Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill

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

Volume 1

Technical amendments to the portfolio investment entity rules

Offshore portfolio share investment rules

Life insurance and portfolio investment entity rules

Other policy matters

Remedial amendments

Other matters raised by officials

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CONTENTS

Technical amendments to the portfolio investment entity rules

OVERVIEW

New tax rules for collective investment vehicles that meet the definition of a "portfolio investment entity" were enacted by the Taxation (Savings Investment and Miscellaneous Provisions) Act in December last year.

These optional rules were designed to alleviate a number of long-standing problems with the taxation of collective investment vehicles. The rules will treat investment through portfolio investment entities in the same way as direct investment by individuals, thus removing long-standing disadvantages of saving through intermediaries like managed funds. The changes were particularly important given the implementation of KiwiSaver this year.

Portfolio investment entities will not be taxable on realised share gains made on New Zealand and Australian companies. Portfolio investment entities will pay tax on investment income based on the tax rates of their investors (capped at 33%, and at 30% from 1 April 2008). Income earned via a portfolio investment entity will not affect investors' entitlements to family assistance, or their student loan repayments or child support obligations.

The portfolio investment entity rules apply from 1 October 2007.

A number of submissions were received on technical aspects of these rules. The changes that have been recommended are of a remedial nature, and include ensuring that the rules for portfolio investment entities that derive income from land – such as listed property trusts that own commercial property – achieve their intended policy effect.

INVESTOR REQUIREMENTS

Issue: Breach of investor requirements

Submission
(55 – New Zealand Funds Management Ltd)

When a portfolio investment entity breaches the investor requirements, it has until the end of the quarter following the quarter in which the breach occurs to rectify it, before losing its portfolio investment entity status. This safe harbour period should be changed because it is still possible for the portfolio investment entity to be unaware that the requirements have been breached after the time limit for correction.

The qualifying unit trust safe harbour in section HL 6(3) should therefore be available to an entity that is or has been offered to the public under the Securities Act 1978.

Alternatively, the portfolio investment entity should have until the end of the quarter following the quarter in which the breach is discovered to rectify the breach, providing the portfolio investment entity has proper procedures in place to identify any breaches.

Comment

The main reason that a fund that offers its units to the public under the Securities Act 1978 would not be able to meet the definition of "qualifying unit trust" (and therefore gain the benefit of a safe harbour) is that they would have fewer than 100 investors. A fund with this number of investors should be able to monitor whether any of its investors have more than 20 percent of the fund, and whether there are more than 20 investors. The current rules only require them to monitor this on a quarterly basis. If there is a breach, the entity has up to two quarters to rectify that breach. Officials consider that this provides reasonable opportunity for a fund to comply with the investor requirements.

Recommendation

That the submission be declined.

Issue: Investor requirements for superannuation schemes that are declining in size

Submission
(55 – New Zealand Funds Management Ltd)

Existing superannuation schemes, approved KiwiSaver schemes or complying superannuation funds should be able to retain their portfolio investment entity status if they breach the investor requirements as a result of a decline in the size of the scheme.

Alternatively, existing superannuation schemes, approved KiwiSaver schemes or complying superannuation funds should be able to retain their portfolio investment entity status if no member (with their associates) holds more than 40 percent of the scheme.

Comment

Officials agree that problems can arise when superannuation funds that were established before introduction of the portfolio investment entity rules decline in size. The problems can arise because the number of fund investors can fall, which can result in the fund falling below the investor requirements. This is a particular problem for existing superannuation funds because their trust deeds may not have sufficient flexibility to reorganise the membership of their funds so that this does not occur.

Superannuation funds that were in existence before the introduction of the Taxation (Savings Investment and Miscellaneous Provisions) Bill 2006 on 17 May 2006 should therefore not be required to meet the investor test, provided that no investor (other than the fund's manager or trustee) can control the investment decisions relating to any of the entity's funds. This would apply only to superannuation funds that, if they were unit trusts, meet or would have once met paragraphs (a) and (c) to (e) of the definition of "qualifying unit trust".

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Qualifying unit trust safe harbour should apply to portfolio investor class

Submission
(Matter raised by officials)

The portfolio investment entity rules should be amended so that the exemptions from the investor membership and investor interest size requirements only apply if each "portfolio investor class" of the entity would, if it were a unit trust, meet the requirements of paragraphs (a) and (c) to (e) of the "qualifying unit trust" definition.

Comment

To qualify as a portfolio investment entity, an entity must generally meet the investor membership requirement and the investor interest size requirement. There are exemptions to these requirements if the entity, if it were a unit trust, would meet the requirements of one or more of paragraphs (a) and (c) to (e) of the "qualifying unit trust" definition. These exemptions are designed to provide widely held savings vehicles with more certainty that they will meet the portfolio investment entity eligibility requirements. These exemptions currently apply if the entity can satisfy the qualifying unit trust definition. The problem is that this could result in a portfolio investor class of a qualifying entity gaining portfolio investment entity status even though that particular class is not widely held. This is inconsistent with the policy intent of the rules. Therefore, it is recommended that these exemptions are amended so that each "portfolio investor class", rather than the entity itself, is required to meet paragraphs (a) and (c) to (e) of the definition of "qualifying unit trust" (if the entity were a unit trust).

Recommendation

That the submission be accepted.

Issue: Definition of "portfolio investor class" to clarify that investors can benefit differently from proceeds of a portfolio investment if difference only due to different tax rates

Submission
(Matter raised by officials)

The definition of "portfolio investor class" should be clarified so that investors can benefit differently from the proceeds of a portfolio investment if that difference results only from the application of different portfolio investor rates over the term of the investment.

Comment

For a group of investors to constitute a single "portfolio investor class" each investor must participate equally (in proportion to their percentage holding in the fund) in the underlying investments of the fund. An issue arises in relation to financial arrangements held by the portfolio investment entity that provide investors with capital guarantees. Typically, under these arrangements if investors suffer a capital loss over the investment term the portfolio investment entity exercises the capital guarantee and receives a taxable amount that, after application of investors' portfolio investor rates, is sufficient to compensate each investor for their capital loss.

As investors can have different portfolio investor rates there is an argument that this results in investors having different interests in a portfolio entity investment, (the capital guarantee being the portfolio entity investment). In many cases, the financial arrangement that provides the capital guarantee would not be a portfolio entity investment as the arrangement would not generally be entered into with the prospect of deriving a positive return. However, it should be put beyond doubt that people who invest in a portfolio investment entity that holds such a capital guarantee will not be prevented from being part of the same portfolio investor class merely because they have different portfolio investor rates. The definition of "portfolio investor class" should therefore be clarified so that investors can benefit differently from the proceeds of a portfolio entity investment if that difference results only from the application of different portfolio investor rates over the term of the investment.

Recommendation

That the submission be accepted.

INVESTMENT TYPE REQUIREMENTS

Issue: Investment type requirements should include land not currently in use

Submission
(61 – KPMG, 59 – Property Council of New Zealand)

Currently, section HL 10(1)(a) requires that an entity must use or have available to use 90 percent or more by value of the entity's assets in deriving income from owning an interest in land. The section should be amended to ensure that it covers land that is not currently in use, but will be in the future. An example of this is when land is vacant or when property is under construction.

Comment

Officials consider that the concern raised in the submission can be resolved by amending section HL 10(1) to remove the current income derivation wording. Therefore, the investment type requirement would be that 90 percent or more by value of the entity's assets must be qualifying assets.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Operating expenses for land

Submission
(61 – KPMG, 59 – Property Council of New Zealand)

In the income type requirement in section HL 10(2), the word "rent" should be replaced by a reference to payments received in relation to an interest in land. This is so that it includes operating expenses in relation to the land.

Comment

Officials agree that payments from lessees that relate to their interest in land, such as operating expenses, should be covered by section HL 10(2)(b)(iii). Officials do not agree that the word "rent" should be removed, as this provides helpful clarification that payments for licences are not qualifying income for the purposes of section HL 10(2)(b)(iii).

Officials also consider that section HL 10(2)(iv) should be clarified by referring to proceeds from the disposal of property referred to in section HL 10(1).

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Investments in other portfolio investment entities should be taken into account for the entity shareholding investment requirement

Submission
(61 – KPMG)

The reference in section HL 10(4) to investments in subsection (3) should be clarified to ensure that investments in other portfolio investment entities are taken into account in working out whether the entity shareholding investment requirement (in relation to investments of over 20 percent) is satisfied.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

FOREIGN INVESTMENT VEHICLES

Issue: Application of foreign investment vehicle definition to trusts

Submission
(59 – Property Council of New Zealand)

The test for whether an entity is a foreign investment vehicle should be applied to the level of the trust rather than the trustee.

Comment

Some types of trusts in a chain of foreign entities investing into New Zealand do not technically come within the "unit trust" definition, and therefore the foreign investment vehicle definition does not apply. This problem would be resolved if the settlor of the trust that does not meet the "unit trust" definition is treated as the investor.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Controlled foreign company rules and foreign investment vehicles

Submissions
(55 – NZ Funds)

Currently, section EX 1(1B) applies only where one of the tests in section EX 1(1) is met. Therefore it could be argued that on a strict application of the provision, it does not apply where more than one of the section EX 1(1) requirements are satisfied. Section EX 1(1B) should be amended to ensure that it applies where one or more of the tests in subsection EX 1(1) are met.

The rules providing for the re-application of the controlled foreign company rules when a foreign company ceases to be a foreign investment vehicle should be clarified.

Comment

Officials agree with the first submission that the application of section EX 1(1B) be clarified.

Officials do not consider the rules providing what happens when a foreign company ceases to be a foreign investment vehicle need to be clarified. If the foreign company meets any of the controlled foreign company tests in section EX 1(1) at any time in the foreign company's accounting period and the foreign company is not a foreign investment vehicle at that time, then the company is treated as a controlled foreign company for the whole of the accounting period.

Recommendation

That the submission ensuring that section EX 1(1B) applies when one or more of the tests in section EX 1(1) are met be accepted.

That the submission requesting clarification of the rules on what happens when a foreign company ceases to be a foreign investment vehicle be declined.

PORTFOLIO LISTED COMPANIES

Issue: The qualifying unit trust requirement should be removed for portfolio listed companies

Submission
(74D – Deloitte)

Currently, under section HL 11B, an unlisted company must meet the requirements of paragraph (a) of the definition of "qualifying unit trust" in order to be treated as a portfolio listed company.

This requirement should be replaced with a requirement that the company has at least 100 shareholders.

Comment

Officials agree with the submission, as the replacement requirement would ensure that the unlisted company is widely held.

Recommendation

That the submission be accepted.

Issue: Taxation of trustee income

Submission
(59 – Property Council of New Zealand)

Trustees in portfolio listed companies should be taxed at 30%.

Comment

The policy underlying the portfolio investment entity rules is that the maximum tax rate on any investor in a portfolio investment entity should be 30% from 1 April 2008. Currently, section CX 44D(3)(b) can result in a trustee investor in a portfolio listed company being taxed at 33% on their imputed income from the portfolio listed company. Officials agree that this treatment is not consistent with the policy intent, and therefore recommend that New Zealand-resident trustee investors in portfolio listed companies should be treated the same as individual New Zealand-resident investors in respect of imputed income from portfolio listed companies.

Recommendation

That the submission be accepted, subject to officials' comments.

PORTFOLIO LAND COMPANY SHOULD BE SUBJECT TO THE INCOME TYPE REQUIREMENT

Submission
(Matter raised by officials)

The income type requirement in section HL 10(2) should apply to a portfolio land company.

Comment

Portfolio investment entities can own and lease land and buildings to active businesses as long as they are not themselves active businesses. Examples of non-active businesses are listed property trusts that own commercial property.

The income type requirement in section HL 10(2) provides that the majority of the entity's income must be passive income, such as dividends, interest and rent.

Currently, this requirement does not apply to a portfolio land company, which is a subsidiary of a portfolio investment entity. This is contrary to the policy intent of the rules. Officials recommend that this should be corrected.

Recommendation

That the submission be accepted.

Issue: Transfer of unvested contributions if vesting schedule is longer than five years

Submission

(23 – Investment Savings and Insurance Association of New Zealand Inc, 54 – ASB)

If a member transfers to a master scheme or new provider, the new superannuation fund should be able to apply the member's prescribed investor rate to unvested employer contributions regardless of the length of the vesting period.

Comment

Officials consider that transfers from a superannuation scheme that existed before 17 May 2006 to a new superannuation scheme, and where there is no change in substance to the benefits a member will receive from unvested contributions, should continue to be treated as if the transfer had not occurred. This means that income relating to the unvested contributions will continue to be taxed at the portfolio investor's rate.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Fund withdrawal tax for non-KiwiSaver superannuation funds becoming portfolio investment entities

Submission

(23 – Investment Savings and Insurance Association of New Zealand Inc)

The timing of the fund withdrawal tax (FWT) when employer-contributed funds are withdrawn from a superannuation fund that is a portfolio investment entity is misaligned.

Fund withdrawal tax is imposed in the tax year after the year of withdrawal. However, if a superannuation fund is a portfolio investment entity, tax is payable within one month of the end of the month in which the portfolio investor exit-period occurs.

To remedy this misalignment, FWT should be abolished, or the superannuation fund should be able to pay FWT at the same time as tax on partial or full withdrawals by portfolio investors.

Comment

Officials consider that FWT obligations are quite separate from portfolio investment entity tax obligations. Therefore it would be incorrect to abolish FWT as a consequence of the portfolio investment entity tax rules.

Aligning the payment of FWT with the payment of tax on full or partial withdrawals by investors would be legislatively complicated to achieve. Also, the systems of some portfolio investment entities may not be sufficiently developed to cater for this. Officials therefore do not support such alignment of payment dates.

Recommendation

That the submission be declined.

Issue: Unit pricing for material timing differences

Submission
(24 – AMP Financial Services and AMP Capital Investors)

Unlisted property trusts that are portfolio tax rate entities often include certain material timing differences in their unit pricing. These material timing differences include depreciation of property held on capital account and revaluations of property held on revenue account. Section EG 3, as currently drafted, suggests that these items be taxed at the time they are factored into unit pricing. However, these should not be taxed until they are realised.

Comment

Officials and AMP have discussed the problem and agree that it is largely an accounting concern, for which a legislative solution is inappropriate.

Recommendation

That the submission be noted.

Issue: Zero-rated investor deduction in section DB 43B should refer to the portfolio tax rate entity's tax year

Submission
(61 – KPMG)

Section DB 43B(2)(a) currently states that a zero-rated portfolio investor has a deduction for an amount of portfolio investor allocated loss from a quarterly tax paying portfolio tax rate entity if "the investor's income year includes the end of the portfolio calculation period". This should refer to the portfolio tax rate entity's tax year, rather than portfolio calculation period.

Comment

Officials agree with the submission. Section DB 43B(2) would therefore provide that an investor has a deduction for the amount of portfolio investor allocated loss in the investor's income year that includes the end of the portfolio tax rate entity's income year.

Recommendation

That the submission be accepted.

Issue: Definition of "portfolio investor rate"

Submissions

(17 – Mercer Human Resource Consulting, 23 – Investment Savings and Insurance Association of New Zealand Inc, 61 – KPMG)

The definition of "portfolio investor rate" in section OB 1 should ensure that portfolio investment entities are not required to retrospectively apply changes of tax rates advised to them by portfolio investment entity members. To achieve this, the word "period" in para (b)(iii) of the definition of "portfolio investor rate" should be replaced with a reference to "portfolio allocation period". *(Mercer Human Resource Consulting)*

The legislation should be amended to clarify that if an investor changes their portfolio investor rate at any time during the year, the new portfolio investor rate will apply to any amount for which the tax liability has not already been calculated. *(Investment Savings and Insurance Association of New Zealand Inc)*

The definition of "portfolio investor rate" should make it clear what the term "calculated" in subparagraph (iii) means for the purposes of the definition. *(KPMG)*

Comment

The intention of the legislation is that the reference to "period" should be a reference to "portfolio allocation period". This amendment would resolve the concerns of Mercer Human Resource Consulting and the Investment Savings and Insurance Association.

