 1.

The proposed dividend exclusion in section CD 24B is designed to clarify the conditions under which a co-operative can deduct payouts as an expense in relation to transactions with a member. This new provision should not preclude a co-operative from distributing under any of the other existing provisions. Rather, section CD 24B should complement the other provisions by allowing the co-operative the choice of excluding the payout as a dividend and obtaining a deduction.

Officials agree that allowing co-operatives to elect to apply section CD 24B would provide clarity and certainty on the treatment of payouts.

Recommendation

That the submission be accepted.

Issue: Definition of co-operative company

Submissions
(44 – Foodstuffs (Auckland Ltd), 46 – PricewaterhouseCoopers, 48 – New Zealand Institute of Chartered Accountants)

To provide certainty for taxpayers, the term "co-operative company" in section CD 24B should be defined by reference to the definition contained in the Co-operative Companies Act 1996.

Comment

The Income Tax Act 2004 defines a co-operative company as not including statutory producer boards (OB 1). Therefore, with the exclusion of statutory producer boards, a co-operative company would be defined according to its ordinary meaning.

Although defining the term "co-operative company" according to the Co-operative Companies Act would provide some certainty, officials understand this could also exclude certain co-operatives that are not co-operative companies under the Co-operative Companies Act but would be co-operative companies under the Income Tax Act.

Furthermore, amending the definition of co-operative company would also have wider implications because references to co-operatives are included elsewhere in the Income Tax Act. A wider review would need to be undertaken to ensure that these are consistent throughout the Act.

Recommendation

That the submission be declined.

Issue: Drafting clarification

Submissions

(32W – Fonterra, 48 – New Zealand Institute of Chartered Accountants)

Section CD 24B(3) should be re-drafted to make it clear the amount that is to be excluded as a dividend.

Comment

Fonterra has some concerns about the current drafting of section CD 24B(3), which relates to the amount of the distribution that is to be excluded as a dividend. It accepts that the wording attempts to preserve the dividend treatment for transactions between the co-operative and member shareholders whose equity interest bears no relation to the level of transacting between the two parties. Nevertheless, Fonterra is of the opinion that this section could be drafted more clearly to avoid uncertainty and confusion.

The purpose of section CD 24B is to specify the amount of the distribution by the co-operative to the member shareholder that can be excluded as a dividend under the section. It is intentionally drafted so that it does not apply to distributions that relate to shares held in the co-operative that have no relation to the amount of trading stock supplied to, or by, the co-operative to the member. If a member holds shares in the co-operative and those shares are not required in order to trade with the co-operative, any distribution relating to those shares will be treated as a dividend.

Officials agree that the section should be redrafted to make clear the policy intent that distributions may be excluded from the definition of "dividend" if they are in relation to shares that members are required to hold in order to trade. Distributions will not be excluded from the definition of "dividend" if they are in relation to shares that members are not required to hold in order to trade with the co-operative.

Recommendation

That the submission be accepted.

Issue: Extension of dividend exclusion

Submissions
(36 – Deloitte)

The ability of co-operatives to deduct as an expense and exclude from being a dividend certain payouts to members should apply to all types of transactions, including the provision of services that include financial services.

(41W – Deloitte)

Co-operatives should be able to deduct all rebates paid to members subject only to the restriction that the rebates must constitute taxable income in New Zealand.

(35W – Deloitte on behalf of Market Gardeners Ltd)

The proposed amendment should also apply to consignment stock transactions where the co-operative sells on behalf of members.

Comment

Co-operatives may currently deduct any payout to members, as long as the payment relates to the profits from transactions between the co-operative and member shareholders.

The intention of this amendment is to clarify the treatment of profits from non-member transactions, where the payments relate to trading stock transactions, rather than introducing a dividend deduction scheme for co-operatives. Extending this treatment to all rebates paid to members is beyond the scope of the current bill.

The main reason for limiting the application to trading stock is to minimise the risk that businesses that would not normally set up as a co-operative would use the provision to achieve inappropriate results.

This is done by linking any payout from the co-operative to the member to the sale or receipt of trading stock and to the level of shareholding held for that member to trade.

When a co-operative is buying or selling trading stock it can be reasonably certain that the shareholder vendor or purchaser (as the case may be) is undertaking the activity on revenue account and is inside the New Zealand tax base. From an integrity perspective this is important.

This level of confidence would fall away if the scope of the amendment were extended, even by the limited suggestion of the provision of services relating to consignment stock transactions.

Recommendation

That the submissions be declined.

Issue: Extension of trading stock definition

Submissions

(47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

The definition of "trading stock" should be widened.

Comment

The New Zealand Institute of Chartered Accountants submitted that the definition of "trading stock" should be widened because parts of the payouts may not qualify as relating to trading stock, such as royalty or commission payments. The New Zealand Law Society submitted that the dividend exemption should apply to intangibles in some circumstances.

The deductibility of parts of payouts not relating to trading stock, such as royalty or commission payments, is covered in other parts of the Income Tax Act. Officials therefore believe that it is unnecessary to widen the definition of trading stock to include these payments.

As noted earlier, the main purpose of limiting payouts to those relating to trading stock is to connect the payout to the trading relationship between the co-operative and the member. Therefore deductions are limited to shares required for the purpose of trade in a product with the co-operative, and do not include payments for shares held for the purpose of investing in the co-operative.

Under the proposed amendment, payments relating to the sale of intangibles will not be allowed to be deducted as trading stock by a co-operative. This is to avoid the risk that co-operatives would be set up to take advantage of the deductibility of payouts, and to ensure that the intended scope of the amendment as described is maintained.

Recommendation

That the submission be declined.

Issue: Consistency of application dates

Submissions
(47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

The application dates should be consistent and should reflect the fact that the changes are intended to clarify the law only.

The New Zealand Law Society submitted that the application date should therefore be from the date of Royal assent. The New Zealand Institute of Chartered Accountants submitted that the provisions should be backdated, or alternatively they should be consistent.

Comment

Currently, section DV 10B allows a deduction for those distributions that meet the requirements of section CD 24B. The deduction applies to the tax year in which the payments are made. The application date of the section is currently the 2006–07 and subsequent tax years. However, the application date for the dividend exclusion in section CD 24B is the date of Royal assent. Co-operatives with late balance dates may be allowed an exclusion as a dividend for a payment that is made after Royal assent (for example, 1 April 2006) but because of their late balance date (for example, 30 September 2006) they cannot receive a deduction for the payment. The application date of section DV 10B should be amended to apply from the 2005–06 and subsequent tax years. This means that a co-operative would be permitted a deduction for payments made under section DV 10B that also met the requirements of section CD 24B on any date after Royal assent.

Recommendation

That the submissions be accepted in part, and that the application date of sections DV 10B and CD 1B be amended to apply from the 2005–06 and subsequent tax years.

Issue: Drafting

Submission
(47 – New Zealand Law Society)

The proposed amendments should clarify that amounts paid by a co-operative company to members, which are deductible to the co-operative, are taxable to the members.

Comment

Under proposed section CD 1B, a distribution made by a co-operative to a member is income to the member. Officials consider that this provision is sufficiently clear and do not recommend that further clarification is necessary.

Recommendation

That the submission be declined.

Submission
(47 – New Zealand Law Society)

New section DV 10B is unnecessary.

Comment

The purpose of section DV 10B is to ensure that a payout will be deductible expenditure to the co-operative if the payout meets the criteria outlined in section CD 24B. Officials do not believe that widening section HF 1, as suggested, is preferable to the current drafting, and it would create complexity and uncertainty.

Recommendation

That the submission be declined.

Submission
(47 – New Zealand Law Society)

Given that the re-write exposure draft proposes to move deductions from section HF 1 to a new section DV 14, proposed DV 10B should be moved to the end of subpart DV.

Comment

This issue will be resolved when the bill is included in the rewrite of Part H.

Recommendation

That the submission be noted.

Submission
(Matters raised by officials)

Section CD 24B should require that any company making a distribution under the proposed rules should be resident in New Zealand.

A further requirement, that the co-operative has no reasonable grounds to believe that the member receiving the distribution is not resident in New Zealand (except if they are trading with the co-operative company through a fixed establishment in New Zealand), should be added.

Comment

The bill requires that a co-operative be resident in New Zealand in order for a distribution to be deductible to the co-operative. However, the legislation as currently drafted does not specifically require that a subsidiary making a payment to a member must be a resident. Officials recommend that the legislation should clarify that any company making a distribution under the proposed rules should be resident in New Zealand.

The proposed changes are intended to restrict the treatment to New Zealand-sourced income, ensuring that the payment to the member is taxed in New Zealand. To reflect this intention, officials also recommend that the co-operative must have no reasonable grounds to believe that the member receiving the distribution is not resident in New Zealand (except if the member is trading with the co-operative company through a fixed establishment in New Zealand), in order for the distribution to be deductible to the co-operative.

Recommendation

That the submission be accepted.

TAX CONSEQUENCES OF NATURAL DISASTERS

Clauses 34, 42, 49, 60, 61, 82, 98, 143(43) and (59), 186, 187 and 192

Submissions were generally supportive of the proposed solutions to technical problems arising from the floods in the lower North Island and the Bay of Plenty in 2004. One submission recommended extending the solutions. Another recommended that deductions should be allowed for losses on farm improvements when the improvement is destroyed by natural causes.

Issue: Support for amendments

Submission
(24 – Federated Farmers)

Federated Farmers note that they were consulted on the proposals and they support them.

Recommendation

That the submission be noted.

Issue: Application dates

Submission
(48 – New Zealand Institute of Chartered Accountants)

The application date for the proposed amendments should be from the 2003–2004 year because in a number of cases the donation of livestock or the restorative grant has already been made.

Comment

The proposed application date for restorative grants is from the 2003–2004 income year. This is necessary to deal with the problems arising from the major floods of 2004.

The application date for transfer of livestock is from the 2005–2006 year. The 2004 events were explicitly dealt with at the time, and this bill introduces the generic legislation.

Recommendation

That the submission be declined.

Issue: Exclusion of associated persons from trading stock donations

Submission
(48 – New Zealand Institute of Chartered Accountants)

The exclusion for trading stock donations by an associated person should be removed.

Comment

Typically, trading stock (which includes livestock) is deemed to be disposed of and acquired at market value. Officials would have concerns about reversing this paradigm, and believe that the proposal is already generous because farmers can self-assess the qualifying event. Therefore, at this stage, we do not recommend the exclusion be extended to cover associated persons.

Recommendation

That the submission be declined.

Issue: Definition of self-assessed adverse event

Submission
(48 – New Zealand Institute of Chartered Accountants)

The definition of "self-assessed adverse event" should be amended to include any other event outside the control of the person.