Officials do not consider it is necessary to clarify what "calculated" means in the section OB 1 definition of "portfolio investor rate". It is clear from the context that "calculated" refers to calculation events such as year-end calculations, portfolio exit period calculations and calculations under section HL 23B. Therefore, if there has been no calculation event, a portfolio investment entity can apply the most recently notified rate for each day in the calculation period.

Recommendation

That the Mercer Human Resource Consulting and the Investment Savings and Insurance Association submissions be accepted.

That the KPMG submission be noted.

Issue: Charities investing in portfolio investment entities should be taxed at their marginal rates

Submission
(58 – Trustee Corporations Association)

Charities should get a rebate of imputation credits to ensure that they are taxed at their correct marginal rate.

Comment

The portfolio investment entity rules maintain the current position that imputation credits are not refundable to charitable investors. The question of whether imputation credits should be refunded is being considered in a separate review. Whether the benefit of imputation credits should be provided to charitable investors under the portfolio investment entity rules should be considered as part of this review.

Recommendation

That the submission be noted.

Issue: Option to not use excess foreign tax credits from one portfolio investor class to offset tax from other portfolio investor classes

Submission
(Matter raised by officials)

The rules should be amended so that it is clear that portfolio investment entities and portfolio investor proxies have the option of not using excess foreign tax credits from one portfolio investor class to offset tax from other portfolio investor classes.

Comment

The intention of the rules is that portfolio tax rate entities and portfolio investor proxies should be allowed, but not required, to use excess foreign tax credits received for an investor from one portfolio investor class against the tax liability of that investor from other portfolio investor classes. This flexible approach is appropriate as the sophistication of systems will vary across providers. Currently it is not clear whether section HL 27 provides portfolio tax rate entities and portfolio investor proxies with the option of not using excess foreign tax credits from one portfolio investor class to offset tax from other portfolio investor classes. Section HL 27 should therefore be clarified to provide this flexibility.

Recommendation

That the submission be accepted.

Issue: Foreign tax credits

Submissions

(74C – Deloitte, 61 – KPMG, 58 – Trustee Corporations Association, 54 – ASB)

A portfolio investor proxy's foreign tax credits are restricted to the lesser of the allocated credits or the maximum tax liability on the allocated income. The foreign tax credits available to a portfolio investor proxy should not be restricted. *(Deloitte, Trustee Corporations Association)*

It is unclear whether there is a restriction on portfolio investor proxies transferring foreign tax credits. Section HL 27 should be amended accordingly. *(KPMG)*

The legislation should clarify that a custodian investing into several different portfolio investment entities on behalf of an investor can group income, losses and tax credits in relation to those investments. *(ASB)*

Comment

It is fairly common for people to hold a portfolio of investments via a custodian. These are often referred to as "wrap accounts" and provide investors with the same benefits of direct ownership of the underlying investments. In addition, the custodian will often provide a range of investment services including, in some cases, the deduction of resident withholding tax (RWT) on dividends and interest.

The portfolio of investments that the custodian holds for the investor is likely to include interests in managed funds. The portfolio investment entity rules have been designed so that a custodian (referred to in the legislation as a "portfolio investor proxy") can calculate tax on behalf of its investors when someone invests through a custodian into an underlying portfolio investment entity. This makes sense because the custodian is likely to be deducting RWT for the investor on the investor's non-portfolio investment entity investments.

The rules achieve this treatment by the portfolio investment entity applying a zero percent tax rate to the PIE income earned on behalf of the portfolio investor proxy, with the PIE income flowing through to the portfolio investor proxy. The portfolio investor proxy is then required to calculate and deduct tax on that income as if the portfolio investor proxy were a portfolio investment entity. Broadly, this means that the portfolio investor proxy can treat the person's separate investments in underlying PIEs as if they were a single investment in an underlying PIE. The person's separate investments in underlying PIEs, from the perspective of the portfolio investor proxy, are treated as separate portfolio investor classes in the same PIE. This approach allows the rules relating to investor exit, use of tax credits and losses to work appropriately.

However, as the submissions point out, the tax credit rules in section HL 27 should be amended so that portfolio investor proxies can use the full amount of foreign tax credits received from portfolio investment entity investments to offset tax on PIE income. This would align the foreign tax credit rules that apply to portfolio investor proxies investing in portfolio investment entities with those applying to portfolio tax rate entity PIEs that invest in other PIEs.

Recommendation

That the submissions be accepted, subject to officials' comments.

Issue: Portfolio investor proxies should be able to satisfy PIE tax on behalf of investors by directly accessing cash accounts

Submission
(Matter raised by officials)

A portfolio investor proxy should be allowed to satisfy portfolio investment entity tax on behalf of its investors by directly accessing cash accounts that the investor holds with the portfolio investor proxy.

Comment

Under the rules, portfolio tax rate entities will generally pay tax on behalf of investors by reducing investors' interests in the portfolio investment entity. In contrast, some portfolio investor proxies have been structured to pay portfolio investment entity tax on behalf of investors by directly accessing the cash accounts that investors hold with the portfolio investor proxy. There is no policy reason why a portfolio investor proxy should not be able to satisfy portfolio investment entity tax on behalf of their investors in this way and the PIE rules should be amended to explicitly provide for this option.

Recommendation

That the submission be accepted.

Issue: Portfolio investor rate that is lower than the prescribed investor rate

Submission
(Matter raised by officials)

Portfolio investor allocated income should continue to be excluded income to the investor if the investor provides to the portfolio investment entity a portfolio investor rate that is lower than their prescribed investor rate and the portfolio investment entity has not subjected that income to a final tax calculation.

Comment

Currently section CX 44D can be interpreted so that the portfolio investor allocated income of an investor for the year is not excluded income if the investor has provided the portfolio investment entity at the start of the year with a portfolio investor rate that is lower than their prescribed investor rate. This could result in portfolio investor allocated income being taxed to investors even if the investor provides their correct rate before the portfolio investment entity performs a final tax calculation for the investor. Therefore, section CX 44D should be amended so that portfolio investor allocated income remains excluded income for a year and the PIE applies the investor's correct rate when performing a final tax calculation.

Recommendation

That the submission be accepted.

Issue: Administration and management fees

Submission
(54 – ASB)

Investors should be able to elect to either deduct administration and management fees charged by a portfolio investor proxy for managing an investor's investment portfolio against the portfolio investor proxy income in the portfolio investor proxy tax computations, or deduct the administration and management fees charged by a portfolio investor proxy in their individual tax returns.

Comment

Officials consider that the current legislation provides that administration and management fees that investors incur for investments through a custodian are allocated to:

- the investor directly when the investment through the custodian is not portfolio investment entity-related; and
- the portfolio investor proxy (which is treated as a portfolio investment entity) when the investment is portfolio investment entity-related.

Recommendation

That the submission be noted.

Issue: Timing of receipt of tax credits

Submission
(61 – KPMG)

The same timing rules should apply to receipt of credits for both zero-rated investors and exiting investors.

Comment

Officials agree with the submission. The credits should be treated as being received in the investor's income year that includes the end of the portfolio investment entity's income year.

Recommendation

That the submission be accepted.

Issue: Allocation of credits by portfolio tax rate entities

Submission
(Matter raised by officials)

It should be clarified that section EG 3 allocates tax credits to the same period as the income to which the credits relate. (Section EG 3 allows PIEs to recognise amounts for tax purposes at the same time they recognise those amounts for unit pricing and financial reporting purposes.)

Comment

This amendment is consistent with the current section EG 3.

Recommendation

That the submission be accepted.

PRESCRIBED INVESTOR RATE FOR TRUSTEES

Submission
(61 – KPMG, 58 – Trustee Corporations Association)

Trustees should be able to elect a prescribed investor tax rate of 19.5% in addition to the current options of 0% and 33%. Under this approach the income would be taxable (that is, not excluded income) to the trustee with a credit available for the 19.5% tax that was deducted at the portfolio investment entity level. This would allow trustees to manage their fiduciary obligations and minimise compliance costs because it would reduce the risk of beneficiaries becoming subject to the provisional tax rules.

Comment

It has not been possible in the time available to develop this proposal sufficiently to allow it to be incorporated in this bill. The proposal could be considered for a future tax bill if the writers of the submission wish to discuss this further with officials.

Recommendation

That the submission be noted.

INVESTOR EXPENDITURE

Submissions
(23 – Investment Savings and Insurance Association of New Zealand Inc, 71 – PricewaterhouseCoopers)

Expenses transferred under subpart DV are currently treated as expenditure at the portfolio investment entity level in section HL 20. It should be clarified that a deduction for expenditure transferred from an investor under subpart DV is deductible as investor expenditure under section HL 20. *(PricewaterhouseCoopers)*

An amendment should be made so that a non-portfolio investment entity super fund that invests in a portfolio tax rate entity can treat expenditure as a deductible investor fee. *(Investment Savings and Insurance Association of New Zealand Inc)*

Comment

Officials agree with the submissions. The relevant expenditure should be treated as investor-specific "fees" for the purposes of section HL 20(4).

Recommendation

That the submissions be accepted.

FORMATION LOSSES

Issue: Formation losses should be tested on a net basis

Submission
(61 – KPMG, 58 – Trustee Corporations Association)

A portfolio investment entity's formation losses are restricted to 5 percent of the market value of a portfolio investment entity's portfolio entity investment. Currently, the amount of formation loss is tested on a gross basis. However, losses in the portfolio investment entity's balance sheet would be expressed as a net amount. Similarly, formation losses should be tested on a net basis.

Comment

The proposal would, in effect, significantly increase the amount of formation losses available immediately. This would be inconsistent with the policy intent of the portfolio investment entity rules.

Recommendation

That the submission be declined.

Issue: Formation losses should be able to be used against refundable credits

Submission
(61 – KPMG, 58 – Trustee Corporations Association)

When a fund has formation losses, the investor cannot rebate refundable credits. This restriction should be removed.

Comment

Officials are of the view that formation losses should not be used against credited income, regardless of whether the credit is an imputation credit or a refundable credit. If formation losses were able to be used in this way, it would mean that formation losses could effectively be cashed out, which is contrary to the policy intent of the portfolio investment entity rules.

Recommendation

That the submission be declined.

EXITING INVESTORS

Issue: Accommodation of partial withdrawals and switches within the same portfolio investment entity

Submission
(61 – KPMG)

Section HL 23B should accommodate partial withdrawals and switches between investor classes within the same portfolio investment entity.

Comment

The current wording of section HL 23B can be interpreted as only applying when an investor reduces their total interest in the portfolio investment entity. The provision should be amended so that it is clear that it applies when an investor switches their investment from one class in the portfolio investment entity to another class in the same portfolio investment entity.

Recommendation

That the submission be accepted.

Issue: Optional payments of tax by a portfolio tax rate entity

Submission
(55 – New Zealand Funds Management Ltd)

Section HL 23B should be clarified to make it clear that the optional tax payment made under the section is for a "tax year" for annual portfolio investment entities, and for the "quarter of exit" for a section HL 21 quarterly portfolio investment entity.

Comment

Officials consider that the current wording of section HL 23B already caters for section HL 21 quarterly portfolio investment entities.

Recommendation

That the submission be noted.

Issue: Exiting investors should not have to return excess tax credits

Submission
(61 – KPMG)

Under section HL 27(9), investors in portfolio tax rate entities must return any excess New Zealand tax credits in their tax return if it exceeds the investor's share of the portfolio entity tax liability for the portfolio investor exit period. This is contrary to the policy intention that investors in portfolio tax rate entities should have no further tax obligations if they fully exit a fund, and any excess tax credits should be rebated to the entity.

Comment

Officials agree with the submission and consider that section HL 27(9) should be repealed.

Recommendation

That the submission be accepted.

Issue: Portfolio investment entity income should not affect family tax credits for exiting investors

Submission
(55 – New Zealand Funds Management Ltd)

Portfolio investment entity income should not affect family support entitlements for exiting investors who are required to file tax returns for their portfolio investment entity income.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

GROUPING RULES

Issue: Grouping of unlisted property portfolio investment entities

Submission
(24 – AMP Financial Services and AMP Capital Investors)

An unlisted property portfolio tax rate entity should be allowed to offset losses against the income of its subsidiaries.

Comment

Officials consider that the submission is inconsistent with the policy intent of the portfolio investment entity rules in relation to losses and portfolio tax rate entities, which is that the tax benefit of losses should be flowed through to investors. This policy explains why portfolio tax rate entities cannot carry forward or group losses with other entities.

Recommendation

That the submission be declined.

Issue: Portfolio investment entities should be able to be part of a group

Submission
(59 – Property Council of New Zealand)

The grouping provisions in section IG 1 should continue to apply to a group of companies if the only entities in the group include a portfolio tax rate entity which only holds shares in portfolio land companies.

Comment

Officials agree with the suggested approach. In particular, the grouping provision should apply if the only entities in the group are a single portfolio tax rate entity parent which only holds shares in portfolio land companies.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Portfolio investment entities should be able to be part of a group for GST purposes

Submission
(61 – KPMG, 59 – Property Council of New Zealand)

Section 55 of the Goods and Services Tax Act should be amended to allow portfolio investment entities to be part of a group for GST purposes.

Comment

Officials agree with the submission. This could be achieved by amending section 55 of the Goods and Services Tax Act to allow portfolio investment entities to be part of a group for GST purposes if they would have been eligible to be a group for income tax purposes (in the absence of the prohibition on portfolio tax rate entities being part of a group under section IG 1 of the Income Tax Act).

Recommendation

That the submission be accepted, subject to officials' comments.

CANCELLATION OF SHARES

Issue: Power to cancel units on same-day basis

Submission

(23 – Investment Savings and Insurance Association of New Zealand Inc)

Section HL 7 should clarify that the fund can cancel units at any time up to the end of the relevant period.

Comment

Officials agree with the submission. In particular, the current references to "period" in section HL 7(3)(a) should be made consistent.

Recommendation

That the submission be accepted.

Issue: Companies Act should be amended to allow a company to cancel shares

Submissions

(61 – KPMG, 55 – New Zealand Funds Management Ltd)

A legislative override to section 69 of the Companies Act 1993 is required so that a company can cancel shares to comply with section HL 7 of the Income Tax Act 2004. *(KPMG)*

The legislation should give the portfolio investment entity authority to reduce an investor's holding in the portfolio investment entity in circumstances where, in the manager's opinion, the reduction in holding is necessary to maintain portfolio investment entity status. *(New Zealand Funds Management Ltd)*

Comment

Officials note that a company can currently comply with section HL 7 by paying investors on different tax rates different dividends. It is therefore unnecessary to amend the Companies Act.

Recommendation

That the submissions be declined.

LIFE INSURANCE PROVIDED THROUGH A SUPERANNUATION SCHEME

Submission
(91 – New Zealand Institute of Chartered Accountants)

Superannuation schemes that provide life insurance to their members should be able to qualify as portfolio investment entities. In particular, there is a concern that the "income interest requirement" in section HL 3(9) will be an obstacle to this.

Comment

Officials consider that the current law does allow superannuation schemes that provide life insurance to their member investors to qualify as portfolio investment entities. The "income interest requirement" in section HL 3(9) is based on the definition of "portfolio entity investment". The provision of life insurance to investors is not generally in the nature of a portfolio entity investment, as the ordinary meaning of "investment" requires the prospect of a positive return on the amount invested, and not merely protection, against potential future loss. Therefore, the "income interest requirement" in section HL 3(9) does not prevent superannuation schemes that provide life insurance to their members qualifying as portfolio investment entities.

Recommendation

That the submission be noted.

PORTFOLIO LAND CLASS LOSSES

Submission
(91 – New Zealand Institute of Chartered Accountants)

Section HL 30 requires that the measurement test be carried out at the end of a portfolio investment entity's calculation period, and not when a partial or full redemption of an investor's units occurs during the portfolio investment entity's calculation period. This should be changed to ensure that a portfolio class land loss can only be offset against portfolio land class income and cannot be rebated or offset against other classes of income.

Comment

Officials consider that the concerns raised will not generally arise in practice as the calculation period for most portfolio investment entities is a day and not a year. Therefore, the fact that an investor leaves part-way through a year does not preclude the measurement test for a portfolio class land loss applying on a daily basis.

Recommendation

That the submission be noted.

EXCLUSION OF AUSTRALASIAN SHARE GAINS

Issue: Australasian share options

Submission
(91 – New Zealand Institute of Chartered Accountants)

Portfolio investment entities should not be taxed on income arising from the disposal of Australasian share options. An individual holding these options directly would generally hold the options on capital account, and would therefore not be taxed on any realised gains.

Comment

The policy objective of the Australasian share trading exclusion for portfolio investment entities was to remove the principal distortion between investing directly in Australasian shares and investing in the same shares indirectly through a managed fund. This objective has been achieved by the share trading exclusion in section CX 44C. It is not clear that extending this exclusion to options over shares would, in practice, provide any further significant neutrality of treatment in this area.

Recommendation

That the submission be declined.

Issue: Portfolio investment entity rules should apply to other instruments with the same economic effect as investment in shares

Submission
(52 – Tower)

The portfolio investment entity rules should apply to other instruments that have the same economic effect as investment in shares.

Comment

The exclusion from share gains for portfolio investment entities was introduced to remove the distortion between a person investing in shares through a managed fund and a person making the same investment directly. This distortion does not arise in the case of derivatives, which are taxed under the same rules regardless of whether they are held directly or indirectly.

Recommendation

That the submission be declined.

Issue: Anti-avoidance rule

Submission
(Matter raised by officials)

The anti-avoidance rule contained in proposed section CX 44C(d) in clause 12 of the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill, as introduced in May 2006, should be reinstated.

Comment

Proposed section CX 44C(d) provided that the Australasian share gains exclusion would not apply when the gain on the share was guaranteed. This provision was inadvertently omitted at the Finance and Expenditure Committee stage of the bill. It was only intended that this provision be amended to focus on the time of acquisition of the relevant share. Accordingly, the provision should be reinstated with this amendment.

Recommendation

That the submission be accepted.

Issue: Disposal of certain shares by a portfolio investment entity after declaration of a dividend

Submission
(55 – NZ Funds)

Section CB 4B provides that where a share is sold between the date a dividend is declared and the date it is paid, an amount representing the unimputed dividend must be included in the portfolio investment entity income calculation. This should apply on a net basis.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Reflecting changes made to section EX 33C

Submission
(55 – NZ Funds)

That the Australasian share gains exclusion in section CX 44C be amended to reflect the changes proposed to the foreign investment fund exemption for Australian shares in section EX 33C.

Comment

The grounds for allowing portfolio investment entities to rely on the listing status of Australian shares on the first day of their income year for the purposes of section EX 33C do not apply to the Australasian share gains exclusion in section CX 44C. The relevant date in the Australasian share gains exclusion is the date the share is disposed of. The exclusion should apply to an Australian share that is listed on the date of disposal but it should not if the share is not listed.

Recommendation

That the submission be declined.

Issue: New Zealand Superannuation Fund should be subject to dividend stripping rule

Submission
(Matter raised by officials)

The New Zealand Superannuation Fund should be subject to the dividend stripping rule in section CB 4B.

Comment

Under section CX 44C, the New Zealand Superannuation Fund (NZSF) has been provided with the exclusion from tax on gains from the disposal of New Zealand and certain Australian shares. This is the same exclusion that portfolio investment entities benefit from. Therefore the NZSF should, like portfolio investment entities, be subject to the dividend stripping rule in section CB 4B. Section CB 4B should be amended so that it applies to the NZSF.

Recommendation

That the submission be accepted.

FILING AND INFORMATION REQUIREMENTS

Issue: Treatment of unvested employer contributions in reserve accounts

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

Investor certificates should be able to be filed under the employer plans or reserve accounts' name, rather than the portfolio investment entity's name.

Comment

Officials note that this concern has been dealt with at an operational level, consistent with the current legislation.

Recommendation

That the submission be noted.

Issue: Portfolio investment entity processing errors

Submissions
(23 – Investment Savings and Insurance Association of New Zealand Inc, 71 – PricewaterhouseCoopers)

A portfolio investment entity should be able to correct an error if the tax effect of the error is less than $500 in the next period in an income year without having to file a NOPA or a section 113 notice. Errors in excess of $500 should be subject to the normal rules for underpayment of tax in a period. *(PricewaterhouseCoopers)*

The error threshold should be 1 percent of the net tangible assets of the fund. *(Investment Savings and Insurance Association of New Zealand Inc)*

Comment

Officials note that tolerances for administrative errors are dealt with at an operational level.

Recommendation

That the submissions be noted.

Issue: Resident investors should be required to advise the portfolio tax rate entity of a tax file number

Submission
(55 – New Zealand Funds Management Ltd)

Section 28B of the Tax Administration Act 1994 should be amended to require that all resident investors investing in a portfolio tax rate entity provide their tax file number to the entity.

Comment

Officials agree with the submission. As a consequential amendment, paragraph (b)(ii) of the definition of "portfolio investor rate" in section OB 1 of the Income Tax Act should be repealed. These amendments should apply from 1 April 2008.

Recommendation

That the submission be accepted.

Issue: Timeframe for providing information to zero-rated portfolio investors

Submission
(61 – KPMG)

The timeframe for providing information to zero-rated portfolio investors should be specified in section 31B of the Tax Administration Act.

Comment

Section 31B does not fix a timeframe by which statements must be given to zero-rated investors. Officials agree with the submission that such a timeframe should be set. This could be achieved by removing the subsection (1) reference from section 31B(3).

Recommendation

That the submission be accepted.

Issue: Information relating to associates of investors

Submission
(55 – New Zealand Funds Management Ltd)

Section 32D of the Tax Administration Act should be amended to allow portfolio investment entities to request information from investors about their associates, and to rely on the answers provided to them.

Comment

Officials note that section HL 9(6) already provides tolerance for associated persons who invest in portfolio investment entities, when the associated person has a portfolio investor interest fraction of less than 5 percent. Officials do not consider that further amendments are necessary.

Recommendation

That the submission be declined.

Issue: Provision of information by section HL 22 portfolio investment entities with non-standard balance dates

Submission
(Matter raised by officials)

Section 31B(3) of the Tax Administration Act 1994 should be amended to cater for section HL 22 portfolio tax rate entities with non-standard balance dates.

Comment

Section 31B of the Tax Administration Act deals with the provision of information by portfolio tax rate entities to their investors. Section 31B(3) sets a timeframe for the provision of this information. This provision does not currently cater for section HL 22 portfolio tax rate entities with non-standard balance dates. A provision similar to new section 57B(6)(b) of the Tax Administration Act 1994 (enacted by section 55 of the Taxation (KiwiSaver and Company Tax Rate Amendments) Act 2007 should be inserted in section 31B(3) to cater for these taxpayers.

Recommendation

That the submission be accepted.

Issue: Returns by portfolio tax rate entities and section HL 23B payments

Submission
(Matter raised by officials)

Section 57B of the Tax Administration Act 1994 should be amended to ensure that optional payments of tax made by portfolio tax rate entities under section HL 23B of the Income Tax Act 2004 are made with a return.

Comment

Section 57B of the Tax Administration Act deals with the provision of returns by portfolio tax rate entities and portfolio investor proxies. Section 57B(3) should be amended to ensure that section HL 23 portfolio tax rate entities that make optional payments of tax under section HL 23B are also required to make a return with these payments. This could be achieved by inserting in section 57B(3)(a) a reference to the reduction of an investor's interest referred to in section HL 23B(3)(b).

Recommendation

That the submission be accepted.

Issue: Changing December due date to 15 January

Submission
(Matter raised by officials)

For a section HL 21 or section HL 23 portfolio tax rate entity, any due date for a return or payment which falls on 31 December should be changed to the following 15 January.

Comment

A number of provisions in the Inland Revenue Acts provide that if the due date for a return or payment falls on 31 December, that due date is changed to the following 15 January. To be consistent, if the due date for making a return or payment by a section HL 21 or section HL 23 portfolio tax rate entity falls on 31 December, that date should be changed to the following 15 January.

The amendments would include inserting a reference to "by the following 15 January, if the month following the end of the portfolio calculation period is December" in sections HL 21(3)(b) and HL 23(2)(b). Similar amendments for return due dates should be made to sections 57B(1)(b) and (3)(a)(ii).

Recommendation

That the submission be accepted.

Issue: Assessments for section HL 21 and section HL 23 portfolio tax rate entities

Submission

(Matter raised by officials)

The Tax Administration Act 1994 should be amended to provide an assessment for section HL 21 and section HL 23 portfolio tax rate entities which have provided the tax returns required under section 57B.

Comment

An "assessment" is defined in section 3 of the Tax Administration Act 1994 as "including an assessment of tax made under a tax law by a taxpayer or by the Commissioner". The definition is a core one because it links with a number of important tax administration provisions such as the definition of "disputable decision", section 108 (time-bar for amending assessments), section 109 (assessments deemed correct except in proceedings), section 113 (Commissioner's power to amend assessments) and the disputes and challenge provisions in Parts IVA and VIIIA.

The legislation does not currently provide for an assessment for a section HL 21 or section HL 23 portfolio tax rate entity. This gap in the law should be remedied. This could be achieved by inserting a provision in Part VI of the Tax Administration Act 1994 to provide that a section HL 21 or HL 23 portfolio tax rate entity that is required to furnish a tax return under section 57B must make an assessment in respect of those returns. Section 57B should be amended to provide that a return made under that section by a section HL 21 or section HL 23 portfolio tax rate entity must contain a notice of the assessment required under the corresponding provision in Part VI of the Tax Administration Act; this provision would be analogous to section 33(2). The references to "return" in section 57B should also be changed to "tax return", consistent with the definition of "tax return" in section 3 of the Tax Administration Act.

Recommendation

That the submission be accepted.

Issue: Section HL 22 portfolio tax rate entities should file tax returns

Submission
(Matter raised by officials)

The reference to portfolio tax rate entities in section 33(1) of the Tax Administration Act 1994 should not include section HL 22 portfolio tax rate entities.

Comment

Currently, all portfolio tax rate entities are excluded from the requirement to file income tax returns under section 33(1) of the Tax Administration Act. This exclusion should apply only to section HL 21 and section HL 23 portfolio tax rate entities, and not section HL 22 portfolio tax rate entities.

This is a drafting error and should be corrected.

Recommendation

That the submission be accepted.

Issue: Disclosure of portfolio investment entity status to portfolio investor proxies

Submission
(54 – ASB)

Entities should be required to disclose their portfolio investment entity status when requested by a portfolio investor proxy.

Comment

Officials do not agree with the submission. The arguments for requiring a portfolio investor proxy to disclose its status to a portfolio investment entity do not apply the other way. In particular, there are already significant disclosure requirements applying to portfolio investment entities. Therefore it is not necessary to apply additional disclosure requirements on portfolio investment entities.

Recommendation

That the submission be declined.

Issue: Transitional tax payment by portfolio investment entity

Submissions
(54 – ASB, 61 – KPMG, 58 – Trustee Corporations Association)

When an entity becomes a portfolio investment entity, its unrealised gains or losses are taxable, and any resulting tax liability must be paid over the next three years. The current legislation is unclear about when the tax must be paid each year. Rather than requiring the tax to be paid by the end of the relevant income year, the tax should be payable on or before the terminal tax date of that entity. *(ASB)*

The legislation should state a due date (March 31) for these payments. *(KPMG, Trustee Corporations Association)*

Comment

Officials consider that the legislation already achieves a due date of 31 March for these payments.

Officials note that the transitional rule for the tax liability resulting from an entity becoming a portfolio investment entity is already concessionary because the payment is spread over three tax years. The submission could result in a further deferral which is not justified.

Recommendation

That the submissions by KPMG and the Trustee Corporations Association be noted, and that ASB's submission be declined.

Issue: Imputation credits earned before entity was a portfolio investment entity

Submission
(23 – Investment Savings and Insurance Association of New Zealand Inc, 24 – AMP Financial Services and AMP Capital Investors, 71 – PricewaterhouseCoopers)

A portfolio investment entity should be able to distribute the benefit of imputation credits to its investors, when those imputation credits arise from the entity's tax obligations before it became a portfolio investment entity.

Comment

Officials consider that the concern raised can be resolved by an amendment switching off imputation penalty tax resulting from the transition of entities into the portfolio investment entity rules.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Application of FDR rules to funds with non-standard balance dates

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

A fund with a non-standard balance date that elects to become a portfolio investment entity on 1 October 2007 must apply the fair dividend rate (FDR) rules from 1 October 2007. The fund should be able to apply the FDR rules from 1 July 2007.

Comment

Officials consider that the current legislation would allow the fund referred to in the submission to apply the FDR rules from 1 July 2007.

Recommendation

That the submission be noted.

Issue: Removal of penalties and interest when provisional tax increased as a result of becoming a portfolio investment entity

Submission
(Matter raised by officials)

Portfolio investment entities with investments in other portfolio investment entities that are zero-rated and exempt from resident withholding tax may incur an increased provisional tax liability. Entities with a standard balance date that elect to become portfolio investment entities on 1 October 2007 would have had their first provisional tax payment due on 7 July 2007 so could not have prevented an underpayment.

Portfolio investment entities may also have difficulty establishing the tax result for all investments to re-estimate the provisional tax liability in time for the second provisional tax instalment.

Penalties and interest should not be imposed in these circumstances. Section HL 13 should cater for circumstances where there is an increase in provisional tax for any income due directly to an entity becoming a portfolio investment entity in the income year.

Comment

Portfolio investment entities should not have penalties or interest imposed as a result of increases in provisional tax liability that arise from becoming a portfolio investment entity in the income year that the transition occurs.

This relief should apply for provisional tax payments that have already been made for the income year in which the transition occurs, and any provisional payments falling due within two months of becoming a portfolio investment entity.

Recommendation

That the submission be accepted.

Issue: Share lending rules and deemed sale and reacquisition of Australian shares

Submission
(Matter raised by officials)

The new share lending rules should be switched off for the purposes for the deemed sale and reacquisition of Australian equities rule in section HL 12(3) for entities transitioning into the portfolio investment entity rules.

Comment

Under section HL 12(3) there is a deemed sale and reacquisition of Australian shares held at the time an entity becomes a portfolio investment entity. This provision ensures that any gain or loss on Australian shares that are held on revenue account by entities becoming portfolio investment entities is realised at the time of entry into the PIE rules. Section HL 12(3) refers to "shares held by the entity". This wording may not capture shares subject to share lending transactions whereby shares are lent shortly before an entity enters into the portfolio investment entity rules (the earliest date being 1 October 2007) and reacquired after that date. The share lending rules could prevent a tax liability arising for the intending portfolio investment entity. This is because the shares are not held by the intending portfolio investment entity on the transition date and therefore would not be caught by section HL 12(3). The share lending rules themselves would prevent there being a taxable event on the date the shares are lent and the Australasian share trading exclusion for portfolio investment entities in section CX 44C would still seem to apply when the relevant shares are eventually sold.

It is therefore necessary to amend section HL 12(3) to ensure that for the purposes of that provision any original share subject to a returning share transfer is treated as being held by the share supplier (that is, the intending portfolio investment entity) and not by the share user. The treatment of any dividend paid on the lent shares should continue unchanged – that is, the dividend would be taxable to the share user under ordinary rules with the replacement payment for dividends being deductible to the share user and taxable to the share supplier.