Comment

The proposed definition has been copied (with no substantive changes) from the long-standing definitions in section EH 36 and EH 63, which deal with income equalisations schemes. This definition has operated as intended for over ten years. Officials do not believe any further extension to cover off-farm events is necessary.

Recommendation

That the submission be declined.

Issue: Farming, horticultural, aquacultural and forestry improvements destroyed by natural causes

Submission
(50W – McCullochs, 46 – PricewaterhouseCoopers)

Deductions for losses on capitalised and amortisable farm development expenditure (improvements such as farm tracks and culverts) should be allowed when the improvement is destroyed by natural causes. *(McCullochs)*

Deductions for losses on farm development expenditure should be allowed where the improvement is destroyed by the taxpayer or another party, or alternatively, when the improvement is destroyed by events beyond the taxpayer's control.
(PricewaterhouseCoopers)

Comment

The Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 allowed a deduction for losses on buildings when a building is irreparably damaged and rendered useless for the purposes of deriving income, when the damage is caused by events beyond the taxpayer's control.

Officials agree that it would be appropriate to similarly allow deductions for losses on capitalised and amortisable farm and horticultural development expenditure when the improvement is irreparably damaged and rendered useless for the purposes of deriving income, and when the damage is *not* caused by the owner or a related party, or their failure to act.

Officials recommend that it would also be appropriate to allow deductions for losses on forestry and aquacultural improvements in the same circumstances.

Recommendation

That the submission be accepted.

Issue: Late estimates of provisional tax for those affected by a self-assessed adverse event

Submission
(Matter raised by officials)

Taxpayers should be able to request that the Commissioner of Inland Revenue accepts late estimates of provisional tax if they are significantly affected by either a self-assessed adverse event or a qualifying event.

Comment

Under current law, Inland Revenue can accept late estimates of provisional tax from a taxpayer if that taxpayer is significantly affected by a qualifying event. The definition of “qualifying event”, which requires the declaration of a state of emergency and the passage of an Order in Council, is overly restrictive. There are other situations which do not meet the criteria of “qualifying event” but where it is appropriate for taxpayers to be able to provide late estimates of provisional tax.

An amendment in the present bill therefore aims to make those measures apply more generally. Under the proposed changes, “qualifying event” has been replaced by “self-assessed adverse event”. This will allow taxpayers to provide late estimates of provisional tax when some natural event has materially affected their farming, agricultural or fishing business. However, under this proposed amendment, taxpayers who do not have farming, agricultural or fishing businesses will not be able to provide late estimates.

Although the criteria for a qualifying event is set at a much higher threshold, it is not restricted to taxpayers with a farming, agricultural or fishing business. Officials believe that it would be appropriate to continue to allow taxpayers significantly affected by a qualifying event to provide late estimates of provisional tax.

Comment

That the recommendation be accepted.

Issue: Remission of penalties on written application

Submissions
(Matter raised by officials)

The application date for the amendment to 183H of the Tax Administration Act should be changed from the 2005–2006 income year to the date of Royal assent. The legislation should clarify that the amendment applies to requests for remissions of penalties from the date of assent.

Comment

The proposed amendment will remove the requirement that requests for remissions of certain penalties be in writing. Currently this amendment will apply from the 2005–2006 income year. This means that some taxpayers, depending on the balance date of their income year, will be able to use the new law earlier than others, which does not seem justified. It seems appropriate to allow all taxpayers to apply for remissions from the date of Royal assent. The amendment should also clarify that the application date relates to the request and not to the time that the penalty arises.

Recommendation

That the submission be accepted.

Issue: Miscellaneous – clarification of EB 23

Submission

(48 – New Zealand Institute of Chartered Accountants)

Section EB 23 should be clarified to apply to those in the primary sector.

Comment

Under section EB 23, taxpayers with turnover of less than $1.3 million do not have to value their trading stock at year-end if their trading stock can reasonably be estimated at less than $5,000.

Amendments to this section were not included in the present bill. However, identification of whether further clarification of section EB 23 is necessary could be considered for inclusion in the government's tax policy work programme.

Recommendation

That the submission be noted.

ACC ATTENDANT CARE

Issue: Application date

Submission
(Matter raised by officials)

The application date of the ACC attendant care proposal should be deferred.

Comment

Officials have reported to the government on the application date of the ACC attendant care proposal.

The ACC attendant care provisions will require regulations to give full effect to the policy intent of the proposals, and enactment of the legislation in March 2006 will not allow sufficient time for the necessary regulations to be prepared and promulgated 28 days before the intended commencement date of both proposals on 1 April 2006. There are also indications that a 1 April 2006 commencement date will not provide sufficient time for all the system changes that ACC and Inland Revenue need to make.

The government has therefore agreed that the commencement date be deferred. The new commencement date is 1 April 2007 for the ACC attendant care proposal.

It is recommended that the application date of the ACC attendant care proposal be amended to reflect the government's decision to defer the application date and to clarify the wording of the application provision.

Recommendation

That the submission be accepted.

Issue: Gross income of an attendant caregiver being paid by an ACC claimant

Submission
(Matter raised by officials)

In accordance with the overall policy of this proposal, two further substantive amendments should be made.

Comment

The change will ensure the gross income of an attendant care provider being paid by an ACC claimant includes the amount of tax originally withheld by ACC (15 cents in the dollar) when it made ACC attendant care payments to the claimant. The second amendment will allow the caregiver a tax credit equivalent to the amount withheld.

It will ensure that caregivers who earn more than $9,500 annually will be taxed at the correct marginal rate. This will also mean that Family Assistance and child support obligations will be calculated accurately.

Recommendation

That the submission be accepted.

Issue: Minor drafting amendments

Submission
(Matter raised by officials)

Minor technical revisions should be made to clauses 17, 144, 158, and 159 to clarify the intent of the provisions.

Comment

Minor technical amendments should be made to clauses 17, 144, 158, and 159.

Clause 17 – section CF 1(2)

This provision should be redrafted to better express the policy intent by making it clearer that the payment addressed in this section goes first to a claimant, and then may be made by the claimant to a caregiver. Only the amount not used to obtain attendant care services should be included as income of the claimant. If the claimant uses all their attendant care payments to pay caregivers, then those payments are exempt income. Clauses 34B, 41B and 42B have been added to ensure this legislation reflects the policy intent.

A typographical error should also be corrected. The reference to the "Injury Prevention, Rehabilitation, and Compensation Act 1991" should be changed to the "Injury Prevention, Rehabilitation, and Compensation Act 2001".

Clause 144 – section OB 2(1)

Two typographical errors relating to references to the Injury Prevention, Rehabilitation, and Compensation Act 2001 and the Income Tax (Withholding Payments) Regulations 1979 should be corrected.

Clause 158 – section 33A(1)(a)(iiic)

The redrafted version of this clause makes it clearer that this provision caters for claimants. It also removes an unnecessary reference to the tax code used by the caregiver.

Subparagraph (iv) is also amended to include a cross-reference to subparagraph (iiic).

Clause 159 – section 33C

The redrafted provision clarifies that returns are personal to the taxpayer, and do not relate to a particular type of income only. The filing threshold in an income year for attendant caregivers is set at more than $9,500 of total income in the income year. A typographical error in the reference to the Injury Prevention, Rehabilitation, and Compensation Act 2001 is also corrected.

Recommendation

That the submission be accepted.

VENTURE CAPITAL INVESTMENT ALONGSIDE THE VENTURE INVESTMENT FUND

Clause 21

Submission
(17, 17A and 17B – New Zealand Venture Investment Fund Limited)

The current drafting of the legislation does not exempt non-resident investors who, as a result of the complexities of the legal structure of the relevant fund, co-invest alongside the New Zealand Venture Investment Fund Limited (VIF) pursuant to separate agreements with the venture capital manager. The bill should include investments made with these types of agreements.

Comment

The VIF enters into two main types of investment agreement. Under the first type, the VIF, its co-investors and a venture capital manager (who makes investments on behalf of the VIF and its co-investors), are party to the same agreement. The current drafting of the bill exempts non-resident co-investors who are party to this type of agreement from tax on realised gains.

Under the second type of agreement, the VIF is party to an agreement with a venture capital manager and its co-investors are party to a separate agreement with the same venture capital manager. Officials agree that the current drafting does not exempt non-resident co-investors who are party to the second type of agreement from tax on realised gains. This is despite the second type of agreement having the same investment conditions and restrictions as the first type.

The proposal is intended to cover all investments made alongside the VIF. Given that there is no reason to distinguish between the types of legal structure of the investment agreements, officials agree that the drafting should be altered to capture all investments made alongside the VIF.

Recommendation

That the submission be accepted.

Submission
(17, 17A and 17B – New Zealand Venture Investment Fund Limited)

That the exemption contemplated in the bill be extended to 31 March 2010 to allow a sufficient period for the VIF to enter into venture investment agreements.

Comment

The proposal is intended to have a temporary effect because the VIF has a limited number of funds to invest. When the funds have been committed, new investors will not be able to access the tax exemption. To ensure that the exemption can apply to all investments made under the current VIF programme, officials agree that the date to which the exemption applies should be extended. If the VIF is still in operation when this amendment ceases to have effect, the issue of whether the exemption should be extended further will be reviewed at that time.

Recommendation

That the submission be accepted.

Submission
(17, 17A and 17B – New Zealand Venture Investment Fund Limited)

Remove the requirement that, for a co-investor to be eligible for the exemption, the VIF be reasonably satisfied that no co-investor (and its associated persons) who is resident in New Zealand has a direct or indirect interest of more than ten percent in the company being invested in.

Comment

In effect, this requirement means the VIF has to investigate the tax residency of the ultimate owners of a VIF co-investor. Officials agree this is not practical.

Recommendation

That the submission be accepted.

EXEMPTION FOR INTERESTS IN EMPLOYMENT-RELATED FOREIGN SUPERANNUATION SCHEMES

Clause 73

Issue: Qualifying private foreign annuity – time period

Submission
(48 – New Zealand Institute of Chartered Accountants)

The four-year timeframe in section EX 37, which contains the qualifying foreign private annuity exemption, should be aligned with the new five-year timeframe in section EX 36(2)(b)(ii).

Comment

The policy intention of the proposed amendments to section EX 36 is to streamline the various FIF exemptions that apply to foreign superannuation scheme interests thereby ensuring both consistency and equity in the FIF rules. Officials consider that aligning the timeframes, which relate to the period of New Zealand residence covered by the exemptions, will be consistent with the stated policy intention.

Recommendation

That the submission be accepted.