Recommendation

That the submission be accepted.

DRAFTING ISSUES

Issue: Definition of "investor" should refer to trust not trustee

Submission
(59 – Property Council of New Zealand)

When shares in a company are held by a trust, it should be clear that it is the trust rather than the trustee that is the investor.

Comment

Officials consider that it is clear that the current definition of "investor" caters adequately for the situation when the shareholder in a company is a trustee.

Recommendation

That the submission be noted.

Issue: Definition of "portfolio land company"

Submission
(61 – KPMG)

The definition of "portfolio land company" requires that 90 percent of the company's assets must be land assets and that this must be the case for 80 percent of the year. This requirement should have to be met for "at least" 80 percent of the year.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Heading of section HL 27(8)

Submission
(61 – KPMG)

In the heading to section HL 27(8), the reference to "portfolio investment entities" should be replaced by "portfolio tax rate entities".

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Cross-referencing error in section HL 27(10B)

Submission
(Matter raised by officials)

The reference to section HL 22 in section HL 27(10B) should be removed.

Comment

The reference to section HL 22 in section HL 27(10B) is a drafting error.

Recommendation

That the submission be accepted.

Issue: Investor in a section HL 21 portfolio investment entity should recognise losses in their income year that includes the end of the PIE's income year

Submissions
(Matter raised by officials)

Section DB 43B should be amended to provide that an investor in an HL 21 portfolio investment entity recognises losses in the investor's income year that includes the end of the PIE's income year.

The reference to section HL 22 in section DB 43B(2) is an error and should be deleted.

Comment

Section DB 43B(2) provides that zero-rated and certain exiting investors in portfolio investment entities are generally allowed a tax deduction for losses that flow through to them from those PIEs. Currently, the provision requires investors in portfolio tax rate entities that pay tax under section HL 21 to recognise such losses in the investor's income year that includes the end of the portfolio investment entity's portfolio calculation period (usually a quarter). To maintain consistency with other similar provisions in the rules, section DB 43B should be amended to provide that the investor recognises these losses in the investor's income year that includes the end of the portfolio investment entity's income year. In addition, the reference to section HL 22 in section DB 43B(2) is an error and should be removed.

Recommendation

That the submissions be accepted.

Issue: Drafting consistency with core provisions

Submission
(Matter raised by officials)

The following drafting amendments should be made to ensure that the portfolio investment entity rules interact correctly with the Income Tax Act's core provisions and are consistent with the rewrite of that Act:

- A provision should be inserted in subpart HL to ensure that the income tax liability of portfolio tax rate entities calculated under section HL 20 is schedular income for the purposes of the core provisions.
- Subpart HL should be amended to ensure that the payment of tax by section HL 21 and section HL 23 portfolio tax rate entities satisfies the PIE's income tax liability for the purposes of core provisions.
- It should be clarified that portfolio class land losses should not be rebated, but should be carried forward to offset income in future periods.
- Portfolio investment entity rebates for excess credits and losses should be excluded from the section OB 1 definition of allowable rebates.
- For rebates payable to portfolio tax rate entities it should be clarified that the rebate is due to be paid by the Commissioner at the same time as tax would have been payable by the portfolio investment entity in the absence of a rebate.

- It should be clarified that credits refundable under the portfolio investment entity rules are not separately refundable under the core provisions. This could be achieved by an amendment to section HL 27(1), ensuring that section HL 27 overrides section BC 10.
- It should be clarified that the timing rule in section HL 25 that allocates a portfolio investor allocated loss should be the same as the rule in section DB 43B.

Comment

These technical amendments are necessary to ensure that the portfolio investment entity rules interact with the core provisions correctly, and are consistent with the rewritten Income Tax Act.

Recommendation

That the submission be accepted.

Issue: Cross-referencing in section HL 27(11)

Submission
(Matter raised by officials)

The references in section HL 27(11) to subsection (10B) should be replaced with subsection (10C) references.

Comment

This amendment corrects a cross-referencing error.

Recommendation

That the submission be accepted.

Issue: Tax year references

Submission

(Matter raised by officials)

The reference to the entity's "tax year" in section HL 7(3)(a)(ii) – relating to the investor return adjustment requirement – should be replaced with a reference to the entity's "income year".

The reference to "in a tax year" in the opening wording of section 57B(5) of the Tax Administration Act 1994 – requiring returns to be made by portfolio tax rate entities – should be replaced with "for a tax year".

Comment

These amendments cater for non-standard balance date section HL 22 portfolio tax rate entities.

Recommendation

That the submission be accepted.

Offshore portfolio share investment rules

OVERVIEW

Clauses 13, 31, 60 to 65, 67 to 76, 93(2) and 165

New tax rules for offshore portfolio investment in shares were enacted by the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 on 18 December 2006. The new rules apply for income years beginning on or after 1 April 2007.

The new rules generally apply to an investment by a New Zealand resident in a foreign company when the investor owns less than 10 percent of the company. Under the new rules, offshore portfolio investment in shares is taxed consistently, regardless of the country where the investment is located and whether the investment is made by an individual directly or through a collective investment vehicle.

The new tax rules for offshore portfolio investment in shares mainly involve changes to the foreign investment fund rules in the Income Tax Act 2004. The main changes are that the "grey list" exemption in the foreign investment fund rules has been removed and a new fair dividend rate method – which broadly taxes 5 percent of a person's offshore share portfolio's opening value each year – has been introduced.

The bill makes a number of remedial amendments to the new rules, consistent with their policy intent.

A number of submissions were received on the remedial amendments and some other technical aspects of the new offshore portfolio share investment tax rules. The changes recommended are of a remedial nature and ensure that the new rules achieve their intended policy effect.

Issue: $50,000 minimum threshold and exemption changes

Submission
(91 – New Zealand Institute of Chartered Accountants)

NZICA supports the clarifying amendments which will ensure that the deemed disposition and reacquisition that occurs when there is a change in application of exemptions from the foreign investment fund rules are ignored for the purposes of the $50,000 minimum threshold rules in sections CQ 5 and DN 6. The amendments ensure that the original cost basis applies. However, NZICA considers that similar clarifying amendments are required to the Income Tax Act 1976 and the Income Tax Act 1994.

Comment

Officials agree that a similar clarifying amendment should be made for the purposes of the $50,000 minimum threshold rule in section CG 15(2)(d) of the Income Tax Act 1994. However, because the time-bar will prevent assessments made under the Income Tax Act 1976 being reopened, it is not necessary to amend that earlier Act.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Election out of the $50,000 minimum threshold

Submission
(54 – ASB)

Natural persons should be able to elect not to apply the $50,000 minimum threshold in section CQ 5 therefore subjecting all their overseas equity investments to the foreign investment fund rules. This will allow investors who hold overseas investments of around $50,000 and who flip into and out of the foreign investment fund rules to reduce the complexity of their tax affairs by being able to apply a foreign investment fund method consistently to all their offshore investments each income year.

Comment

If the original cost of an individual's offshore shares totals NZ$50,000 or less at all times in an income year, the foreign investment fund rules do not apply for that year. The individual investor will continue to pay tax only on dividends if they hold the shares on capital account. This $50,000 minimum threshold is a general rule and is not elective.

To make the $50,000 minimum threshold elective would considerably increase the complexity of the foreign investment fund rules. It is desirable to keep the foreign investment fund rules as straightforward as possible. Any election mechanism such as that proposed is also difficult to track by both investors and Inland Revenue for elections that were made many years previously. The foreign investment fund rules should be as certain in their application as possible.

Recommendation

That the submission be declined.

Issue: Minimum threshold amount

Submission
(54 – ASB)

The submission notes that the current minimum threshold amount of $50,000 has remained unchanged for a number of years. Increasing this threshold to $100,000 at which the more complex foreign investment fund rules begin to apply to investments would reduce the compliance costs for natural persons.

Comment

The submission to increase the amount of minimum threshold for the application of the foreign investment fund rules from the current $50,000 to $100,000 is outside the scope of the bill.

Officials note that the submission's proposed increase of the threshold to $100,000 is significant and would undermine a core objective of the recent tax reforms for offshore portfolio investment in shares, which was to remove the previous distortion between investing directly in offshore shares and investing through New Zealand resident managed funds (managed funds are not entitled to the minimum threshold for application of the foreign investment fund rules). A modest minimum threshold, such as the current $50,000 threshold, can be justified on compliance cost grounds.

Recommendation

That the submission be declined.

Issue: Listing requirement in Australian shares exemption

Submissions
(23 – ISI, 55 – NZ Funds, 71 – PricewaterhouseCoopers, 74 – Deloitte)

All the tests in proposed section EX 33C(2) for determining whether a company falls within the Australian shares exemption should be applied at the first unit valuation period in an income year for a unit valuer that is a portfolio tax rate entity. Alternatively, any breaches of the requirements should be applied to only future periods for unit valuers that are portfolio tax rate entities. *(ISI)*

The test for whether an Australian share is listed on an approved index should apply in either of the following ways:

- the test for applying the exemption is on the first day of the income year for all taxpayers; or
- taxpayers who do not apply a daily valuation are not liable to use-of-money interest or late payment penalties if the status of the Australian company changes.

If a share is not listed on an approved index on the first day of the income year, the taxpayer will assume the foreign investment fund exclusion does not apply and will pay tax under the fair dividend rate method. If, at any time during the income year that share moves onto the exempt list, then the taxpayer would be required to treat the investment outside of the foreign investment fund rules. Accordingly, they will be required to file and pay tax (or DWP) based on the dividends received. At its extreme, a share could become exempt towards the end of the income year. In this case, the taxpayer may have paid incorrect provisional tax or failed to meet its DWP liability during the year. *(Deloitte)*

The listing requirement in proposed section EX 33C(2)(b) should be expanded to cater for the circumstance where the investment is acquired for the first time in an income year. The listing requirement should then be tested at the date of acquisition for unit valuers and any other persons applying the fair dividend rate method on a daily basis. *(PricewaterhouseCoopers)*

Proposed section EX 33C(2)(b)(ii) should be amended to provide that the time referred to in the provision should be the “first day of the first unit valuation period”. *(NZ Funds)*

Comment

Investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange (ASX), such as the All Ordinaries index, are exempt from the foreign investment fund rules. To assist compliance with this exemption, in section EX 33C the current requirement that Australian-resident companies must be included in an approved ASX index at all times during the income year is amended by the bill so that the listing requirement is tested at the start of the income year for managed funds such as portfolio tax rate entities. It is the listing requirement in the Australian exemption that in practice is more likely to change in relation to a specific company than in any of the other requirements. Officials do not consider it is worthwhile increasing the complexity of the Australian shares exemption rules in the case of the non-listing requirements which are much less subject to change than the listing requirement for a particular company.

The bill provides that for persons who do not do daily valuations, the Australian shares exemption will apply for the whole of the income year if that share was exempt under section EX 33C at any time in the income year. This proposed change was designed to ensure that the Australian shares exemption would apply for an income year if a company that was listed on the ASX All Ordinaries index at the beginning of the year is omitted from the index during the year. However, the Deloitte submission raises a valid concern in relation to the situation when a company is added to the approved index during the year.

Officials therefore support the proposal that the test for determining whether shares are listed on an approved index is on the first day of the income year for all taxpayers. However, as the PricewaterhouseCoopers submission contends, there should be an additional criterion applying for the situation when a person acquires shares in a company during the income year and did not previously hold any shares in that company in that year. In this case, the test should be whether the company's shares were listed on an approved index on the day of acquisition. This is because the person would probably have based their decision on the status of the company at the date they acquired shares in it and they should not be expected to ascertain the listing status of the company at the beginning of their income year when they did not hold any shares in the company.

Recommendation

That the submissions be accepted, subject to officials' comments.

Issue: Election to use the foreign investment fund rules for all Australian shares

Submission
(54 – ASB)

Investors should be able to elect that their Australian shares – which are currently covered by the exemption for investments in certain Australian-resident listed companies in section EX 33C – are instead subject to the foreign investment fund rules. This election would require investors to apply the foreign investment fund rules to all their Australian shares in every income year. The submission considers that the current exemption may complicate some investors' tax affairs as they will need to review their Australian investments on a regular basis to determine whether the foreign investment fund rules will apply to those investments as there will be regular amendments to the securities which are included on an approved ASX index.

Comment

The current exemption for investments in certain Australian-resident listed companies is currently not elective. Making this exemption elective would increase the complexity of the foreign investment fund rules. Officials consider it desirable that the Australian exemption be kept as straightforward and certain as possible. Another reason for not introducing an election mechanism is that it can become difficult for both investors and Inland Revenue to track elections that were made many years ago.

To assist compliance with the Australian-resident company exemption, the bill contains an amendment that will make it easier to satisfy the requirement that the company must be listed on an approved ASX index.

Recommendation

That the submission be declined.

Issue: Application date of Australian shares exemption

Submission
(58 – Trustee Corporations Association of New Zealand)

The changes to the foreign investment fund exemption for shares in certain listed Australian companies in section EX 33C should be effective from the date of enactment rather than from 1 April 2007. In the role of corporate trustees, members may not have authority to approve systems changes for which there is no legislative authority, albeit in the knowledge of pending legislation which would have retrospective effect.

Comment

Officials consider it is preferable for all the amendments to the new foreign investment fund rules to have the same application date – that is, 1 April 2007. We understand that a number of unit valuers would prefer that the new rules for the listing requirements for unit valuers (the first valuation period for the income year) apply from the beginning of the new foreign investment fund rules – that is, 1 April 2007. In any event, it is unlikely that the result for unit valuers would be different whether the new listing requirement rule is effective from 1 April 2007 or from the enactment of the bill.

Recommendation

That the submission be declined.

Issue: Publishing an approved Australian share list

Submission
(54 – ASB)

The Commissioner should be required to publish a quarterly list of approved Australian equities that are exempted from the foreign investment fund rules. Publication should be required by the 20th of the month immediately following the end of a quarter. The list would reduce the compliance burden on investors and minimise the risk that investors will incorrectly classify their Australian equity investments.

Comment

Officials do not support the proposal that Inland Revenue be required to publish a binding list of companies on a quarterly basis that qualify for the exemption from the foreign investment fund rules for investments in certain Australian-resident listed companies. Under the previous grey list exemption in the offshore tax rules, investors were required to ascertain whether a foreign company was resident in one of the eight grey list countries and Inland Revenue never published a list of companies qualifying for this exemption. This self-assessment approach should continue with the Australian-listed company exemption.

Officials consider that there is a reasonable level of awareness in the marketplace about the current scope of the Australian-listed company exemption. In particular, a number of stock broking firms and financial advisors have compiled lists of specific companies whose shares qualify for the current Australian exemption.

Generally a New Zealand investor who receives a franked dividend from a company listed on the Australian Stock Exchange (ASX) All Ordinaries index will be entitled to the Australian-listed company exemption. The list of companies on the ASX All Ordinaries index can be easily accessed online. Inland Revenue publications contain a link to the relevant website. When investors who hold an interest in a company that is listed on the ASX All Ordinaries index receive their dividend statement, it will say whether or not the dividend is franked. It should therefore be relatively easy to self-assess this exemption.

A foreign company listed on the ASX All Ordinaries index, such as James Hardie Industries, is not permitted to maintain an Australian franking account. A New Zealand investor will not receive a franked dividend from such a company and therefore will know that the exemption does not apply to that investment.

Recommendation

That the submission be declined.

VENTURE CAPITAL EXEMPTION

Submissions
(41 – New Zealand Private Equity and Venture Capital Association, 71 – PricewaterhouseCoopers)

The venture capital exemption in the new foreign investment fund rules should be expanded to cover all venture capital investments.

After consultation with officials, it is alternatively submitted that the existing exemption should be extended in the following ways:

- The "business", rather than the "company", must have been in operation in New Zealand for at least 12 months pre-migration.