Issue: Part entitlements to benefit from a foreign superannuation scheme

Submission
(48 – New Zealand Institute of Chartered Accountants)

Section EX 36 should be amended to clarify that these rules can apply to part of an entitlement to benefit from a foreign superannuation scheme.

Comment

It is the view of officials that the issue raised in this submission should be clarified in the *Tax Information Bulletin* dealing with the new legislation.

Recommendation

That the submission be declined.

Issue: Australian superannuation funds

Submission
(48 – New Zealand Institute of Chartered Accountants)

Foreign investment fund interests in Australian superannuation funds should be subject to the grey-list exclusion when they are acquired through employment in Australia.

Comment

Officials are currently working on the proposal to amend the FIF rules to exempt interests in specified Australian superannuation schemes. The change was signalled in the speech by the then Minister of Finance and Minister of Revenue at the International Fiscal Association on 29 April 2005. The change would apply to first-time and returning residents to New Zealand who hold interests in an employment-related superannuation scheme in which the entitlements under the scheme are generally locked in until retirement.

Further work is being undertaken on the proposal to determine the scope of the exemption – whether it should be extended to all Australian superannuation scheme interests and, if so, whether this extension will resolve the longstanding compliance issues or reduce the disincentive for people to take up long-term or permanent employment in New Zealand.

The submission will be considered in the context of ongoing work.

Recommendation

That the submission be declined.

Issue: Reinstating the exemption relief for current taxpayers

Submission
(46 – PricewaterhouseCoopers)

The amendments to section EX 36 of the Income Tax Act 2004 should not remove the exemption for people who currently rely on it. The amendments were supposed to extend rather than remove the current exemption.

Comment

Officials agree that the proposed amendments to section EX 36 of the Income Tax Act 2004 should be clarified to make it clear that they extend rather than remove the current exemption for interests in employment-related foreign superannuation schemes.

Recommendation

That the submission be accepted.

Issue: Amendments to section EX 36 should be retrospective

Submission

(Matter raised by officials)

The amendments to section EX 36 of the Income Tax Act 2004 should apply from the commencement of the foreign investment fund rules.

Comment

A number of private sector individuals have commented that the relief provided by the proposed exemption should also apply to returning residents who have arrived in New Zealand before 1 April 2006. They consider that the vast majority of people who are aware of their FIF obligations have interpreted the current exemption as applying to returning residents anyway. The effect of the suggested change is that the proposed exemption would apply retrospectively.

Officials are aware that people may not be complying correctly with their tax obligations under the current FIF rules and, indeed, may not even be aware that they have to account for tax. It is recognised that this non-compliance is largely due to the complexity of the FIF rules (and, in particular, the application of the current exemptions) and the differing treatment of first-time residents and returning residents.

It is the view of officials that the suggested change should be accepted as it will simplify the application of the new exemption and improve the equity of the FIF rules as they apply to first-time and returning residents. Although the suggested change is likely to give rise to a fiscal cost this is expected to be small because some existing FIF exemptions relating to superannuation scheme interests have been interpreted by taxpayers as applying to them. A precise measure of the fiscal cost can not be quantified because there is no information readily available on the number of taxpayers who currently hold such interests or who are currently exempt from the FIF rules.

Recommendation

That the submission be accepted.

Issue: Technical deficiencies in new section EX 36

Submission
(48 – New Zealand Institute of Chartered Accountants)

New section EX 36 should be clarified to ensure it applies to both first-time residents and returning residents to New Zealand. As currently drafted, this provision assumes that the person is a first-time resident.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Submission
(48 – New Zealand Institute of Chartered Accountants)

New section EX 36(2)(b)(ii) should refer to the sixth income year after the year of becoming a New Zealand resident.

Comment

New section EX 36(2)(ii) refers to "the fifth income year following the year in which the person becomes a New Zealand resident". This provision ensures that employment-related superannuation scheme interests acquired by new migrants or returning residents in the first five years of New Zealand residence will be covered by the new exemption. Officials consider that the draft legislation accurately reflects the relevant period of New Zealand residence to which the new exemption should apply.

Recommendation

That the submission be declined.

Submission
(46 – PricewaterhouseCoopers)

The period that is referred to in new section EX 36(2) should be properly reflected in new section EX 36(3).

Comment

Officials agree.

Recommendation

That the submission be accepted.

INCREASE IN CHILD TAX REBATE

Clause 89

Submission
(24 – Federated Farmers of NZ, 26W – National Council of Women of New Zealand)

Federated Farmers supports the proposed change. *(Federated Farmers of NZ)*

While this clause offers greater fairness to young workers, the submitter would be concerned if such a measure was seen as an incentive by children and their parents to allow them to work longer hours. The Committee should consult with the Commissioner for Children to ensure that regulations governing the paid employment of children are strictly enforced. *(National Council of Women of New Zealand)*

Comment

The child rebate is being increased so children who earn income below a certain level do not have to complete tax returns. The measure is aimed at reducing compliance and administrative costs.

Recommendation

Note that such consultation is outside the scope of the bill.

REVERSE TAKEOVERS AND CONTINUITY RULES

Issue: Support for amendment

Clauses 2, 146 and 147

Submission
(47 – New Zealand Law Society, 48 – New Zealand Institute of Chartered Accountants)

The Society and the Institute support the amendments.

Recommendation

That the submissions be noted.

Issue: Application date

Submission
(23 – Citibank, N.A. (New Zealand Branch), 48 – New Zealand Institute of Chartered Accountants)

The "clarification" to the concessionary continuity rules should have retrospective effect from 1 April 1992 (the date on which they first came into force).

Comment

The proposals "extend" existing law, but the change applies prospectively.

The present law requires a company to maintain a continuity of shareholding of 49 percent in order to carry forward tax losses, and a continuity of 66 percent for imputation credits to be allocated to dividends. These continuity rules are premised on tracing shareholdings through groups of companies back to non-corporate shareholders. The concessionary continuity rules acknowledge that this is not practicable in some circumstances.

These concessionary rules are not comprehensive in their coverage. This is the second extension to them. The first was in 2002 and allowed for "spinouts" (where a subsidiary of the top-tier company was "spun out" to the top-tier company's shareholders, with no real change in shareholding). In contrast, the underlying tracing rules, while sometimes not practical to apply, are comprehensive.

The concessionary continuity rules do not currently provide continuity when a smaller widely held company takes over or merges with a larger one (for example, a reverse takeover).

From a policy perspective such a takeover or merger should not result in losing tax losses or imputation credits when there is clearly a continuity of shareholding through the process of at least 49 percent or 66 percent respectively. This proposal incorporates changes to reflect this in the concessionary continuity rules.

Citibank argues that the proposal should be made effective retrospectively.

Any decision on the application date of the changes is essentially a matter of judgement. Precedent also needs to be considered. Further, there is a general presumption against making legislation retrospective.

Grounds that may justify a retrospective amendment include:

- the law as written is manifestly unjust under the circumstances; or
- the law as written gave rise to rational and legitimate expectations ("rational expectations") as to how it would apply, and the law did not apply in that way (perhaps due to an unexpected interpretation of the law).

The present concessionary continuity rules are having the effect intended and were generally understood when they were enacted, although some of the outcomes are not appropriate from a policy perspective because the reverse takeover scenario was not specifically considered when the rules were designed. Therefore, it cannot be argued that they are manifestly unjust, or that Citibank should have a reasonable expectation that they should have applied to a merger.

Citibank New Zealand and its tax advisors argue otherwise quoting, in particular, a letter from Policy Advice Division of Inland Revenue dated October 2000. Officials agree that the letter confirms that the merger transaction itself should not, from a policy perspective, cause losses to be lost. In fact, under the underlying tracing rules continuity would not be lost because of the merger transaction. However, this letter should not have caused a rational expectation of what the law is because it makes clear that the opinion is from a policy perspective and does not purport to be an analysis of law.

Citibank also argue that the proposal clarifies existing law and is not a change to it. Officials agree that if the proposal was merely a clarification, retrospectivity could be justified. However, officials believe these proposals change the concessional continuity rules by extending them.

The main argument for retrospective legislation is that Citibank New Zealand has 49.8 percent continuity through its merger process and thus it should be able to carry its losses through the merger in accordance with the underlying policy intent as generally reflected in the continuity legislation. The submission is that the concessionary rules should be retrospectively extended to reflect the policy intention. If its submission is successful, Citibank would still have to establish that they otherwise complied with the concessionary continuity rules throughout the period they had losses.

Notwithstanding this, the government has a general policy of not enacting retrospective tax legislation, and the criteria discussed above for doing so are not satisfied.

Recommendation

That the submission be declined.

Issue: Drafting

Submission
(47 – New Zealand Law Society)

Section OD 5AA(2) should be amended to begin with the words "Subsections (3) and (4) apply if".

Comment

The intention is that subsections (3) and (4) should apply only if subsection (2) is satisfied.

Recommendation

That the submission be accepted in principle

Submission
(47 – New Zealand Law Society)

The words "by reason of having been holders of ownership interests in the initial parent" should be added at the end of section OD 5AA(2)(f)(ii).

Comment

The submitter is making the point that a shareholder may hold other shares in a "new parent" and that these should not upset the continuity measurement. This point is valid.

Recommendation

That the submission be accepted in principle.

Submission
(47 – New Zealand Law Society)

It should be made clear that in applying subsection (2)(e), ownership of the initial and new parents is determined without applying section OD 5(5), or else the relationship between the provisions should be clarified.

Comment

Determining ownership interests in subsection (2)(e) under section OD 5(6)(b) would be consistent with subsection (2)(d). Officials consider that the subsection should be clarified in this way.

Recommendation

That the submission be accepted.

Submission
(47 – New Zealand Law Society)

It is not clear what the purpose of subsection (5) is and this should be spelt out explicitly in any Inland Revenue explanatory material on the provision.

Comment

After further consideration of this complex area of the legislation officials agree that proposed section OD 5AA(5) should not be proceeded with.

Recommendation

That the submission be accepted, and that proposed section OD 5AA(5) should be omitted.

Submission
(47 – New Zealand Law Society)

Subsection (6) does not seem to make sense, and should be amended to do so.

Comment

Officials have discussed this submission with the author, and agreement has been reached that no change is required.

Recommendation

That the submission be declined.

Submission
(47 – New Zealand Law Society)

Subsection (7) marks a change in policy relating to the market interest test.

Comment

Officials agree that subsection (7) needs revisiting. Its intention, to state which core tests apply, is clear but repeated references to section OD 5AA(5) are redundant because of the recommendation to repeal that subsection.