Additional criteria to allow a venture capital investment to qualify for the exemption should be added. These include:

- that 25 percent of a migrated company's expenditure is incurred, or 25 percent of its employees engaged, through the currently required fixed establishment in New Zealand;
- that the fixed establishment in New Zealand incurs no less expenditure, or engages no fewer employees than in the year immediately before the company's migration;
- if the company has received seed or venture capital equity investment through New Zealand Venture Investment Fund Limited.

Comment

Officials support an exemption in the offshore portfolio share tax rules for investments in New Zealand start-up companies that migrate offshore to gain access to finance. This covers situations where an investor has invested in a New Zealand firm, and although the firm has had to migrate to access more capital, is still essentially a firm based in New Zealand. The exemption is justified on the basis that venture capital investments do not compete with investment via New Zealand managed funds. Importantly, it also fits within the wider principle underlying the FIF rules, which is to treat all domestic portfolio investments alike, and to treat all offshore portfolio investments alike, thus minimising tax distortions on investment decisions.

The criteria that need to be met to qualify for and keep the exemption were designed accordingly, in consultation with members of the venture capital industry. Officials consider that generally, the criteria currently in place are consistent with the policy intent of the exemption. However, we also agree with some of the submission proposals. These are discussed below.

Officials recognise that expansion of one criterion, and the addition of two new criteria would make the exemption more accessible to venture capital in some circumstances, in accordance with the policy intent of the exemption.

The following proposed changes have been developed in consultation with the venture capital industry, and officials note that although NZVCA agrees with these proposals, its overall view is that venture capital investments should be exempt from the FIF rules because of the merits of venture capital, and that it should be enough that a firm started in New Zealand, and falls within a venture capital definition.

"Business" versus "company"

One of the criteria that must be satisfied for a firm to qualify for the exemption is that it must be a company, or own a company, that for 12 months or more was resident in New Zealand with more than 50 percent of its assets in New Zealand. This does not currently accommodate situations where start-ups have been operating for 12 months or more, but have not been incorporated for that long, or that have restructured pre-migration.

Officials therefore propose legislative changes to sections EX 33(3)(d) and EX 33(4)(d) that will put the focus on the *business carried on* by the migrated firm in the 12 months before migration. As well as being a more robust test than the current "company resident" test, the changes will ensure that the policy intent of the exemption operates effectively.

25 percent of expenditure or employees in New Zealand

One of the criteria that must be satisfied for the exemption to apply is that the migrated company must have a fixed establishment in New Zealand. Currently, the company must, through the fixed establishment, either incur expenditure of at least \$1 million or engage no fewer than 10 full-time employees or contractors at all times in the year.

Officials agree that there should be an additional criterion added to the "fixed establishment" requirements. It will allow the exemption to apply if the company, through the fixed establishment, incurs at least 25 percent of its expenditure or has at least 25 percent of its employees in New Zealand. This change would be of particular benefit to smaller start-ups that may have trouble satisfying the \$1 million or 10 employee requirements.

Expenditure/number of employees must be no less than in year before migration

The submission proposes an additional criterion to the "fixed establishment" requirements. This would be that the exemption would apply as long as the fixed establishment's expenditure and/or number of employees were no less than in the year before migration. Officials believe that there is significant risk that this test could be easily manipulated simply for a tax advantage, and therefore do not recommend this proposal be accepted.

NZVIF-specific exemption

Officials agree with the proposal for a specific exemption for New Zealand residents that co-invest with the New Zealand Venture Investment Fund. Extending an exemption to New Zealand residents that co-invest with the VIF (and not prescribing a level of New Zealand connection) poses less revenue risk than extending a similar exemption to all New Zealand-resident venture capital investors, and the vetting of investments by the NZVIF provides a degree of assurance that the company will keep its connection with New Zealand.

Recommendation

That the submission be accepted, subject to officials' comments.

OTHER EXEMPTIONS

Issue: Australian unit trusts exemption

Submission

(91 – New Zealand Institute of Chartered Accountants)

Statutory protection should be available for investors that use the exemption for investments in unit trusts in section EX 33D. The tax outcome for investors relying on a statement from the unit trust manager that an investment in the trust is entitled to the section EX 33D exemptions could be:

- No reassessment of past years' returns, or no additional tax liability on any foreign investment fund income that would otherwise have arisen if the trust does not ultimately qualify.
- The assessment of any foreign investment fund income tax arrears (plus use-of-money interest and any penalties, if applicable) be made to the unit trust manager/RWT proxy responsible.
- At the very least, there should be no use-of-money interest or penalty implications if there is an increase in tax liability.

Comment

Officials consider that if an investment in an Australian unit trust does not qualify for the specific exemption for such investments in section EX 33D, then the same treatment should apply when the requirements in other exemptions from the foreign investment fund rules are not satisfied. Namely, the offshore investment would be subject to the foreign investment fund rules with the new fair dividend rate method probably being applicable.

There is no policy basis for treating this exemption differently from other exemptions from the foreign investment fund rules, such as shares in Australian-listed companies.

It would not be practical or appropriate to make the Australian unit trust manager responsible for any use-of-money interest or penalties if the investment does not in fact qualify for the exemption.

Recommendation

That the submission be declined.

Issue: Employee share purchase scheme exemption

Submission:
(91 – New Zealand Institute of Chartered Accountants)

The reference to the value of the shares in an employee share purchase scheme being affected by a restriction on the disposal of the shares should be removed so that new section EX 33(5)(f) simply refers to a restriction on the disposal of the shares. Even though the amendment removes the current reference to section CE 3, which imposes an eight-year restriction on the disposal of shares, it is arguable that reference is still required back to that section in valuing the benefit to the person under a share purchase agreement.

Comment

Officials agree with the submission's proposal to remove the reference to the value of the shares in an employee share purchase scheme being affected by a restriction on the disposal of the shares.

Recommendation

That the submission be accepted.

Issue: Restrictions on using the fair dividend rate method

Submissions
(55 – NZ Funds, 61 – KPMG, 71 – PricewaterhouseCoopers, 85 – Minter Ellison Rudd Watts, 91 – New Zealand Institute of Chartered Accountants, 95 – New Zealand Law Society)

Proposed section EX 40(9)(d) is unworkable in its current form. For example, what is a "debt instrument" in this context? What type of "arrangement" is envisaged and what is meant by "economic effect"?

Proposed section EX 40(9)(d) should be redrafted to better target the mischief at which it is aimed. In particular:

- The requirement to consider the economic effect of an arrangement should be removed, or the arrangement limited to transactions undertaken by the offshore fund, or an associate of offshore fund, to which the investor would apply the fair dividend rate method.
- A safe harbour should be introduced to require taxpayers to consider an indirect investment only if they invest more than 50 percent of their assets in, and hold more than 50 percent of, the investment vehicle through which that indirect investment is held.
- Section EX 40(9) should be amended to replace "debt instrument" with "a financial arrangement that provides funds to the issuer" to align the text with the definition of debt for the purposes of the thin capitalisation rules.
- Clause 64(4) is too wide in its scope. In particular, what is meant by assets "directly or indirectly" – how wide is that intended to be? What is the mischief intended to be covered by these words? What is meant by being "part of an arrangement having an economic effect" as if the instrument were denominated in New Zealand dollars? What investments of the foreign entity (which has a New Zealand investor) should be taken into account? When is the provision meant to be tested by the New Zealand investor?

Given the scope of the proposed provision and its uncertainties, there will be an upturn in applications for determinations from the Commissioner. With the current costs and significant time delays in the taxpayer rulings unit in the office of the Chief Tax Counsel (which is where we assume such determinations will be managed), and the logistical difficulties that unit faces on its current workload, we wonder about that unit's capacity to deal with this issue.

This provision in its current form – section EX 40(8)(a)(iii) – should be repealed and any amendments not be proceeded with because the express purpose of this provision is covered by other provisions, in particular, current section EX 40(9).

Proposed section EX 40(9)(d) should be amended from an operative provision to an anti-avoidance provision to more accurately reflect its nature and purpose.

Comment

Officials do not agree that the wording of proposed section EX 40(9)(d) – which prevents the fair dividend rate method being used for certain investments – is generally too wide and uncertain. Proposed section EX 40(9(d) is part of, and consistent with, the general policy that the fair dividend rate method cannot be used for guaranteed return-type investments. The policy intent is that the fair dividend rate method should not be used for investments which are, in substance, debt investments designed to achieve a return higher than the fair dividend rate of 5 percent. These guaranteed return-type investments should be subject to full taxation under the comparative value method.

Officials agree with submissions that the reference to "debt instruments" in proposed section EX 40(9)(d) should be replaced with a reference to "financial arrangements that provide funds to the issuer". This is because "financial arrangements", being a defined term, has greater certainty of meaning than "debt instrument", which is not defined.

Officials consider that proposed section EX 40(9)(d) is generally sufficiently targeted at the mischief at which it is directed. However, officials agree with the part of the submission that notes that the current wording may not be effective in situations where an investment in financial arrangements denominated in foreign currency is hedged back to New Zealand dollars and that hedging is 80 percent or more effective. As currently drafted, the provision would require 80 percent of the fund's assets to be fully hedged to give the same effect as if the instrument were in New Zealand currency. Officials would therefore support an amendment to ensure that the provision prevents the fair dividend rate method being applied to an investment where foreign financial arrangements are hedged back to New Zealand dollars and that hedging is at least 80 percent effective.

Officials also consider that the assets of the non-resident that are taken into account under proposed section EX 40(9)(d) should include fixed rate shares as well as financial arrangements because such instruments are equivalent to debt.

It is appropriate for the Commissioner to take into account the whole arrangement, including any interposed entities or financial arrangements, in ascertaining whether the investment in a foreign entity provides investors with a return similar to a New Zealand dollar denominated debt, which is the basic policy objective underlying access to the fair dividend rate method. If the test looking at the proportion of the foreign entity's assets that comprise debt considered only the first tier foreign entity, it would be quite easy to circumvent this test by interposing another foreign company between the New Zealand investors and the foreign company holding the financial arrangements.

The proposal to require taxpayers to consider an indirect investment only if they invest more than 50 percent of their assets in, and hold more than 50 percent of, the investment vehicle through which that indirect investment is held would mean that the provision would not be effective in many cases where it should be.

The reference to "an arrangement having an economic effect" as if the instrument were denominated in New Zealand dollars is designed to take into account situations where derivatives such as swaps and forward currency contracts are used so that even though the underlying financial arrangements may not be denominated in New Zealand dollars, they are hedged to achieve the effect of New Zealand dollars.

Some submissions considered that the wording of the current provision would be difficult to apply in practice and, in particular, that the reference to "arrangement" is very broad and could apply to hedging undertaken outside of the offshore fund. Officials consider that it is necessary to take into account hedging arranged outside of the offshore fund itself because the provision could be too readily circumvented if it only considered hedging undertaken by the offshore entity in which the New Zealand taxpayer has invested.

A submission also suggested that hedging undertaken at the New Zealand investor level should not be within the ambit of the arrangement contemplated by the proposed section EX 40(9)(d). Officials do not agree with this view because even though the hedging arrangement would be within the New Zealand tax base, it is still appropriate to subject the offshore investment to the comparative value method as that would produce a similar result if the investor had invested directly in a New Zealand dollar denominated financial arrangement.

The test in proposed section EX 40(9)(d) would have to be satisfied for each income year, and not just at the commencement of the arrangement.

The Commissioner's power to make determinations that the fair dividend rate method may or may not be used for a particular type of investment has been delegated to the Deputy Commissioner, Policy. Applications for these determinations will therefore be managed by the Policy Advice Division of Inland Revenue rather than the office of the Chief Tax Counsel.

It is not correct that the function of current section EX 40(8)(a)(iii) or proposed section EX 40(9)(d) is already covered by current section EX 40(9). The latter provision targets investments which involve an effectively non-contingent obligation to return an amount to the investor that exceeds the issue price of the investment. However, a limitation on this provision is that it may not apply to the standard bond fund situation where a New Zealander makes a portfolio investment in a foreign company that invests in high-yield debt. The obligation to return an amount to the investor that exceeds the issue price of the investment is in fact owed by the debt issuer to the foreign company rather than by the debt issuer to the New Zealand investor. It is therefore necessary to have a provision like the current section EX 40(8)(a)(iii) to ensure that such investments are in fact excluded from the fair dividend rate method.

Officials are not in favour of replacing substantive provisions such as proposed section EX 40(9)(d) with "anti-avoidance provisions" because in this circumstance it would result in more uncertainty than the current objective rule.

Recommendation

That proposed section EX 40(9)(d) be amended so the assets of the non-resident taken into account are financial arrangements providing funds to the issuer and fixed rate shares. The provision should also be amended to ensure that it applies to an investment where financial arrangements or fixed rate shares denominated in foreign currency are hedged back to New Zealand currency and that hedging is at least 80 percent effective. The other submissions should be declined.

Issue: Drafting of the restrictions on the use of the fair dividend rate method

Submission
(85 – Minter Ellison Rudd Watts)

Clause 64(3) is unnecessary and should not be proceeded with. The clause does not amend anything in the current provisions, and simply reinserts the same language into a new provision. We are concerned with endless tinkering to this important regime which has only just recently been passed and the added confusion that arises for taxpayers. This is particularly the case where no amendments are being made at all; just a reordering of existing matters. As an alternative, the opening words to clause 64(3) should be more clearly drafted.

Comment

Officials consider that the new provisions in the bill concerning restrictions on the use of the fair dividend rate method – proposed section EX 40(8)(a) and (9) – are clearer than the current provisions. In particular, the types of interests for which the fair dividend rate method cannot be used are now listed in a single subsection – proposed section EX 40(9) – instead of being spread over two provisions as they are currently. The opening wording of proposed section EX 40(9) will be amended to make it more helpful for readers.

The provisions referring to the making of positive and negative determinations that the fair dividend rate method may be or may not be used for a type of investment are now more clearly separated into separate subsections: proposed section EX 40(8)(a) and EX 40(9)(a). Currently, the power to make positive and negative determinations is contained in the same subsection – existing section EX 40(8).

Officials therefore consider that the reordering of the provisions governing the use of the fair dividend rate method is a worthwhile improvement on the current provisions.

It is also not correct that the new provisions do not amend anything in current sections EX 40(8)(a) and EX 40(9). The Commissioner's power to make a positive determination that the fair dividend rate method may be used for a type of interest (even though the specific restrictions in the legislation in proposed section EX 40(9) may not otherwise allow it to be used) is considerably widened under the bill. Currently, the Commissioner can only make such a positive determination in relation to non-contingent obligation-type interests that would otherwise not qualify for the fair dividend rate method (existing section EX 40(8)(a)(iv)).

Recommendation

That the submission be declined.

Issue: Commissioner's power to make a determination on the use of the fair dividend rate method

Submissions
(20 – Bell Gully, 33 – Corporate Taxpayers Group, 54 – ASB, 55 – NZ Funds, 71 – PricewaterhouseCoopers, 74 – Deloitte, 85 – Minter Ellison Rudd Watts, 91 – New Zealand Institute of Chartered Accountants, 95 – New Zealand Law Society)

The amendment widening the Commissioner's power to make determinations on who can use the fair dividend rate method by removing the determination-making criteria in section 91AAO(2) of the Tax Administration Act 1994 is strongly opposed.