Recommendation

That the submission be noted. Section OD 5AA(7) is to be redrafted for greater clarity and to remove references to section OD 5AA(5).

INCOME TAX RATES

Clause 3

Issue: Confirmation of annual income tax rates for 2005–06 tax year

Submission
(Matter raised by officials)

As the legislation to confirm the annual income tax rates for the 2005–06 tax year was recently enacted via the Taxation (Annual Rates of Income Tax 2005–06) Act 2005, clause 3 of the bill is now redundant and should be removed.

Recommendation

That the submission be accepted.

Issue: Adjustment for inflation

Submission
(24 – Federated Farmers)

The personal income tax thresholds should be adjusted to take into account inflation from 1 April 1998 and thereafter be adjusted regularly for inflation.

Comment

As recommended above, clause 3 of the bill should be removed as it has been already enacted. Given this, officials consider that the submission is outside the scope of the bill.

Recommendation

That the submission be declined.

Issue: Tax rates

Submission

(24 – Federated Farmers, 11W – Business NZ)

Income tax rates should be reduced.

Comment

As recommended above, clause 3 of the bill should be removed as it has been already enacted. Given this, officials consider that the submission is outside the scope of the bill.

Recommendation

That the submission be declined.

FARM CONVERSIONS

Clauses 45, 46, 143(12), 143(47), 150, 193, 200(4), 200(5) and 201

Issue: Support for amendments

Submissions

(24 – Federated Farmers, 48 – New Zealand Institute of Chartered Accountants)

Both Federated Farmers and New Zealand Institute of Chartered Accountants (NZICA) support the proposed changes.

Federated Farmers supports the proposed changes, notes the consultation with officials in developing the changes and acknowledges that the proposal takes account of modern farming practices by enabling regrassing and fertilising expenditure to be amortised for tax purposes at 45% each year when it is incurred in connection with a significant capital activity such as a farm conversion.

Federated Farmers' comment is that although the proposal is not as favourable as would be the case if all such expenditure could be deducted in the year it was spent, it provides a substantially better result than under current law, which would require amortisation of the capital expenditure at 6% a year.

The New Zealand Institute of Chartered Accountants also endorses the proposed changes and discusses several minor technical points.

Issue: Application from the 2005–06 tax year

Submission

(48 – New Zealand Institute of Chartered Accountants)

Instead of the proposed changes applying to expenditure incurred on, and after 1 April 2005, they should apply to the 2005–06 tax year because many farmers have non-standard balance dates.

Comment

As noted in the commentary on the bill, the proposed changes will apply to expenditure incurred on, or after 1 July 2004, and not 1 April 2005, as preferred in the submission.

July 2004 is the month when Inland Revenue issued its Operational Statement (OS 007) on the treatment of farm conversion expenditure. 1 July was set as the application date because the Operational Statement changed the commonly held view of the law by providing a statement for the first time.

A clear, simple switch in treatment under the amortisation rules is provided by having the amendments apply to expenditure incurred after a date, rather than on an income-year basis. This avoids the possibility of having different treatments result for farmers because they have different income years with different balance dates. The amendments will override the Operational Statement in relation to the treatment of regrassing and fertilising expenditure associated with farm conversions and should thereby avoid any further confusion for taxpayers.

Recommendation

That the submission be declined.

Issue: Procedure for claiming deductions for the 2005–06 tax year

Submission
(48 – New Zealand Institute of Chartered Accountants)

The rules should allow taxpayers to "catch up" any deduction that cannot be made in tax returns for the 2005–06 tax year either by reassessment or adjustment in the next tax return period.

Comment

In practice the problem is unlikely to arise as the bill is likely to be enacted in March, which is the same month as Inland Revenue sends out tax returns for the 2005–06 tax year. If there are farmers who have already filed returns that are affected retrospectively by the amendments, Inland Revenue advises that adjustments will be made, on application, by agreement with farmers to reflect the retrospective application of the new law after it comes into force. This is most likely to be the case for expenditure incurred in, and returned for, the 2004–05 tax year.

Recommendation

That the submission be declined.

Issue: Subsection numbering

Submission
(48 – New Zealand Institute of Chartered Accountants)

Section 46 should state:

> Order in Council to amend Schedule 7
> (8) (1) The Governor-…

Comment

The submission refers to clause 46 of the bill, which currently reads:

> **46 Improvements to farm land**
> (1) After section DO 4(7) (Link with subpart DA), the following is inserted:
> ''Order in Council to amend Schedule 7
> ''(8) The Governor-General may from time to time by Order in Council, make regulations to amend Schedule 7 so as to vary the categories of improvements and percentages of diminished value of those improvements allowed as a deduction.''
> (2) Subsection (1) applies for income years corresponding to the 2005–06 and subsequent tax years.

The current drafting follows the conventional way of adding a new subsection – in this case, adding a subsection (8), after the current subsection (7) of section DO 4 of the Income Tax Act 2004. Officials have discussed this submission with the drafter.

Recommendation

That the submission be declined.

Issue: Straight line versus diminishing value amortisation rates

Submission
(48 – New Zealand Institute of Chartered Accountants)

The amortisation rate should be straight line rather than diminishing value. Pasture only has an effective life of three years but expenditure on pasture is never completely written off under the amortisation rules, which only operate on a diminishing value basis.

Comment

The amendments reflect a three-year life for pasture, according to modern farming practices. The specific proposal for grassing and fertilising expenditure proposes a diminishing value rate of 45%. Under Schedule 10 to the Income Tax Act 2004, 45% is the closest equivalent diminishing value rate to the equivalent straight line depreciation rate for an asset with a three-year life, which is 33.33%, rounded to 33.5%.

The changes proposed in the bill make minor amendments to the existing amortisation rules to update and clarify the treatment of grassing and fertilising expenditure. The amortisation rules relate to a significant number of other activities and categories of expenditure affecting not just farming but aquaculture and forestry. Changing the methods used under the amortisation rules would require a broad review of the way farming and other primary sector expenditure is treated, which is beyond the scope of the current minor amendments.

Recommendation

That the submission be declined.

Issue: Definition of significant capital activity

Submission
(48 – New Zealand Institute of Chartered Accountants)

The meaning of a change in the nature or character of a farming activity is too open to interpretation. The definition should be more positive and should exclude conversions that change less than 75 percent of a farming activity.

Comment

A key objective of the amendments is to ensure that some regrassing and fertilising expenditure is recognised as capital account expenditure when it is incurred as part of a larger, significant capital account project.

Accepting the submission would mean in all likelihood that no such expenditure would ever be recognised on capital account. A likely consequence of imposing a fixed limit is that conversions would be timed to straddle two tax years so that the limit is not breached in any one tax year, with the effect that all such expenditure would be treated on revenue account.

Moreover, imposing any set boundary would be arbitrary and inappropriate in relation to assessments which must be made in the circumstances of each case, as each will raise different questions of fact and degree. For example, a significant capital activity for a very large farming business conducted over many farms might never affect anywhere near 75 percent of the business. This means that the capital costs of grassing and fertilising expenditure associated with farm conversion would only be recognised when incurred by smaller, typically single farm, businesses.

Further defining the terms used would risk reducing the flexibility necessary to deal with a wide range of circumstances. The amendments are constructed on the general principles developed by the courts that are used to distinguish activities conducted on capital account from those conducted on revenue account. These principles are discussed in Inland Revenue's Operational Statement (OS 007), issued in July 2004, and help define the meaning of the words in the proposed amendments.

The proposed amendments define a significant capital activity, "in relation to a farming or agricultural business on land in New Zealand", as "an activity that enables a change in the nature or character of a farming activity from that undertaken on the land immediately before the change." In addition, the definition excludes changes in the intensity of farming activities from being treated on capital account, despite that, under general principles, such changes could, in some circumstances, be regarded as being on capital account.

Recommendation

That the submission be declined.

Issue: Guidelines

Submission
(48 – New Zealand Institute of Chartered Accountants)

Guidelines should be provided on what is meant by a change in the nature or character of a farming activity and a change in intensity of a farming practice.

Comment

Inland Revenue's July 2004 Operational Statement (OS 007) refers to a widely understood example of a farm conversion: that of converting a sheep to a dairy farm. The commentary on the bill includes an example of a change in the intensity of a farming activity: moving from eight (low intensity) to 12 (high intensity) sheep or other stock units per hectare. Inland Revenue will consider providing further guidance through its operational statements if there are specific situations of concern.

Recommendation

That the submission be noted.

ROLLOVER OF EXEMPTION FOR INVESTMENTS IN LISTED CFCS

Issue: Consequential amendments

***Clause** 77*

Submission
(46 – PricewaterhouseCoopers)

The bill proposes to replace section EZ 29 with a new section EZ 29. The purpose of the amendment is to extend the exemption for interests in certain listed controlled foreign companies (CFCs) until the 2010–2011 tax year. The current sections EX 19(5), EX 21(35) and EX 46(7) refer to section EZ 29 using the words, "Disclosure restrictions on grey list CFCs before 2006–07". Given that the CFC exemption is being extended, these sections should be amended so that they refer to section EZ 29 using the words, "Disclosure restrictions on grey list CFCs before 2011–12".

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Other changes to the GST Act

GST ON GOODS AND SERVICES SUPPLIED TO SECURITY HOLDERS

Issue: Purpose of the amendments and consultation

Clauses 203(2) and (6), 20, 205(2) and (4), 206, 207(2) and (5), and 209

Submissions
(48 – New Zealand Institute of Chartered Accountants)

The amendments do more than clarify the application of GST to suppliers of financial services and, in fact, overturn the Court of Appeal decision *Commissioner of Inland Revenue v Gulf Harbour Development Limited*.[16] As such, it is a base-maintenance measure, not a clarification.

Consultation on the proposal was not on the basis envisaged by the generic tax policy process.

The GST Act should follow the legal form of transactions. The amendments are inconsistent with this principle.

The amendments will create uncertainty, create areas of dispute and cause difficulties with determining the value of supplies that are caught by the changes.

Comment

Officials agree that the amendments are of a base-maintenance nature, but consider that they also clarify application of GST to supplies of financial services. Specifically, the amendments clarify the scope of the GST exemption that applies to financial services with a view to stopping arrangements that substitute the supply of otherwise taxable goods and services with GST-exempt financial services.

The general concern regarding the scope of the financial services exemption in connection with substituting otherwise taxable goods and services with financial services was raised in the discussion document, *GST and financial services*, which was released in October 2002 with the usual opportunity to make submissions.[17] The proposal outlined in the discussion document for dealing with substitution problems was not considered to be effective following the later High Court decision *Gulf Harbour Development Limited v Commissioner of Inland Revenue*[18] and further work was carried out which has resulted in the amendments in this bill.