The amendment offends the principles of fairness and certainty. Essentially the Commissioner could determine at any time whether the fair dividend rate method can be used without regard to any statutory or other objectively prescribed criteria. *(New Zealand Institute of Chartered Accountants)*

The proposal to repeal section 91AAO(2) should be reconsidered, or at a minimum a requirement be imposed upon the Commissioner to publish formal guidance on the factors Inland Revenue will consider when issuing determinations. This guidance could be in the form of standard practice statements or regulations. *(ASB)*

Some restrictions should be placed on the Commissioner's determination-making power and that taxpayers be provided with some guidance on the type of determinations being applied. *(Bell Gully)*

The Society disagrees with the proposed repeal of section 91AAO(2), though it accepts that an alternative might be to amend it. In particular, the amendment should require the Commissioner to focus on whether or not a foreign investment fund interest is economically equivalent to a New Zealand dollar denominated debt instrument in making a determination on whether taxpayers can use the fair dividend rate method. *(New Zealand Law Society)*

Section EX 40(9) of the Income Tax Act 2004 and section 91AAO of the Tax Administration Act 1994 should be amended to provide that determinations made by the Commissioner are product-specific instead of the "interest-type" approach used in the current legislation. *(NZ Funds)*

Comment

Clause 165 of the bill would remove the determination-making criteria for use of the fair dividend rate method in section 91AAO(2) of the Tax Administration Act 1994. The amendment would effectively widen the Commissioner's power to determine when the fair dividend rate method can or cannot be used for a type of investment. For example, if the Commissioner considers that the compliance costs of applying the fair dividend rate method to an investment would be higher than is appropriate and that not applying the method would not pose a revenue risk, the Commissioner can make a determination that the fair dividend rate method may not be used for that investment.

A problem with the current determination-making criteria in section 91AAO(2) is that it is not clear that the current criteria are inclusive only and are not intended to preclude other relevant factors being taken into account by the Commissioner. The determination-making process for the fair dividend rate method is intended to provide sufficient flexibility to deal with cases close to the boundary.

The current criteria – that attempt to define what is an in-substance equity investment – seem to provide little useful guidance.

Officials agree that it would be preferable to have some statutory criteria that more accurately reflect the factors that should be taken into account when a determination is made if it is clear that these criteria are inclusive only and do not restrict the flexibility of the determination-making process to deal with cases close to the boundary.

It is therefore proposed that the determination-making criteria in section 91AAO(2) be replaced with a rule that says that the criteria that the Commissioner may take into account in making a determination include:

- The fair dividend rate method should not be used for investments which are economically equivalent to New Zealand dollar denominated debt, taking into account the whole arrangement, including any interposed entities or financial arrangements.
- Whether substantial equity and foreign exchange risk has been removed under the relevant arrangement.
- The proportion of the foreign entity's assets that comprise debt or other fixed return instruments (such as fixed rate shares).
- The extent to which the entity's investments are denominated in New Zealand currency or the extent to which the exchange rate risk has been removed by the use of financial derivatives.
- Compliance costs.

The legislation currently provides that the Commissioner may determine that the fair dividend rate method can or cannot be used for a type of investment. Officials would not be in favour of changing this "interest-type" approach to a product-specific approach as this could significantly increase compliance and administration costs of the fair dividend rate method determination process for both taxpayers and Inland Revenue. A product-specific approach would seem to require taxpayers, if they wanted certainty, to seek new determinations when there were only inconsequential changes to a particular product for which a determination has been made or a current product is simply reissued on the same terms. Officials therefore consider that the current interest-type approach to fair dividend rate method determinations should be retained.

Recommendation

That the submissions supporting the replacement of current section 91AAO(2) be accepted, subject to officials' comments.

Issue: Commissioner's power to make positive determinations that the fair dividend rate method can be used

Submission
(61 – KPMG)

Section 91AAO(2) of the Tax Administration Act 1994 should be clarified to allow Inland Revenue to issue a positive determination confirming that an investment in a fund is subject to the fair dividend rate method, without first establishing that section EX 40(9) applies.

Comment

Officials consider that the provisions in the bill – in particular, proposed section EX 40(8)(a)(i) would already allow the Commissioner to make a positive determination that the fair dividend rate method can be used for a type of investment. For such a positive determination to be made it is not necessary that the investment would otherwise fail to qualify for the fair dividend rate method under section EX 40(9).

Recommendation

That the submission be noted.

Issue: Application date of Commissioner's power to make a determination on the use of the fair dividend rate method

Submissions

(14 – Liontamer, 15 – Macquarie, 20 – Bell Gully, 71 – PricewaterhouseCoopers, 83 – Public Trust)

The bill's extension of the Commissioner's determination-making powers over when the fair dividend rate method can or cannot be used for a type of investment is supported. However, a further amendment is required to section 91AAO(2) of the Tax Administration Act to allow a determination to be effective from the beginning of the income year in which the determination is made, when this is chosen by the taxpayer, by completing their income tax return for that period. Alternatively, this retrospective application should apply automatically when the applicant (normally the foreign investment fund) so requests.

If the taxpayer does not elect to use the method from the beginning of the income year in which the determination is made, the determination should apply by default from the beginning of the following income year.

Comment

Section 91AAO(2) provides that a determination made by the Commissioner – that the fair dividend rate method can or cannot be used for a type of investment – applies generally on a prospective basis only.

Officials agree with the submission that a determination should apply from the beginning of the income year in which the determination is made if the taxpayer elects this by completing their income tax return for that period. This amendment will allow for the more efficient application of the new tax rules for offshore portfolio investment in shares. In particular, it takes into account that the new determination-making powers are not likely to be enacted until part-way through the 2007–08 income year. The proposed amendment will allow any determination made after the enactment of these provisions and before the end of the 2007–08 income year to apply from the beginning of that year at the discretion of the taxpayer.

Officials do not consider it is necessary for the application date provision in section 91AAO(2) to provide that if the taxpayer does not elect to apply the determination from the beginning of the income year in which the determination is made, the determination will apply by default from the beginning of the following income year. Section 91AAO(2) already provides that a determination may be made for tax years that are specified in the determination but may not apply to a taxpayer for a date before the date of the determination. The Commissioner has stated in the *Tax Information Bulletin* of April 2007 that the general application-date policy for determinations is that they will apply from the start of the tax year beginning after the making of the determination. It is only when investments have been designed to circumvent the restrictions on the use of the fair dividend rate method that they may apply from the date they are made. Officials therefore consider that the current provision already contains the necessary flexibility. We also consider that the part of section 91AAO(2) providing an exception to the general prospective date rule (when the taxpayer would be subject to a shortfall penalty in respect of the investment that is affected by the determination) should be omitted in order to streamline and simplify the application-date provision for determinations.

Officials consider that the current wording of section EX 40(8)(b) would not prevent a taxpayer who does not elect to apply a determination from the beginning of the income year in which it is made, from using the fair dividend rate method for other offshore portfolio share investments.

Recommendation

That the submissions be accepted, subject to officials' comments.

Issue: Quick sales formula

Submission
(54 – ASB)

The quick sale formula should be clarified to allow the amount of dividend income received included in the quick sale compilation to be calculated on a pro rata basis using the following formula:

$$\text{Quick sales dividend} = \frac{\text{Total dividends received}}{\text{during the income year}} \times \frac{\text{Total shares purchased/sold}}{\text{Peak holding of shares}}$$

The above formula should be an additional option to the current method permitted by the legislation, which requires the amount of dividends received on the shares bought and sold during the period to be included.

Comment

Officials consider that the pro rata approach under the suggested formula is already permitted in working out the quick sale gains under section EX 44C. An example of this approach is contained in the *Tax Information Bulletin* (April 2007) article on the fair dividend rate method.

Recommendation

That the submission be noted.

Issue: Allowing non-unit valuers to calculate for each interest on a daily basis

Submissions

(33 – Corporate Taxpayers Group, 36 – Infratil)

Non-unit valuers should have the option to calculate their fair dividend rate income for each attributing interest on a daily basis. This calculation would be based on opening value, or in the year of acquisition, the cost of the investment. If a person elected to use this daily method for any foreign portfolio investment, they would have to use this method for all their foreign portfolio investments, including in subsequent years. *(Corporate Taxpayers Group, Infratil)*

At a minimum, the daily market value method allowed for non-unit valuers in the bill should only be applied to interests in foreign companies which are sold and purchased during the year and not to other investments. In years when there has been no sale or acquisition of the foreign company, the taxpayer should be able to simply use the opening value to determine their fair dividend rate income. *(Corporate Taxpayers Group)*

Comment

Officials note that the fair dividend rate method was developed in part to address the concerns that people had with the complexity of other foreign investment fund calculation methods. It is an accepted feature of the standard fair dividend rate method that in years of acquisition or sale of an interest in a foreign company the method does not produce a result that is as accurate as a method that calculates foreign investment fund income for each day of the income year. The standard fair dividend rate method involves a trade-off between accuracy and simplicity. The aspect of the method that focuses on the opening market value only for non-unit valuers is an example of simplicity being chosen over accuracy.

Officials acknowledge that for larger, more sophisticated taxpayers that are not unit valuers, it may be desirable to have a fair dividend rate method option that produces a more accurate result in years of acquisition and sale. However, more work needs to be done in developing such a daily apportionment method before it could be considered for adoption. For example, rules would need to be developed to deal with shares in a foreign company that are bought and sold during the same year (referred to in the legislation as "quick sales"). In particular, it would seem to be necessary to trace such shares including their particular cost and acquisition date, and apply an accounting rule to subsequent sales if there were earlier multiple acquisitions of the same stock. Rules would also need to be developed for requiring consistency of use of particular fair dividend rate calculation methods both within a year and over subsequent years. For example, it would not be appropriate for persons to use the standard fair dividend rate method for acquisitions (resulting in no tax in the year of acquisition) while using the daily apportionment method for sales (resulting in less tax than under the standard method). It would also be necessary to have rules and systems for tracking elections over a large number of years.

Recommendation

That the submissions be declined.

Issue: Returning share transfers and the fair dividend rate method

Submission

(85 – Minter Ellison Rudd Watts)

The references to “returning share transfer” in proposed section EX 44B(4) should be replaced by references to “share lending arrangements” and the bill clarified that the share user will not be subject to income tax under the foreign investment fund rules in respect of an original share that is acquired under a share-lending arrangement.

Comment

The proposed amendment treating a share supplier in a returning share transfer as holding the original shares for all fair dividend rate purposes is considered necessary to protect the tax base against arrangements whereby shares could be lent by residents to non-residents shortly before 1 April each year and reacquired after 1 April to avoid the foreign investment fund rules. It is necessary for the proposed amendment to refer to a “returning share transfer” instead of “share-lending arrangements” because the latter term is more narrow and effectively applies only on a self-selection basis. Because this would mean that the amendment would no longer achieve its base protection objective, officials do not support the submission’s proposed change.

Officials consider that the effect of the current wording of the proposed amendment is that the share user will not be subject to the fair dividend rate method in respect of an original share that is acquired under a returning share transfer. However, officials agree it should be clarified that this is the case and that the foreign investment fund rules generally do not apply to a share user in respect of an original share. Although the share supplier should be treated as holding the original share for all foreign investment fund rule purposes, the share user should still derive any dividend paid on the original share. Therefore proposed section EX 44B(5)(b) should be omitted.

Recommendation

That the submission concerning the treatment of the share user be accepted, subject to officials’ comments.

COST METHOD

Issue: Transitional rule

Submissions
(32 – New Zealand Superannuation Fund, 74 – Deloitte)

The cost method in section EX 45B should be amended to permit a taxpayer to use their actual cost (and not be required to seek an independent valuation) if the person acquired their interests within 24 months of the transition into the cost method before the start of the 2007–08 income year.

The requirement to obtain independent valuation for all attributing interests in a foreign investment fund that fall within the cost method is unduly costly for affected taxpayers. It is accepted that it may not be appropriate to allow what could be a very old historical cost to be used as the opening value. However, this should not be extended to interests acquired in a period immediately before the introduction of these new provisions.

Comment

Officials agree that it would be appropriate on compliance-cost grounds to allow taxpayers to use their actual cost for their opening value, instead of acquiring an independent valuation, for interests acquired in the 24-month period before the start of the 2007–08 income year, which is the first income year for the application of the cost method in the foreign investment fund rules. This rule could be included in the definition of "opening value" in section EX 45B(4) (before current paragraph (b) concerning independent valuations).

Recommendation

That the submissions be accepted.

Issue: Definition of "opening value"

Submission

(71 – PricewaterhouseCoopers)

The submission supports the amendment in the bill expanding the definition of "opening value" in section EX 45B(4) but seeks a further expansion to allow investors to use the actual cost price of interests for measuring opening value for the purposes of calculating foreign investment fund income in the second year of holding the interest, if those interests were acquired in the previous income year.

Comment

Officials note that the definition of "opening value" – in particular, section EX 45B(4)(d) – already allows the tax treatment that the submission is seeking.

Recommendation

That the submission be noted.

Issue: Interest in grey list company falling below 10 percent during an income year

Submission

(71 – PricewaterhouseCoopers)

If a 10 percent or more holding in a grey list company falls below 10 percent during the year, there should be no foreign investment fund income in that year. In particular, the definition of "opening" in sections EX 44C(4) and EX 44D(4) should be amended to deem opening market value to be zero in the case of an interest in a grey list company that falls below 10 percent during the period.

Comment

Officials agree that in the case of a 10 percent or more interest in a grey list company that falls below 10 percent after the start of an income year, and the fair dividend rate method can be applied to that interest in that year, that there should be no foreign investment fund income in that year. This would be consistent with the general fair dividend rate treatment which ignores purchases of shares during a year (other than quick sales). For example, for a person with a 30 percent interest in a grey list company at the start of an income year that scales down their interest to 8 percent during the year, they should be treated as having acquired an 8 percent interest during the year, the opening value for which would be zero. Officials also agree that this policy would be best achieved by treating the opening market value under the fair dividend rate method to be zero for a 10 percent or more interest in a grey list company that falls below 10 percent during the period (the grey list exemption from the foreign investment fund rules for 10 percent or more interests in grey list companies applies only if the interest remains at 10 percent or more at all times during the relevant income year).

However, if a person's interest in a grey list company falls below 10 percent during an income year, and the fair dividend rate method can be applied to the interest (resulting in nil foreign investment fund income for that year), the interest holder should remain liable to tax on any dividends received in that year. This is consistent with the general treatment of 10 percent or more interests in grey list companies where even though the interest is not subject to the foreign investment fund rules, dividends from those interests remain taxable. This treatment could be achieved by inserting a specific exception in sections EX 47 and CD 26 which will apply in the year that a 10 percent or more interest in a grey list company falls below 10 percent during the year.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Meaning of income interest of 10 percent or more

Submission
(71 – PricewaterhouseCoopers)

The Income Tax Act 2004 should be amended to ensure that the provisions which depend on the application of the 10 percent or greater income interest threshold are consistent with those applying under the Income Tax Act 1994. An amendment is necessary to clarify whether the interests of associated persons are required to be included by the investor when measuring their income interest for the purposes of the controlled foreign company and foreign investment fund rules.

Comment

The concern raised in the submission has been considered by the Rewrite Advisory Panel which has recommended a retrospective remedial amendment to the Income Tax Act 2004 to deal with this issue.

Recommendation

That the submission be noted.

Issue: Family trusts and the fair dividend rate and comparative value methods

Submissions
(71 – PricewaterhouseCoopers, 91 – New Zealand Institute of Chartered Accountants)

As currently worded, sections EX 40(6) and EX 50(8) of the Income Tax Act 2004 will prevent a large number of family trusts from using the comparative value method in years in which foreign investment fund income would be lower under that method than under the fair dividend rate method. A number of remedial amendments are required to ensure that this safety net option is available to family trusts as intended. These suggested changes are that:

- The ordinary definition of the term "settlor" in paragraph (a)(i) of the section OB 1 definition – which is limited to dispositions of property at less than market value – should be adopted. The term "settlor" should also include deceased persons.
- Section HH 1(1) should apply to nominal settlements for the purposes of sections EX 40(6) and EX 50(8).
- Resettlements of family trusts should not prevent the application of sections EX 40(6) and EX 50(8) if the trust and the settlors of the trust from which the resettlement is made satisfy the requirements of those provisions.