Officials agree that, for the most part, determining the GST treatment of a transaction according to its legal form produces the most efficient tax outcome. This outcome, however, needs to be balanced against the effect that substitution can have on consumer behaviour because of its potential tax advantages. If, in the absence of suitable anti-avoidance measures, a product can be offered without GST, consumers

[16] (2004) 21 NZTC 18,915.
[17] See paragraphs 6.21 to 6.24, page 40, *GST and financial services*.
[18] (2003) 21 NZTC 18,192.

will have an obvious preference for this product over an identical product that is subject to GST, resulting in inappropriate policy outcomes. Since its enactment, the GST Act has contained a number of measures that deal with the substitution of otherwise taxable goods and services with GST-exempt financial services. The amendments in this bill are consistent with these earlier anti-avoidance measures.

The boundary between taxable goods and services and GST-exempt financial services, as with any tax boundary, creates uncertainty and areas of dispute. The court decision involving Gulf Harbour Development Limited is an illustration of this. The amendments seek to reduce the extent to which disputes occur and uncertainty arises by refining the boundary between taxable and exempt supplies, and setting out the consequences if otherwise taxable goods and services, such as club memberships, are supplied to security holders as a result of a right arising from the security.

Uncertainties regarding the application of the amendments to debt securities are considered in relation to the next submission, "Proposed scope and application of the amendment". Officials consider the recommendation to remove "debt securities" from the scope of the amendments provides a solution that should, to some extent, deal with the New Zealand Institute of Chartered Accountants' concerns.

Recommendation

That the submission be noted.

Issue: Proposed scope and application of the amendment

Clause 203(2)

Submissions
(14W – The Retirement Villages Association of New Zealand Inc, 43AW – Deloitte)

Commentators on the bill have noted that the amendment could require GST to be paid on refundable deposits paid to secure licences-to-occupy at a retirement complex. Although the intent of the amendment is not to impose GST on such supplies, the matter needs to be put beyond doubt. *(The Retirement Villages Association of New Zealand Inc)*

The amendment should not apply to debt securities and the words "debt security" should be removed from the definition of "associated supply". *(Deloitte)*

Comment

Clause 203(2) defines the type of transaction that is to be treated as an "associated supply". The amendments respond to the Court of Appeal case *Commissioner of Inland Revenue v Gulf Harbour Development Limited* and are directed at arrangements that seek to substitute the supply of otherwise taxable goods and services for the supply of GST-exempt financial services (such as shares). The effect of these arrangements is to remove the GST that a consumer would otherwise pay for the supply of goods and services by instead having the consumer acquire shares in a company or other securities that give rights to receive the goods and services.

The amendments attempt to remove any GST advantages associated with these arrangements. The GST advantages are removed as the supplier of the GST-exempt financial services will be required to attribute the consideration received for the financial services to the supply of the otherwise taxable goods and services at the open market value of those goods and services.

The submitters are concerned that the amendment will affect the supply of debt securities (GST-exempt) that give the holder a licence to occupy a dwelling in a retirement complex (a taxable supply). Submitters argue that the effect of the amendments potentially results in GST being payable on the full value of the debt security as this represents the value of the licence-to-occupy.

Typically, an individual will secure a licence to occupy from a retirement village complex by advancing a sum of money to the managers of the complex (in the form of a refundable deposit). The refundable deposit is treated as a loan (debt security) from the individual to the retirement village and interest may or may not accrue on the principal.

When the individual dies or moves, the deposit is returned (with interest, if any) less any costs that the retirement village managers consider should be deducted under the terms of the arrangement. GST is usually returned on any amounts deducted.

One interpretation of the amendments, particularly clause 203(2), is that GST could apply to the refundable deposit for a licence to occupy at the time the deposit is paid.

The amendments are not, however, intended to apply to arrangements where the debt is repaid because there is no discernable substitution between the supply of the refundable deposit (GST-exempt) and the licence-to-occupy (taxable). Further, the GST Act seems to correctly tax these arrangements without the additional assistance of the amendments in this bill.

The inclusion of debt securities in the proposed definition of "associated supply" was in response to concerns regarding the general substitutability between equity and debt investment.[19] Officials consider that the problem the amendments seek to address is less likely to arise under debt securities. Although debt and equity are substitutable economically, investing using equity gives rise to different legal relationships in connection with ownership and participation in assets from those arising from the use of debt.

Officials note from the submission from Deloitte that the definition of "debt security" in the GST Act is limited to interests that provide a right to receive money, unlike the definitions of "equity security" and "participatory security" which include the assets and liabilities of an entity. The narrower focus of the definition of "debt security" and the Privy Council case *Culverden Retirement Village v Registrar of Companies*[20]

[19] Also see *Riverside Country Club v The Queen* 2001 CanLII 778 TCC. This case concerned whether the supply of club membership was substituted for the supply of debt. The Canadian Tax Court considered that the debt did not give membership rights.
[20] (1997) 8 NZCLC 261,301. The case concerned the meaning of the term "debt security" used in the Securities Act 1978. The GST Act uses a similar definition to the one used in that Act.

suggest that it is harder to substitute otherwise taxable supplies for GST-exempt financial services using debt securities.

Officials agree that debt securities should be removed from the proposed definition of "associated supply" in clause 203(2) and the valuation rule in clause 205(2). This change should also address the concerns raised by the Retirement Villages Association of New Zealand in its submission.

Recommendation

That the submissions be accepted. Clause 203(2) and 205(2) should be amended to remove the words "debt security".

GST AND INTERNATIONAL POSTAGE STAMPS

Issue: Support proposed amendment

Clauses 205(1) and (3)

Submission
(22W – Ernst & Young)

Ernst & Young on behalf of DX Mail, agrees with the proposal to ensure a level playing field for all entities operating in the postal services market. This will be achieved by clarifying that all postage stamps supplied in New Zealand are subject to GST irrespective of whether the stamps are used to send mail overseas and irrespective of whether the seller is registered under the Postal Services Act 1998.

Recommendation

That the submission be noted.

Issue: Oppose proposed amendment

Clauses 205(1) and (3)

Submissions
(19 – Universal Mail Limited, 19A – Universal Mail 48 – New Zealand Institute of Chartered Accountants)

The amendment will:

- create more anomalies within the GST Act rather than remove them;
- is not consistent with the policy of GST; and
- will substantially reduce the profitability of Universal Mail. *(Universal Mail)*

The cost of sending an item (letter, parcel or other article) from New Zealand should be zero-rated. GST policy needs to be consistently applied to all items that are delivered overseas. *(New Zealand Institute of Chartered Accountants)*

Alternatively, Universal Mail suggests that the provision that ensures couriers are excluded from the proposal should be removed, or that all international mail be zero-rated.

Comment

Officials agree that the arguments for and against imposing GST on postage stamps used to send mail overseas are finely balanced. However, when considered in the context of the market in which postage stamps are used, compared with the transportation of goods or the communications market, officials consider that, on balance, the better argument is that GST should apply. Officials also note that the policy advanced in this bill is consistent with international agreements on the treatment of charges relating to the delivery of mail and policies being developed in the European Union.

The problem that the amendment seeks to resolve is the result of deregulating the postal services market and the different purposes of the Postal Services Act 1998 and the GST Act. Legislation governing the supply of postal services is concerned with domestic postal services. Postal services involved in overseas mail only are not covered by the Postal Services Act, whereas operators involved in both domestic and international mail delivery are. Persons that are not regulated by the Postal Services Act may use stamps, but these are not "postage stamps" as defined in the Postal Services Act. The reference to the GST Act to "postage stamp" was intended to cover all instances when postage stamps were supplied, not just to those governed by the provisions of the Postal Services Act.

The objective of the amendment in this bill is to ensure that:

- supplies of postage stamps are treated the same regardless of whether the person selling the stamps in New Zealand is registered under the Postal Services Act; and
- the consumption of postal services remains in the GST base.

Officials note that while Universal Mail and the New Zealand Institute of Chartered Accountants oppose the proposed amendment, it is supported by DX Mail, which is also involved in the postal services market. New Zealand Post was consulted during the development of the policy.

Why are stamps taxed when courier services are zero-rated?

GST is a tax on consumption that occurs in New Zealand. For practical purposes this means that sales of goods and services in New Zealand to New Zealanders and tourists alike are subject to GST. This policy is integral to the objectives of maintaining a broad-base, low-rate GST system. In principle this policy suggests that the supply of transportation services involving the movement of goods from New Zealand should also be taxed.[21]

The costs associated with moving goods to and from international borders are considered to be embodied in the value of the goods when they reach their ultimate destination. Transportation costs, including insurance and the declared value of the goods, will often form the dutiable value for excises, duties and indirect taxes (such as VAT or GST) imposed at the border of destination. Transportation costs from the country of origin are therefore zero-rated to reduce the potential for double taxation to

[21] A deduction for any GST paid would be allowed to the NZ exporter if the transportation was incurred for the purpose of making taxable supplies.

arise as goods move from one country to another. Postage stamps are rarely, if ever, included in this calculation.

In the case of stamps that are purchased in New Zealand, the supply occurs in the country of origin. The New Zealander or tourist directly receives the stamp and has the discretion to hold on to the stamp as a collectors' item (souvenir) or use it to post a mail article. If any other product was supplied to a tourist or New Zealander in New Zealand, GST would apply (duty-free shopping would be an exception to this).

Under the principles set out in the Court of Appeal decision *Wilson & Horton v Commissioner of Inland Revenue*,[22] the purchaser in New Zealand is considered to receive the benefit of having the mail sent to another person. While officials note the inconsistency with international travel and international courier services, officials consider that this does not necessarily lead to a presumption that outbound postal services should have the same treatment as these other services.

Officials therefore view outbound mail delivery services purchased in New Zealand to be services consumed in New Zealand. Importantly, this policy is consistent with the Universal Postal Union (UPU) agreement where consumption is considered to occur in the country of residence of the initiator or sender of the mail. Therefore, GST should be charged by the country in which the initiator of the mail resides.

Officials also note that courier services operate in a different market and provide a product that is distinguishable from standard postal services in terms of price, speed of delivery, security and certainty of delivery. Officials are of the view that the services couriers offer are therefore not directly substitutable for the postal market.

Supply of postal services like other communication services

Officials consider that other equally valid comparisons to postal services can be made, for example, telecommunication services and sending electronic mail from New Zealand. These communications services are all subject to GST if initiated in New Zealand because consumption is considered to occur in New Zealand. This policy is consistent with the international treatment of telecommunication services used in Australia, Canada and the European Union. The supply of all forms of communication by fax, e-mail, telecommunication or letter should be treated similarly.

Regardless of which analogies are drawn, an economic distortion may be perceived in these situations depending on an individual's perspective of which "market" they view their products to be competing in.

[22] (1995) 17 NZTC 12,325.

Whether the amendment will create further anomalies

The purpose of the amendment is to remove GST pricing advantages for postal operators who are not required to register under the Postal Services Act, and who argue that they are not required to charge GST on international outbound mail delivery. The amendment ensures that all suppliers of postage stamps are treated equally for GST purposes and that consumption in New Zealand is appropriately taxed. Officials therefore note that the amendment removes an anomaly rather than creates one.

Other matters

Apportionment: Universal Mail notes that most of its services are carried out overseas, leading to an apportionment of the sale price attributable to the domestic and international component of the transaction. Officials note that apportioning the price of a postage stamp in this way is inconsistent with the way the Courts analyse the application of GST.[23] It is more appropriate to consider the application of GST on a supply of goods and services in terms of the product received by the consumer, not according to the means or components that made up the supply. This analysis creates an all or nothing approach in determining the application of the zero-rating rules unless the contract under which the goods and services are supplied makes it clear that there is an intention to make two separate supplies (domestic postage and international postage) rather than one.

Cost to Universal Mail: Universal Mail is concerned that the amendment will reduce its profitability. However, officials are of the view that the amendment reflects the policy intent that goods and services supplied in New Zealand be subject to GST at the standard rate. Further, it is arguable whether an unregistered postal operator can in fact properly apply the criteria governing the supply of vouchers as set out in the GST Act and on which Universal Mail has based its business. The key criterion is whether it can be argued that it is not practical (because the issuer and supplier are different persons) to treat the issue or sale (as opposed to the redemption) of a voucher as a supply of goods and services. Officials acknowledge that the change will have an impact on Universal Mail's profitability.

Alternative proposals

Submitters have recommended two alternative proposals to the change contained in this bill.

Zero-rate international postage stamps: The argument for zero-rating international mail is on the basis that it involves the movement of goods from New Zealand to another country. In support, submitters note that couriers, prepaid delivery vouchers (PAT labels) and similar services involving the movement of mail from New Zealand are similarly zero-rated. Officials estimate that the revenue cost associated with zero-rating international mail would be the region of $1.5 to $2 million a year. However, in addition to the earlier arguments regarding the appropriate place of consumption and the differences between mail and courier services we have wider concerns that zero-rating international mail could create a precedent for zero-rating communications

[23] See *Auckland Institute of Studies Ltd v Commissioner of Inland Revenue* (2002) 20 NZTC 17,685 and *Commissioner of Inland Revenue v Gulf Harbour Development Ltd* (2004) 12 NZTC 18,915.

services to overseas, such as international telephone calls or internet services. Officials consider that international post is in competition with these communication services. The effect of zero-rating these services would give rise to much larger revenue cost and would be inconsistent with international practice.

Do nothing: Universal Mail suggests that as a further alternative, the change in this bill does not proceed. The purpose of the amendment is to ensure that the supply of postage stamps in New Zealand is subject to GST regardless of whether the person providing the mail delivery services in return for the stamp is a registered postal operator under the Postal Services Act. If the amendment does not proceed the current distortion in the GST treatment of postage stamps will remain. Officials note that the submission from DX Mail supports the amendment.

Treatment of postage stamps in other countries

To give an indication of how finely balanced the arguments regarding the treatment of postage stamps are, officials have set out the treatment of postage stamps in other countries:

Australia: Australia zero-rates the supply of postage stamps used for international mail. Officials, for the reasons outlined under this submission, do not consider that this treatment is appropriate.

Canada: Canada taxes the supply of stamps used for international mail up to the value of $CAN5 (as calculated by the face value of the stamp). Stamps that exceed this dollar value are generally considered to involve the movement of goods from Canada and are zero-rated. Officials consider that the treatment of stamps in New Zealand should not be determined on the basis of the value of the stamps used but on the basis of where consumption occurs.

The European Union: The Commission of the European Communities has recognised that the exemption of postal services in the European Union from Value Added Tax (VAT) is creating distortions in the postal sector. Therefore, the Commission has proposed that all postal services, regardless of the destination, will be taxable at the relevant standard-rate of VAT. The place of supply will be in the country of departure. This approach is consistent with the proposed approach contained in the bill.

Conclusion

Officials note that the arguments for and against imposing GST on postage stamps are finely balanced. The comparisons drawn between postal services and couriers handling letters are not necessarily invalid. Officials consider there are some important differences and that other comparisons are also valid. If other policy considerations are taken into account, such as the appropriate place of consumption, the balance of arguments suggests that postal services that are paid for using a postage stamp in New Zealand should be subject to GST at the standard rate of 12.5%.

Recommendation

That the submissions be declined.

Issue: Residual uncertainty

Clauses 205(1) and (3)

Submission
(22W – Ernst & Young on behalf of DX Mail)

There could still be some uncertainty surrounding the nature of the supply for GST purposes. The amendment explicitly states that the supply of a stamp will occur on sale. However the amendment is not explicit about whether the supply is subject to GST at 12.5% or zero-rated.

Comment

The amendment clarifies that the supply of a stamp for GST purposes occurs on issue or sale and not when the stamp is redeemed. The place of supply is in New Zealand as the stamp is issued to a person in New Zealand. Therefore, GST must be charged at 12.5%. In order to zero-rate the supply, the supply would need to satisfy the zero-rating provisions contained in the GST Act and this is fact-specific.

Officials are of the view that any further legislative clarification is unnecessary.

Recommendation

That the submission be declined.

GST AND DISTRIBUTIONS FOR NO CONSIDERATION

Issue: Application date

Clauses 207(1), (2) and (3)

Submission
(48 – New Zealand Institute of Chartered Accountants)

The amendment should be retrospective except for the situation when a GST return has already been filed on a different basis and the taxpayer is not disputing the application of the current law with Inland Revenue.

Comment

The application date for the proposed amendment is when the bill is enacted. The amendment clarifies that supplies between registered, associated people for no consideration are revenue neutral. As the amendment confirms the policy intent, the amendment should apply from the date GST commenced, 1 October 1986.

Recommendation

That the submission be accepted. Clauses 207(1) and (3) should apply from 1 October 1986.

Issue: The scope of the amendment should be extended

Clause 207(3)

Submission
(48 – New Zealand Institute of Chartered Accountants)

The amendment should also apply to relationship property splits.

Comment

The amendment is designed to deal with concerns specific to the distribution of property to a GST-registered beneficiary for no consideration or as a gift. These events are treated as supplies for GST purposes. Officials acknowledge that relationship property splits under the Property (Relationships) Act 1976 may also be treated as supplies for GST purposes.[24]

[24] See *Ti Toki Cabarets (1989) Ltd v Commissioner of Inland Revenue* (2000) 19 NZTC 15,576.

However, officials consider the circumstances under which relationship property splits arise under the Property (Relationships) Act are different from those the amendment seeks to address. The circumstances envisaged by the Property (Relationships) Act are considerably wider than those referred to in the submission as occurring under a matrimonial agreement. Officials therefore consider that extending the application of the amendment to relationship property splits may not be an appropriate policy response for all circumstances where property is divided following a relationship, and that the submitter's concern should be dealt with as far as possible using the existing provisions of the GST Act.

Recommendation

That the submission be declined.

Other changes to the Tax Administration Act

COMMISSIONER MAY ISSUE AN ASSESSMENT WITHOUT FIRST ISSUING A NOPA

Clause 164

Submission
(48 – New Zealand Institute of Chartered Accountants)

The technical amendment to replace the words "income year" with the word "period" in section 89C(db) of the Tax Administration Act is supported, but the circumstances in which the Commissioner of Inland Revenue can issue an assessment without first issuing a notice of proposed adjustment (NOPA) should be limited.

Comment

The amendment is a technical correction that allows section 89C(db) to apply to GST returns as well as to income tax returns.

Section 89C lists the circumstances when the Commissioner may make an assessment without issuing a NOPA. They include when the assessment reflects an agreement between the Commissioner and the taxpayer or when the Commissioner believes a notice may cause the taxpayer to leave New Zealand. Section 89C(db) enables the Commissioner to issue an assessment in relation to a matter that is identical to an assessment of the taxpayer for another income year that is at the time subject to court proceedings. In this situation the disputes process would have been completed in relation to the earlier assessment, and the purpose of the amendment is to reduce the compliance and administrative costs of going through the process again.

Officials note that the circumstances in which the Commissioner may issue an assessment without first issuing a NOPA are already reasonably limited and the amendment seeks to clarify rather than extend these circumstances.

Recommendation

That the submission be declined.

RESPONSE PERIOD TO START A DISPUTE FOR DISPUTABLE DECISIONS

Clause 155(17)

Submission
(Matter raised by officials)

The bill contains a provision to ensure that the four-month response period for the taxpayer to issue a notice of proposed adjustment (NOPA) applies to a "disputable decision" issued by the Commissioner of Inland Revenue under Part IVA.

However, because the term "disputable decision" is also used to establish the response period to start the challenge procedure under Part VIIIA, the proposed amendment is wider than intended.

Comment

Officials recommend that the amendment be restricted to situations where a NOPA is issued in response to a disputable decision under Part IVA – the disputes resolution process. This will ensure that the status quo remains for the two-month period to initiate challenge proceedings.

Recommendation

That the submission be accepted.

DEEMED ACCEPTANCE OF A VALID NOPA IF COMMISSIONER DOES NOT RESPOND WITHIN THE SPECIFIED PERIOD

Submission
(48A – New Zealand Institute of Chartered Accountants)

The dispute resolution rules should be clarified to confirm that the Commissioner of Inland Revenue is deemed to accept a valid taxpayer Notice of Proposed Adjustment (NOPA) if the Commissioner does not respond to that NOPA within the specified response period.

Comment

A key feature of the disputes rules is the timeframe allocated to parties to a tax dispute to lodge notices and respond to notices received from the other party. The purpose of the notices is to encourage an "all cards on the table" approach to tax disputes so that that all relevant evidence, facts and legal arguments are canvassed. Responding to notices within a specified period of time ensures that tax disputes are dealt with efficiently and promptly.

Under the dispute resolution rules taxpayers have four months from the receipt of an assessment if they want to dispute the assessment. The Commissioner then has two months within which to respond to the taxpayer. Alternatively, if the Commissioner issues a NOPA, the taxpayer has two months to respond.