- Sections EX 40(6) and EX 50(8) should be amended to recognise that there can be a series of settlements when property is transferred to a trust after its establishment.
- The natural love and affection requirement in sections EX 40(6) and EX 50(8) should be focussed on each income year rather than the time of a trust's establishment.
- The qualifying trust criterion in sections EX 40(6) and EX 50(8) should be defined with reference to a particular distribution because the term "qualifying trust" is defined in section OB 1 in relation to a particular distribution.

Comment

Officials agree that these remedial amendments would help to ensure that family trusts can use the comparative value method in years in which foreign investment fund income would be lower under that method than under the fair dividend rate method, which is the policy intention.

Recommendation

That the submissions be accepted.

Issue: Trans-Tasman imputation

Submission
(54 – ASB)

No market value adjustment should be required in respect of a fixed rate share where the share is either listed on the Australian Stock Exchange or the New Zealand Stock Exchange and the company has a policy of distributing at least 90 percent of its profits each year. Where the company distributes the majority of its profit each year, double taxation will occur. First, when the taxpayer is subject to tax on any change in the market value (which will reflect any undistributed earnings), and second, when it receives the dividend distribution.

Comment

Officials do not agree that there is double taxation where a fixed-rate share investment in an Australian-resident company – that does not qualify for the Australian-listed company exemption from the foreign investment fund rules – is subject to the comparative value method. Dividends are taken into account in working out foreign investment fund income under the comparative value method. There is no double New Zealand taxation of the same income. To the extent there are distributions made on the share this would reduce the closing value. The dividend itself is not separately taxed on receipt, thereby preventing actual double taxation – this exclusion is provided under section EX 47.

An amendment in the bill to section LB 2 will ensure that a New Zealand investor is entitled to an imputation credit under the trans-Tasman imputation rules when they receive a dividend from an investment in an Australian company that is subject to the distribution exclusion in section EX 47, which is the situation in the example given in the submission.

Recommendation

That the submission be declined.

Issue: Imputation credit under the trans-Tasman imputation rules

Submissions
(91 – New Zealand Institute of Chartered Accountants)

Section EX 44(4) is circular as you need to complete the full taxable income calculation and then work out the allowable credit before you can actually determine the amount of the credit to be included in the item's "gains".

New section LB 2(8) only needs to refer to an attributing interest in a foreign investment fund – not an interest in an attributing interest in a foreign investment fund.

Comment

Officials do not agree that section EX 44(4), containing the definition of "gains" in the comparative value method, is circular. The definition of "gains" requires that any amount that a person derives from holding or disposing of an interest in a foreign investment fund is grossed-up by the amount of foreign withholding tax or other tax that the person is allowed as a credit under section LC 1 or, under the amendment in the bill, any imputation credit allowed under section LB 2. This grossing-up requirement will be satisfied if a person satisfies the requirements in section LB 2 and section LC 1 for an imputation credit or foreign tax credit respectively. Although the equivalent provision in the Income Tax Act 1994 (section CG 18) referred to credits being "allowable" under section LC 1, no change of meaning was intended by using the word "allowed" in the current section EX 44(4); this wording change was made as part of the general rewrite of the Income Tax Act.

However, officials consider that the relevant part of section EX 44(4) would be clearer if it was worded: "the amounts include any foreign withholding tax or other amount that the person is allowed as a credit under sections LB 2 or LC 1".

Officials also agree that new section LB 2(8) would be clearer if the relevant part referred to "assessable income of the taxpayer in respect of an attributing interest in a foreign investment fund". This wording would be consistent with the approach used in the equivalent provision in the foreign tax credit rules (section LC 1(4)).

Recommendation

That the submissions be accepted, subject to officials' comments.

Issue: Consequences of changes in method

Submissions
(55 – NZ Funds)

Proposed section EX 51(5) has an unintended consequence of potentially triggering the quick sale rules in the fair dividend rate method. This should be prevented by extending the application of proposed section EX 44C(13) to proposed section EX 51(5) so that when a person changes from the fair dividend rate method to the comparative value method, the deemed sale and purchase does not trigger a quick sale.

The proposed section CQ 5(1B) should also be extended to section EX 51(5) so that the determination of the $50,000 minimum threshold is not affected by the deemed sale and purchase under section EX 51(5).

Comment

Proposed section EX 51(5) deals with the consequences of changing between the fair dividend rate and the comparative value methods. Officials agree with the submission that the deemed disposal and reacquisition under this provision should not trigger the quick sale rules in section EX 44C and should be ignored for the purposes of the $50,000 minimum threshold rules in sections CQ 5 and DN 6.

Recommendation

That the submissions be accepted.

Issue: Changes in application of foreign investment fund exemptions

Submission
(74 – Deloitte)

Section EX 53 should be amended to ensure there are not multiple deemed realisations in a period. With the interaction of sections EX 33C and EX 54B there are situations where this could produce more than one deemed acquisition and disposal in a period. For example, if a person who values their interest daily holds a share that satisfies the section EX 33C exemption then they will be subject to tax on gains and dividends throughout the income year. However, if during the year that share ceases to satisfy the exemption there is a deemed sale and reacquisition at that date under section EX 53(2), but that person will continue to pay tax on dividends and gains until the next income year because of section EX 33C(2). At the end of the income year, because that interest is an attributing interest for which the person does not have foreign investment fund income, there is a second deemed disposal and acquisition.

Comment

Officials do not consider that there would be multiple deemed disposals and reacquisitions as a result of the section EX 33C amendments. If a company is listed on an approved index of the Australian Stock Exchange on the first day of a person's income year and the company is omitted from the index during the person's income year, that requirement for the Australian shares exemption will still be satisfied for the whole of that year – there is no deemed sale and reacquisition under section EX 53 at the time the company is removed from the index. The person's investment only becomes an attributing interest in a foreign investment fund from the beginning of the next income year and there is only a single deemed disposal and reacquisition at that time under section EX 53.

Recommendation

That the submission be declined.

Issue: Application date provisions for new foreign investment fund rules

Submission
(91 – New Zealand Institute of Chartered Accountants)

The application date provisions that allow the application date of the amended foreign investment fund rules to be extended to 1 October 2007 are too inflexible. The rules should allow entities that are brought into existence between 1 April 2007 and 1 October 2007 to elect to defer the start date of the new foreign investment fund rules within one month, or within such further period as the Commissioner allows.

Comment

The new tax rules for offshore portfolio investment in shares generally apply for income years beginning on or after 1 April 2007. A special application date rule applies for entities that intend to become portfolio investment entities – these entities may choose to delay the application of the new offshore tax rules until 1 October 2007 when the new tax rules for portfolio investment entities come into force. This deferral is achieved by the entity giving a notice to the Commissioner before 1 April 2007 (if the entity exists before that date) or within one month of the day on which the entity comes into existence (if the entity comes into existence between 1 April 2007 and 1 October 2007).

Officials consider that the part of the application date provisions allowing certain entities to defer the start date of the new tax rules for offshore portfolio investment in shares are sufficiently flexible to deal with taxpayers' circumstances. Also, given the short period until the start date of the new portfolio investment entity tax rules on 1 October 2007 and the large number of application date provisions for the new offshore tax rules, it would not be desirable to make further amendments to these application date provisions.

Recommendation

That the submission be declined.

Submissions
(Matters raised by officials)

In section CQ 5(1)(db), replace "the person holds attributing interests" with "the person holds at any time during the income year attributing interests" to be consistent with the companion provision in section CQ 5(1)(d).

In section CQ 5(1)(f), the previous cross-references to sections EX 48 and EX 49 should be reinstated.

In section DN 6(1)(db), replace "the person holds attributing interests" with "the person holds at any time during the income year attributing interests" to be consistent with the companion provision in section DN 6(1)(d).

In clause 64, replace the reference to "fair dividend method" in new section EX 40(8)(a)(i) and EX 40(9)(a) with "fair dividend rate method".

In section EX 40(6)(b), replace "subsection (8)(a)(i) to (v)" with "subsection (9)(a) to (e)".

In section EX 44(6B), replace "section EX 40(8)(a)(i) to (v)" with "section EX 40(9)(a) to (e)".

Section EX 41(2)(b)(ii) and (iii), concerning the default calculation method in the foreign investment fund rules, should be amended to cater for the situation where the accounting profits method is allowed but it is not practical to use it. This situation was covered in the previous section EX 41(2)(b) and was inadvertently omitted when the current section EX 41(2) was enacted in 2006.

In section EX 45B(11)(b), replace "section EX 44C" with "section EX 44E".

In section EX 51, replace "subsections (2) to (7)" with "subsections (2) to (8)".

Comment

The minor remedial amendments outlined above are consistent with the policy intent of the new foreign investment fund rules.

Recommendation

That the submissions be accepted.

Life insurance and portfolio investment entity rules

OVERVIEW

Clauses 77, 78, 81 to 83 and 135

The bill introduces a number of changes to ensure greater consistency between the tax treatment of life insurance savings products and those of other savings vehicles. The changes deal with two particular problems.

The first is an unexpected consequence of the fair dividend rate rules that arises because of the complexities of the interplay between a life insurer's life office base and its policyholder base tax calculations.

The second problem deals with applying the Australasian capital gains exclusion contained in the portfolio investment entity rules to unit-linked life products.

Eight submissions were received. Some submissions expressed support for the amendments on unit-linked products, but all submitters wanted the Australasian capital gains exclusion to be extended to non-unit-linked life savings products. Some submissions questioned the percentages of income exclusion from the policyholder base income calculations and suggested alternative approaches. The status of attributed income derived by a life insurer, and technical issues on actuarial concepts and definitions were also raised.

Some submissions touched on matters that are part of the current review of the taxation of life insurance. One submission directly raised the treatment of prepaid policyholder base tax balances that is not related to this bill, but is a transitional issue being considered by the review.

EXTEND AUSTRALASIAN EQUITY CAPITAL GAINS EXCLUSION

Submission
(23 – Investment Savings and Insurance Association, 24 – AMP, 54 – ASB Bank, 61 – KPMG, 52 – Tower Limited, 71 – PricewaterhouseCoopers, 74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The life office base and policyholder base relief should not be restricted to unit-linked products as currently contained in the bill. The bill should expressly exclude gains on all Australasian equities from the life office base, including gains derived from assets backing conventional participating policies (such as whole of life and endowment business) and also gains derived by the shareholder.

Comment

The complexity of life insurance savings products presents challenges with excluding realised gains from Australasian equities. There are two broad categories of products.

The first are conventional participating policies which can be likened to a pool of money into which policyholder premiums and investment income go in and claims, expenses, tax, and provisions for future liabilities go out. The remaining "profit" is allocated between the policyholders and the owners of the life insurer (usually referred to as the shareholders) according to a ratio determined by the rules of the life fund. There is no practical way to separate excluded income between the shareholders and policyholders. The policyholders' share is available for crediting as bonuses to policyholders and represents investment income on the policy, though if the policy is terminated by the policyholder before time, the surrender value is less than the aggregate of the bonuses and premiums. The shareholder's share, however, is available for use (for example, to be paid out as dividends) in its entirety.

The current comprehensive review of the taxation of life insurance requested submissions from the industry on the Australasian capital gains exclusion for participating policies. Officials consider that this particular issue is more appropriately addressed in the context of that review.

The second broad category is unit-linked products. Policyholders' investment income in unit-linked products is determined by the rise or fall in their investment units, reflecting the performance of the underlying investment assets. The nature of most of these products means that the difference between market and surrender values would usually not be as much as that for conventional products. Therefore, tax not paid on realised Australasian equity gains leads to a commensurate increase in the value of units, so the calculation of income is very similar to that of unit trusts.

Recommendation

That the submission be declined.

PROVISION FOR LIFE OFFICE BASE

Submission
(23 – Investment Savings and Insurance Association)

The bill should include a provision to exclude gains on all Australasian equities from the life office base and not just assets held under unit-linked policies.

Comment

Extending the Australasian realised capital gains exclusion on direct investments for assets held for the life insurance business (other than just unit-linked products) is being considered as part of the life insurance tax review.

Recommendation

That the submission be declined.

DEFINITION OF PORTFOLIO INVESTMENT ENTITY ADJUSTMENT

Submission

(23 – Investment Savings and Insurance Association, 54 – ASB Bank, 52 – Tower Limited, 74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The definition of the portfolio investment entity adjustment should also include gains on Australasian equities income and FDR income attributed to the portfolio investment-linked fund from investment in a portfolio investment entity.

Comment

The definition of the portfolio investment-linked adjustment (renamed by officials from "portfolio investment entity" adjustment to remove confusion) refers only to holdings of shares as described in section CX 44C of the Income Tax Act 2004. In proposed section EY 42C (2) there is a reference to "excluded shares" in the portfolio investment-linked fund adjustment formula. "Excluded shares" are defined in subsection (6) but only include shares owned directly and not shares held indirectly through a portfolio investment entity. Excluded Australasian gains should also be excluded from the policyholder base calculation, and the definition of "excluded shares" in proposed section EY 42C (6) (a) amended accordingly.

Similarly, the definition of FDR income includes only FDR income from directly held investments. FDR income attributed from portfolio investment entity investments by the portfolio investment-linked life fund should also be excluded.

Recommendation

That the submission be accepted.

RATE OF TAX APPLIED TO LINKED PRODUCTS

Submission

(23 – Investment Savings and Insurance Association, 54 – ASB Bank)

Unit-linked products are subject to tax at the corporate rate of 33% (though this rate will reduce to 30% in the 2009–10 income year). This rate is excessive as industry data shows that the typical investor is either in or approaching retirement, and these products are not being sold to new customers in any significant volume. Therefore linked products should be taxed in the life office base at 19.5% as a proxy rate, and the income removed from the policyholder base by way of an exemption. Grandfathering provisions could apply to prevent new products exploiting the lower tax rate.

Comment

Using a proxy rate is inconsistent with portfolio investment entity tax policy principles. While some investors are taxed at their correct rate, other investors will not be taxed at their correct rate. The problem of determining the tax rate to apply to portfolio investment entity income that is not allocated to a particular investor was considered in the context of defined benefit funds and it was decided it was appropriate to tax the income at the corporate rate in that case.

Recommendation

That the submission be declined.

DEFINITION OF FIF RESULT

Submissions
(23 – Investment Savings and Insurance Association, 24 – AMP, 74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

In clause 78 of the bill, the "FIF result" which is excluded from the policyholder base (as the income will be taxed under the FDR method) is defined as the gains and losses for the income year:

(a) calculated using accepted accounting practice; and
(b) not differing materially from the amounts of FIF income or FIF loss that would have arisen for the property in the absence of the law enacting the fair dividend rate.

Two approaches were suggested by submissions in amending the definition of the "FIF result".

The first was that the adjustment to the policyholder base should be the amount arising under the comparative method for calculating FIF income or loss. *(New Zealand Institute of Chartered Accountants, Deloitte)*

The second was that any adjustment to policyholder base taxation should be based only on gains and losses in the financial statements as determined by accepted accounting practice. *(Investment Savings and Insurance Association, AMP)*

Comment

The intention of the provision is to ensure that the correct amount of income from the policyholder base is taxed. The reference to a material difference between amounts calculated under accepted accounting practice and under FIF methods (which was stated in the Commentary to the bill to be the comparative method) should, in most cases, arrive at a similar answer. This is because a life insurer is required to record assets held for its investment activities at fair value for financial reporting purposes, and this is likely to be the same as using the comparative value method.

Life insurers, however, may incur compliance costs if the value of some assets cannot be determined. Officials consider in the circumstances that there is no overall benefit in taxpayers incurring these costs as the gains and losses calculated under accepted accounting practice should provide the correct information in the vast majority of circumstances.

Recommendation

That the submission confining the adjustment to the policyholder base only to gains and losses calculated using accepted accounting practice be accepted.

That the submission that the adjustment to the policyholder base should be the amount arising under the comparative method for calculating FIF income or loss be declined.