The submitter notes that underpinning the response time limits is a rule that if there is a failure to respond within the specified period the Commissioner or taxpayer are deemed to have accepted the other party's NOPA. The Commissioner accepts this and is bound by the relevant law. A dispute will end on deemed acceptance (subject to the discretion of the Court in certain limited and prescribed circumstances).

The specific question to be considered is whether, despite having been deemed to have accepted a taxpayer NOPA through not responding in time, the Commissioner is prevented from starting a new dispute, subject to the four-year time bar, when the Commissioner considers that a return is in error. This matter is currently being discussed between representatives of the New Zealand Institute of Chartered Accountants and Inland Revenue.

Recommendation

That the submission be noted and that it also be noted that Inland Revenue officials and representatives of the New Zealand Institute of Chartered Accountants are continuing to discuss the matter.

SHORTFALL PENALTY FOR TAKING AN UNACCEPTABLE TAX POSITION

Submission
(48 – New Zealand Institute of Chartered Accountants)

The unacceptable tax position shortfall penalty in section 141B of the Tax Administration Act should be amended to return to the narrower "unacceptable interpretation penalty", with an increase to the level of temporary shortfall and voluntary disclosure reductions.

Comment

An unacceptable tax position shortfall penalty of 20% is imposed on a taxpayer if, viewed objectively, their tax position fails to meet the standard of being "about as likely as not to be correct". The penalty is only imposed when the tax shortfall is significant – that is, a shortfall over $20,000 and the lesser of either 1% of the total tax figure or $250,000. The penalty does not apply to tax shortfalls that arise from mistakes in the calculation or recording of numbers in a return.

In 2003 the penalties legislation was amended. The "unacceptable tax position" penalty was previously the "unacceptable interpretation" penalty. Before the amendment a taxpayer could argue that they had not made an interpretation and therefore the unacceptable interpretation penalty could not be imposed.

The New Zealand Institute of Chartered Accountants considers that the unacceptable tax position shortfall penalty could penalise most, if not all, errors in excess of the minimum thresholds. If a taxpayer has made and acknowledges an error, by definition, it cannot be "about as likely as not to be correct". The effect is that errors that should be considered under the reasonable care rules are being penalised under the unacceptable tax position rules. This is adversely influencing taxpayer behaviour, with taxpayers less inclined to disclose errors for correction by Inland Revenue.

Mr Jeff Owens has also written to the Committee seeking an amendment to the legislation that would remove the application of the unacceptable tax position shortfall penalty in situations that involve a significant tax shortfall but a minimal risk to the revenue. He is particularly concerned about the imposition of the penalty where a taxpayer lodges a return, discovers an error in the return, corrects the error, and pays the correct amount of tax by the due date.

This submission involves significant policy issues which are not addressed in the bill. Officials are reporting to ministers setting out options to resolve this issue which, if agreed to, could be included in a supplementary order paper introduced at the Committee of the Whole House stage.

Recommendation

That the submission be noted.

Rewrite of the Income Tax Act

Issue: Unintended changes

Submission
(Matters raised by officials on the recommendation of the Rewrite Advisory Panel)

Corrections of unintended changes in legislative outcomes in the Income Tax Act 2004 should be included in the bill.

The provisions affected are: section CB 9(1)(b) and Schedule 22A (sales of land by builders and associated persons of builders), section CD 32(15) (exclusions from dividends for available subscribed capital), section CD 33(2) (exclusions from dividends for capital gains), section CD 33(7)(b) (exclusion from dividends for capital gains), section EC 48 (replacement of bloodstock), section EI 6 (allocation across income years of income derived in anticipation), section EZ 35(3) (base price adjustment result under old financial arrangement rules), section 394L(4A) of the Income Tax Act 1976 (export market development credits and the imputation credit account).

In addition, there are a small number of minor drafting amendments that have been brought to the attention of the Rewrite Advisory Panel. These amendments correct punctuation, spelling, grammar and cross-referencing in the 2004 Act and are listed on the Panel's website on the "Maintenance Items Log".

Comment

At the time of enactment of the Income Tax Act 2004, the Finance and Expenditure Committee (FEC) noted a concern that the new legislation could contain adverse unintended policy changes. In response, the FEC recommended that a panel of tax specialists be appointed to review submissions which stated that a provision of the 2004 Act contained 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. The Rewrite Advisory 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.

These retrospective changes, that merely restore the 1994 Tax Act's status quo, have been recommended by the Panel to officials. Officials agree with them.

Recommendation

That the proposed amendments to restore the 1994 Tax Act status quo be included in the bill and that they apply from the beginning of the 2005–06 income year, being the application date of the 2004 Act for all taxpayers.

Issue: Section OB 1 – definition of "shares of the same class"

Submission

(Matters raised by officials on the recommendation of the Rewrite Advisory Panel)

In section OB 1 of the 2004 Act, the drafting of the definition of "shares of the same class" provides for the three paragraphs (a), (b), and (c) to be alternative conditions to satisfy in order for shares to fall within this definition.

Under the Income Tax Act 1994 definition of "shares of the same class", paragraphs (a) and (b) had to be satisfied cumulatively, and paragraph (c) was an alternative condition.

The Rewrite Advisory Panel recommends the definition of "shares of the same class" be amended to restore the position under the 1994 Act.

Comment

Officials note that the 1994 Act definition of "shares of the same class" contained a drafting error arising from an amendment in the Income Tax Amendment Act 1994 (applying from 1 July 1994).

Before this amendment, the three paragraphs (a), (b) and (c) in the definition were required to be applied cumulatively. The 1994 amendment repealed and replaced paragraph (b) and, in doing so, inadvertently omitted the conjunction "and" between paragraphs (b) and (c). This left some uncertainty about how the provision applied, and the 2004 Act was drafted as if each of the paragraphs was an alternative test.

The rule's intent is that all three paragraphs are to be applied cumulatively. As paragraph (c) does not apply to all situations, the rule is that where paragraph (c) applies, then it is intended to be applied cumulatively with paragraphs (a) and (b) and not as an alternative condition to those two earlier paragraphs.

Officials agree with the Panel that the definition in the 2004 Act contains an unintended change in law when compared with the 1994 Act. However, officials believe it is better to have the definition reflect the correct policy intention rather than being amended to give rise to an incorrect policy outcome. The correct policy outcome is that the three paragraphs (a), (b), (c) should be applied cumulatively. Officials consider this outcome should apply from 1 July 1994, which would require both the 1994 and the 2004 Acts to be amended.

However, because a retrospective amendment of this nature has potential to adversely affect filed tax positions, officials consider that a savings provision would be required overcome this possibility.

Recommendation

That the 1994 Act be amended to correct the drafting of the provision to ensure the conditions in all three paragraphs are to be applied cumulatively, and that this amendment apply retrospectively to 1 July 1994.

That the 2004 Act be correspondingly amended, and that this amendment apply from the beginning of the 2005–06 income year.

That a transitional provision ensures that these amendments do not apply to a person who has a filed tax position before the commencement of the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Bill for any relevant tax year to which the recommended amendment would otherwise apply.

CHANGES RECOMMENDED BY OTHERS

Issue: Remedial amendments required

Submission
(46 – PricewaterhouseCoopers)

The submitter recommends five remedial amendments to correct cross-referencing and wording errors arising from the rewrite of the Income Tax Act.

Comment

Officials note that of the five recommended changes, no change is required to the cross-references in the OB 1 definition of "finance lease" as these are correct.

Of the four remaining recommendations:

- The suggested correction to the terminology used in section CS 1(2) will be considered for possible inclusion in the next tax bill.
- The suggested correction to the cross-referencing error in section FB 2(2) is included in the bill (see clause 77B).
- The cross-referencing error in section EX 22(2) will be considered for possible inclusion in the next tax bill.
- The cross-referencing error identified in section OB 3(1)(b)(i) is corrected by an amendment recommended by officials on page 354 of this report.

Recommendation

That the submission be noted.

Issue: Ordering rule and slice rule

Submission
(46 – PricewaterhouseCoopers)

The submitter recommends a change to the definition of "shares being cancelled of class" as used in a formula to calculate a taxpayer's "available subscribed capital".

Comment

The change suggested by the submitter potentially results in a change in policy. Officials will consider whether the matter should be included on the tax policy work programme.

Recommendation

That the submission be declined.

Other changes recommended by officials

APPLICATION OF SECTION EE 41 TO BUILDINGS

Submission
(Matter raised by officials)

A drafting error in section EE 41(3), which excludes buildings from the depreciation claw-back provisions in section EE 41(1), should be corrected.

Comment

Section EE 41(2) of the Income Tax Act 2004 allows a loss when an item of depreciable property is disposed of for an amount less than its adjusted tax value. The exception is where the item is a building. The Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 allowed, via the insertion of a new subsection (3), a loss on disposal to be claimed for a building in limited cases – that is, if a building has been irreparably damaged and rendered useless for the purposes of deriving income and the damage is outside the control of a taxpayer (for example, as the result of a natural disaster).

However, owing to a drafting error in new subsection (3), section EE 41(1), which claws back depreciation when an item of depreciable property is disposed of for consideration in excess of its adjusted tax value, no longer applies to buildings. A remedial amendment is therefore needed to clarify that section EE 41(1) continues to apply to buildings. The correction should be retrospective to the application date of the changes in the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005.

Recommendation

That the submission be accepted.

PAYE DEDUCTIONS

Issue: PAYE tax deductions

Submission
(Matter raised by officials)

Three problems have been identified in section LD 1 of the Income Tax Act which deals with the way PAYE tax deductions are credited towards the tax liability of taxpayers, namely:

- When an employer fails to account for PAYE actually deducted, employees should be given credit for the amount of PAYE deducted by their employer. However, the legislation incorrectly refers to the employee receiving credit for the amount of PAYE received by Inland Revenue.
- When a shareholder-employee receives a greater refund of PAYE than entitled to, the shareholder-employee and the employer are jointly liable for the difference between the amount refunded and the amount paid to Inland Revenue by the employer. However, the legislation incorrectly refers to the shareholder-employee and the employer being liable for the difference between the amount refunded and the amount shown on the employer monthly schedule, which could inappropriately benefit both parties.
- An amount of PAYE credited to an employee of a close company must not exceed the amount of tax received by the Commissioner of Inland Revenue. However, the legislation incorrectly refers to the refund including any family assistance credits paid to the employee. The employer no longer pays family assistance to employees, and the reference should be removed to avoid confusion with family assistance credits paid by Inland Revenue.

Comment

These problems should be corrected to preserve the integrity of the PAYE tax deduction system and to ensure that the rules operate as intended. This will require a new clause to be inserted into the bill.

Recommendation

That the submission be accepted.

PROHIBITIONS ON HAVING IMPUTATION CREDIT ACCOUNTS

Submission
(Matter raised by officials)

Section ME 1(2)(a) of the Income Tax Act 2004, which prohibits a company resident in a country other than New Zealand from having an imputation credit account, should be repealed with application from the 2005–06 income year.

Comment

A New Zealand-resident company must establish and maintain an imputation credit account (ICA) under section ME 1(1) of the Income Tax Act 2004 unless it is prohibited from doing so under any of the circumstances listed in section ME 1(2).

Before an amendment made by the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004, section ME 1(2)(a) prohibited a company from having an ICA if it was "not resident in New Zealand". This provision was redundant and should have been repealed because only a New Zealand-resident company can have an ICA. However, the 2004 amendment replaced section ME 1(2)(a) with a provision that prohibits a company from having an ICA if it is "resident in a country other than New Zealand".

As a result, the current section ME 1(2)(a) has the unintended effect of prohibiting all dual resident companies from having an ICA. This should not be the case. Only a dual resident company of the type listed in section ME 1(2)(b) – that is, a company treated as not being a New Zealand resident for the purposes of a double tax agreement – should be prohibited. Current section ME 1(2)(a) should therefore be repealed.

Recommendation

That the submission be accepted.

DEFINITION OF “BENEFICIARY INCOME”

Submission
(Matter raised by officials)

The definition of “beneficiary income” in section OB 1 of the Income Tax Act 1994 should be amended so that the reference to “income year” includes a non-standard accounting year.

Comment

The definition of “beneficiary income” in section OB 1 of the Income Tax Act 2004 uses the term “income year”. The term “income year” is defined as the tax year (ending 31 March) or the non-standard accounting year approved by Inland Revenue. The definition of “beneficiary income” provides for distributions to be made to beneficiaries during the income year or within six months after the end of the income year.

The effect of the reference to “income year” is that the six-month period expires on a date that is six months after the (approved) balance date of the trust. This is different from the Income Tax Act 1994 where the period ended six months after 31 March (30 September).

The Rewrite Advisory Panel considered a submission that the 2004 Act contains an unintended change from the 1994 Act. The Panel agreed that such a change had occurred, but decided that the 2004 Act should remain unchanged and that a retrospective change to the 1994 Act should be made to bring it into line with the 2004 Act. This involves amending the definition of “beneficiary income” in the 1994 Act so that the reference to “income year” includes a non-standard accounting year.

The amendment to the 1994 Act will protect the position of all options used by taxpayers by giving them the later of six months post-balance date (for those who followed the 2004 Act position) or 30 September (for those early balance date taxpayers who followed the 1994 Act).

Recommendation

That the submission be accepted.

CROSS-REFERENCES BETWEEN THE GST ACT AND NEW CREDIT CONTRACTS LEGISLATION

Clauses 204(1B) and 207(3B)

Issue: Amendments required to smooth transition

Submission
(Matter raised by officials)

Officials have received submissions from the Financial Services Federation and PricewaterhouseCoopers to consider amending the GST Act to provide transitional relief following changes to legislation governing the treatment of credit contracts.

The GST Act makes two cross-references to the credit contracts legislation:

- in connection with the definition of "financial services" under which services are exempt from GST; and
- a special valuation rule that separates the interest component under a credit contract from the principal value of the goods and services supplied under the contract. Under special valuation rules GST applies to the principal value but not the interest.

A problem has arisen because the GST Act was consequentially amended to reflect the new definition of "credit contract" in the Credit Contracts and Consumer Finance Act 2003 (CCCFA). Some lease arrangements, which were previously treated as "credit contracts" under the Credit Contracts Act 1981, no longer qualify as "credit contracts" under the CCCFA. The term "credit" now applies to a narrower set of contracts under the CCCFA.

For a contract to be considered a "credit contract" it must meet one of three limbs of the definition of "credit".[25] The most significant of these is that the contract must defer a payment of a debt. There are two elements to this requirement:

- there must be a debt; and
- the payment of that debt must be deferred.

Many finance leases do not defer the payment of debt. Each payment is due and payable as and when required under the lease. The total amount of the lease payments are not due on day one of the lease with the payments deferred over the term of that lease. Because of this, there is no deferral of a debt.

[25] See section 6 of the CCCFA.

By contrast, before the CCCFA came into effect on 1 April 2005, leases were treated as “credit contracts” under the Credit Contracts Act 1981 if a contract, under which a person provides or agrees to provide money or money’s worth in consideration of a promise by another person to pay a sum or sums of money, exceeded in aggregate the amount of first mentioned money or money’s worth.[26]

The result of the change in the meaning of “credit” is that lessors, who entered into certain lease arrangements before 1 April 2005 on the expectation that GST would not apply to the interest component, must now return GST. This effect was unintended.

Comment

The changes brought about by the CCCFA, including the change to the definition of “credit contract”, are intended to provide better protection for consumers by:

- simplifying the law in relation to credit products; and
- regulating the supply of consumer credit such as home loans, personal loans, credit sales (including hire purchases) and credit cards.

The policy intent of the reference to credit contract is to exclude the interest component of a contract from GST if the interest component has been clearly identified in the contract.

Officials have consulted with representatives of the finance lease market (the Financial Services Federation) on the effect the change in reference to the new credit contract legislation has had on the application of the GST Act.

To date, members of the Financial Services Federation (FSF) have not been able to reach consensus on whether the GST Act should continue to use the old definition of “credit contract” in the Credit Contacts Act 1981 or use the new definition used in the CCCFA. However, agreement has been reached between officials and the FSF that transitional relief is required to assist taxpayers until the problem of definitions is resolved.

The transitional relief would seek to carry forward the old 1981 definition of “credit contract” for leases:

- entered into before 1 April 2005, and
- entered into after 1 April 2005.

Some members of the FSF have, however, expressed a preference for the new definition of “credit contract”. These members wish to continue to use the new definition for contracts entered into after 1 April 2005. Officials have been advised that there are substantial costs associated with system changes to accommodate the CCCFA. Taxpayers that are complying with the new credit contracts legislation do not want to incur costs in moving back to the old definition.

[26] See section 3(1) of the Credit Contracts Act 1981.

Officials consider that for the purposes of the GST Act, both definitions should be available to taxpayers until the definition problem is resolved.

Officials will recommend to the Minister of Revenue that the issue be included on the tax policy work programme and be advanced for a later taxation bill. The choice that taxpayers will have under the recommended change, in terms of what contracts are treated as "credit contracts", is intended to apply for a limited time until officials, in consultation with the FSF, have developed an agreed solution that applies to all GST-registered persons who offer credit contracts.

Officials consider that both the substantive problem of definition and the recommended transitional relief do not have substantive revenue implications but will have a material impact on compliance costs.

Officials therefore recommend that the GST Act recognises contracts that comply with the Credit Contracts Act 1981 or Credit Contracts and Consumer Finance Act 2003 as meeting the definition "credit contract" where it appears in the GST Act. The amendment should apply from 1 April 2005, the date the CCCFA came into effect.

Recommendation

That the submission be accepted.

Issue: Rebate for gifts of money – Habitat for Humanity New Zealand Limited

Submission
(Matter raised by officials)

Section 67 of the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005 purported to amend section KC 5(1) of the Income Tax Act 2004 to add Habitat for Humanity New Zealand Limited to the list of entities donations to which are eligible for tax rebates from the 2005–06 tax year. Because of an error in the amending words, the amendment is inoperative.

Comment

Re-enactment of the amendment for the 2005–06 and later tax years is necessary to achieve the intended policy outcome.

Recommendation

That the submission be accepted.

Issue: Meaning of "qualifying company"

Submission
(Matter raised by officials)

Section OB 3(1)(b)(i) of the Income Tax Act 2004 should be amended to refer to "subsection (3)" rather than "subsection (2)".

Comment

Section OB 3(1)(b)(i) (Meaning of qualifying company) contains a cross-reference to subsection (2) of that section. Subsection (2) was omitted when section OB 3 was re-enacted as part of the Income Tax Act 2004. The cross-reference should refer to subsection (3).

Recommendation

That the submission be accepted.

Issue: Correction to Schedule 18 of Income Tax Act 2004

Submission
(Matter raised by officials)

Section 169 of the Crown Entities Act 2004 relates to the tax treatment of statutory entities, including the New Zealand Symphony Orchestra Limited. At the time of enacting the Crown Entities Act 2004, the name of the New Zealand Symphony Orchestra Limited should have been omitted from Schedule 18 (which lists State Enterprises) of the Income Tax Act 2004.

Comment

The failure to omit the name of the New Zealand Symphony Orchestra Limited from Schedule 18 does not affect the tax status of the company but should, for reasons of consistency, be done as soon as possible.

Recommendation

That the submission be accepted.

Issue: Disclosure of information to prevent cessation of benefit payments

Submission
(Matter raised by officials)

Section 82A(5) of the Tax Administration Act 1994 should be amended to refer to section 81(4)(o) rather than section 81(4)(n).

Comment

Section 82A(5) contains a reference to section 81(4)(n) of that Act. The reference is incorrect because section 81(4)(n) was repealed in 2003 and re-enacted as section 81(4)(o).

Recommendation

That the submission be accepted.

Other changes pertaining to the bill

WINE EQUALISATION TAX REBATE

SOP 380

Submission
(47 – New Zealand Law Society)

The society queries why the proposed power to make regulation concerning double tax agreements is not general, rather than relating solely to wine and Australia added as a simple addition to section 225(1) of the Tax Administration Act.

Comment

This item has been removed from the bill and enacted as part of the Taxation (Urgent Measures) Act 2005. The amendments referred to by the New Zealand Law Society were redrafted before inclusion in the Taxation (Urgent Measures) Act.

Recommendation

That the submission be declined.

GENERAL MATTERS

Business New Zealand made two general submissions relating to the bill.

Issue: Consultation

Submission
(11W – Business New Zealand)

The submitter notes that they were omitted from the list of parties with whom officials consulted over proposals in the bill.

Comment

The omission of Business New Zealand from the list of professional groups and industry representatives included in the explanatory note to the bill (page 43) was an oversight. Business New Zealand was consulted on a number of the proposals contained in the bill.

Recommendation

That the submission be noted.

Issue: Inland Revenue resources

Submission
(11W – Business New Zealand)

The submitter recommends that Inland Revenue is provided with sufficient resources to administer the policy and legislative initiatives recently outlined by the government, so that resources are not diverted away from further tax simplification initiatives.

Comment

Officials note that Inland Revenue has been allocated additional financial resources to implement the recent changes announced by the government.

Recommendation

That the submission be noted.