DEFINITION OF A PORTFOLIO INVESTMENT-LINKED FUND

Submission
(74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The definition of a portfolio investment-linked fund should be amended by replacing the word "fund" with "pool of investments".

Comment

The definition of a portfolio investment-linked fund states that it means a fund in which certain criteria are satisfied. A "fund" is not defined. A unit-linked fund is made up of a number of assets held to support the policyholder liabilities of the insurer, but these will not necessarily be held in a separate entity. Accordingly, it would be more technically correct to define a portfolio investment-linked fund as a fund or a pool of investments, held to support policyholder liabilities.

Recommendation

That the submission be accepted.

MEMBERSHIP REQUIREMENTS OF A PORTFOLIO INVESTMENT-LINKED FUND

Submission

(74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The definition of a portfolio investment-linked fund should be amended by relaxing the membership requirements under section HL 6, as unit-linked life policies have no concept of membership.

Comment

To elect to be a portfolio investment-linked fund, section HL 6 currently requires the policyholders in the unit-linked product (being a "portfolio investor class of an entity which is not a company") to satisfy an "investor membership requirement" prescribed in that section.

While life insurance products in New Zealand now generally do not have a concept of membership, the important definition is that of "investor". The bill amends the definition of "investor" in a portfolio investment-linked fund to be "a person whose benefits under the relevant life insurance policy are directly linked to the value of investments held in a portfolio investment-linked fund". The membership requirement is therefore met and so officials consider that no change is necessary.

Recommendation

That the submission be declined.

PORTFOLIO INVESTMENT-LINKED FUND AND FDR ADJUSTMENTS

Submission

(23 – Investment Savings and Insurance Association, 24 – AMP, 54 – ASB Bank, 61 – KPMG, 52 – Tower Limited, 71 – PricewaterhouseCoopers, 74 – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The submissions all considered that the bill's exclusion of income not taxed under the FDR method from the policyholder base (90% for unit-linked policies under the portfolio investment-linked fund adjustment, and 40% for participating policies) was too low.

There were four broad approaches contained in the submissions:

- There should be further consultation to determine more appropriate figures. *(KPMG)*
- The limitations should be removed and replaced with actuarially determined rates which reflect investment income attributable to policyholders. *(Tower Limited, ASB Bank, PricewaterhouseCoopers, Investment Savings and Insurance Association)*
- The policyholder base exclusion factors contained in the bill should be an option only when the insurer is unable to calculate the amount actually credited to policyholders. *(AMP)*
- The scaling factors should be increased to 100% for index-linked products and 80% for participating policies. FDR income for participating policies should be the actual allocation of income, but if this cannot be determined, the 80% factor would constitute a "safe harbour". *(New Zealand Institute of Chartered Accountants)*

Comment

The proposed FDR and portfolio investment-linked fund adjustments seek to make a specific and well-defined adjustment to actuarial reserves. Actuarial reserves are not narrowly defined for tax purposes and are calculated in a variety of ways depending on the specific circumstances of each life insurer.

Investment income is ultimately fully attributed to unit-linked policyholders, and we are advised by the industry, up to about 80% to non-unit-linked policyholders. However, timing of the actual income allocation to policyholders differs between income years (according to the circumstances of the policy and investment conditions) and between life insurers. If the policyholder base exclusion factors are too low (as submissions are arguing), more tax than is appropriate will be paid on the policyholder base. If the exclusion factors are too high, a life insurer's policyholder base tax will be understated. Officials have analysed the exclusion factors in light of submissions, and while not proposing a change in the portfolio investment-linked fund adjustment factor, consider that a 60% factor for participating policies is more appropriate.

We are advised that actuaries can, in the majority of circumstances, reasonably accurately calculate the income subject to the portfolio investment-linked fund and FDR adjustments allocated to policyholders on an annual basis. Officials have subsequently discussed the issue with members of the Investment Savings and Insurance Association, and agree that when actuaries are able to make accurate actual allocations the percentage used should be the actual percentage. Alternatively, life insurers could choose the exclusion factors in the bill, though officials acknowledge that life insurers would only adopt this alternative if the actual allocation cannot be accurately calculated, or if the compliance costs to do so would be material. The allocation method adopted has to be used consistently between income years to prevent artificially maximising the policyholder base exclusion.

Recommendation

That the submission be accepted, and that life insurers can choose whether to exclude from policyholder base income the percentages for portfolio investment-linked fund and FDR contained in the bill or, exclude actual amounts credited to actuarial reserves. The method chosen must be used by the life insurer in subsequent income years. The adjustment factor for the FDR adjustment for participating policies will be increased to 60%.

DEFINITION OF PROPERTY

Submission

(23 – Investment Savings and Insurance Association)

In proposed sections EY 42B and EY 42C, the portfolio investment-linked fund and FDR adjustments to policyholder base income are made "to the extent to which property that the life insurer holds to support actuarial reserves…"

This phrase is not defined, and could be difficult to interpret in cases where insurance contracts prescribe participation in pools of assets by both shareholder and policyholder.

No specific submission was made, though the preferred solution was that the portfolio investment entity and FDR adjustments should be made by determining the actual amount of accounting income credited to policyholder reserves.

Comment

The adjustments contained in the bill are limited to life insurance products. These products have actuarial reserves which alter the timing of income recognition. Officials consider that the phrase "actuarial reserves" is generally understood and does not need a specific definition.

The reference to actuarial reserves in proposed sections EY 42B and 42C are used to describe the type of property subject to the rules. In any case, officials have dealt with the portfolio investment entity and FDR adjustments being the actual amounts in response to an earlier submission. Accordingly, no further change to the language of the section is considered necessary.

Recommendation

That the submission be declined.

REALISED AUSTRALASIAN EQUITY GAINS EXCLUSION FROM LIFE OFFICE BASE

Submission
(Matter raised by officials)

The exclusion from the life office base for realised Australasian equity gains in respect of unit-linked product investments should be made explicit.

Comment

Realised Australasian equity gains are excluded from the life office base for portfolio investment-linked funds by the operation of section CX 44C. A practitioner suggested to officials that the exclusion should directly refer to the exclusion for portfolio investment-linked funds. While officials consider that the current wording is technically sufficient, a clarification to section CX 44C regarding its intent for portfolio investment-linked funds will remove any doubt.

Recommendation

That section CX 44C be amended to remove any doubt that it applies to portfolio investment-linked funds.

Other policy matters

REWRITE ADVISORY PANEL – RETROSPECTIVE AMENDMENTS TO THE INCOME TAX ACT 2004

Issue: Unintended consequences

Submissions

(95 – New Zealand Law Society, Matters raised by officials)

Amendments are required to remedy unintended changes in legislative outcomes in the Income Tax Act 2004 with effect from the commencement date of the Act.

The provisions affected are section CB 5 (Disposal of land acquired for purposes or intention of disposal) and EX 15 (Associated persons and income interest thresholds for CFC rules).

Section CB 5 (Disposal of land acquired for purposes or intention of disposal)
Clauses 5B, 25B and 57B

In rewriting section CD 1(10) of the Income Tax Act 1994, the placement of this rule in paragraph (a)(i) of the "land" definition in section OB 1 of the Income Tax Act 2004 has the effect of unintentionally widening the ambit of amounts that are included as income under the land sale rules in sections CB 5 to CB 21. Section CB 5 should be amended retrospectively to ensure that the effect of section CD 1(10) of the income Tax Act 1994 be restored to apply to the land sales provisions in section CB 5 to CB 21. *(Matter raised by officials)*

The "land" definition in the Income Tax Act 2004 should be amended to correct an identified unintended legislative change, with retrospective effect for taxpayers who have taken a tax position consistent with the policy of the amendment. *(New Zealand Law Society)*

Section EX 15 (Associates and 10% threshold)
Clauses 9B, 58B, 58C, 59C and 78C

The drafting of the 2004 Act should be reviewed to ensure that the provisions which depend on the application of the "10% of greater income interest" threshold are consistent with those applying under the 1994 Act.

Comment

When the Income Tax Act 2004 was enacted, the Finance and Expenditure Committee noted that there was concern that the new legislation could contain adverse unintended policy changes. To alleviate that concern, the Committee 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.

The Panel considers that the rewrite of section CD 1(10) as paragraph (a)(i) of the definition of land in section OB 1 of the Income Tax Act 2004 has led to an uncertain result as the operative words of section CD 1(10) of the ITA 1994 are now incorporated into the definition of "land". Officials agree with the submission.

The Panel considers that the drafting of section EX 15 of the Income Tax Act 2004 has limited the application of that section compared with the corresponding provision (section CG 6(92)) of the Income Tax Act 1994.

Officials agree that the rewrite of section EX 15 has given rise to potential differences in treatment between the 1994 and 2004 Acts in applying the 10% income interest threshold for the international tax rules. A retrospective amendment is recommended to restore the effect of the Income Tax Act 1994 in relation to the 10% income interest threshold contained in section EX 15 of the Income Tax Act 2004.

Recommendation

That the submissions be accepted, with the amendments applying from the beginning of the 2005–06 tax year, which is the commencement date for the 2004 Act.

Issue: Recoveries by employers from superannuation schemes

Submission
(71 – PricewaterhouseCoopers)

Section CG 5 of the Income Tax Act 2004 should be amended to ensure that where an employer recovers or receives an amount from a superannuation scheme the amounts received should be tax-free in the hands of the employer, to the extent that specified superannuation contribution withholding tax (SSCWT) has already been paid.

Comment

Officials consider that this submission should be referred to the Rewrite Advisory Panel for consideration as to whether the 2004 Act contains an unintended change in law relating to section DF 3(3) of the 1994 Act.

However, it is clear that the adjustment to deductions under section DF 3(3) was intended to give rise to an adjustment to the employer's net income (and income tax liability). Therefore, the section DF 3(3) adjustment was not a tax-free outcome.

In addition, in the event of a refund of employer superannuation contributions, the policy intention is that the Commissioner would normally issue an assessment under section 98 of the Tax Administration Act 1994 to action any applicable refund of SSCWT.

Officials consider that these policies remain intact as a result of the rewrite of section DF. However, officials agree there are intended changes in law in section CG 5, and this is clearly set out in Schedule 22A of the 2004 Act. There are two intended changes to the section:

- The adjustment to net income is now timed to the year of the receipt of the benefit rather than leading to a re-assessment of an earlier tax year.
- The 12-month restriction is omitted.

Recommendations

That the submission be declined and be referred to the Rewrite Advisory Panel for consideration as a potential unintended change in law in the 2004 Act.

Issue: Duplication of effect

Clause 28

Submission
(91 – New Zealand Institute of Chartered Accountants, Matter raised by officials)

Clause DC 9(3)(b) is not required.

Comment

Officials agree with the submission. The effect of DC 9(3)(b) replicates the effect of the opening words of section DC 9(2) so the subparagraph is unnecessary.

Recommendation

That the submission be accepted.

TAX INCENTIVES FOR CHARITABLE DONATIONS

Issue: Support for amendments

Submissions
(5 – Philanthropy New Zealand, 27 – Presbyterian Support New Zealand, 33 – Corporate Taxpayers Group, 63 – Inter-Church Working Party on Taxation, 74R – Deloitte)

Some submissions supported all of the amendments, while others identified specific amendments that they supported.

Recommendation

That the submissions be noted.

Issue: Concerns with the amendments

Submission
(91 – New Zealand Institute of Chartered Accountants)

NZICA is concerned that the amendments may not increase charitable giving for the betterment of New Zealand and that there may be better, more optimal policy solutions that deserve further consideration. The submission notes that the economic literature is not conclusive about whether increasing or removing a cap on charitable donations actually increases charitable giving. Furthermore, because there is no control over where the taxpayer subsidy goes, there is no means of ensuring taxpayer subsidised gifts go to the wider benefit of all New Zealanders, rather than to sectors of the community that benefit only their members.

Comment

The October 2006 government discussion document, *Tax incentives for giving to charities and other non-profit organisations*, noted that there is no clear consensus about the impact of tax incentives in encouraging philanthropy. While there are some who believe that a lack of tax incentives contributes to low levels of charitable giving in many countries, many others believe there is little relationship between the two.[1]

[1] Johnson P D, Johnson S P and Kingman A, "Promoting philanthropy global challenges and approaches", *International Network on Strategic Philanthropy*, December 2004.

Some empirical evidence suggests that tax incentives to donors can and do lead to larger donations being made, and that high-income people tend to be more responsive to tax incentives. For example, the Asia Pacific Centre for Philanthropy and Social Investment has undertaken research on the strategies that have been applied in different countries to encourage giving, especially by the wealthy in the United States, Britain and Australia.[2]

The general view is that tax incentives introduced in isolation are unlikely to change philanthropic behaviour or attitudes significantly. Rather, a range of initiatives is likely to be required, including better education aimed at promoting awareness of the activities of the charitable and non-profit sector, as well as other promotional strategies. This would have the potential to change philanthropic behaviours and, in the longer-term, have a positive effect on giving to charities and other non-profit organisations.

Recommendation

That the submission be noted.

Issue: Tax relief in the 2007–08 tax year

Submissions
(63 – Inter-Church Working Party on Taxation, 95 – New Zealand Law Society)

The amendments relating to removing the rebate threshold and the company deduction limit should apply from the 2007–08 tax year, rather than the 2008–09 tax year. Delayed introduction of the amendments would have adverse effects on charities and similar organisations that rely principally on donations as a source of funding. There is a serious risk of individuals "storing up" donations until 1 April 2008, with a consequential impact on the funding of charities and similar organisations. There would be no operational difficulties in permitting the removal of the cap to apply from the current tax year, as rebates are processed by Inland Revenue after the end of the tax year. *(New Zealand Law Society)*

Section KC 5(2)(b) should be amended to provide greater relief in the current tax year to encourage individuals to continue donating between now and 31 March 2008. In particular, the rebate threshold should be increased to $5,000 for the tax year ending 31 March 2008. *(Inter-Church Working Party on Taxation)*

[2] Asia Pacific Centre for Philanthropy and Social Investment, "How the wealthy give" (October 2004) and "Encouraging wealthy Australians to be more philanthropic" (February 2005).

Comment

Officials do not support the submissions for the following reasons:

- The suggested changes would require changes to Inland Revenue's system for processing rebate claims and updating the rebate claim form. These changes would not have been taken into account in Inland Revenue's planning and design processes for new legislation.
- The suggested changes would have a fiscal cost, which has not been taken into account in Budget 2007.

Recommendation

That the submissions be declined.

Issue: Other tax incentives to encourage charitable giving

Submission
(27 – Presbyterian Support New Zealand)

Other tax incentives for encouraging giving of time and property to charities and other non-profit organisations should be considered by the government. In particular:

- honoraria payments for substantiated expenses should be exempt from income; and
- goods and services provided to charitable causes should qualify for tax relief, provided they can be independently valued.

Comment

The government is currently reviewing the tax treatment of reimbursement payments to volunteers and honoraria recipients. One of the options being considered is an exemption for honoraria payments for reasonable expenses incurred. Any legislative changes arising from this review are likely to be included in the next available taxation bill.

As part of Budget 2007, the government announced that it would undertake further policy work on a range of other tax incentives for charitable donations, including a gift aid scheme where the tax benefit of donations goes directly to the charitable organisation rather than the donor, and making it possible to claim tax relief for non-monetary donations. The results of this review will be reported to the Ministers of Finance and Revenue by 31 March 2008.

Recommendation

That the submission be noted.

Issue: Non-tax measures for encouraging giving

Submissions
(5 – Philanthropy New Zealand, 27 – Presbyterian Support New Zealand)

Submissions strongly recommended that the government should take a leadership role in promoting philanthropy and a culture of generosity in New Zealand.

Comment

As previously noted, the government recognises that tax incentives alone will not change giving behaviours and that a more pluralistic approach to encouraging giving is required. For example, public awareness campaigns, donor education and donor leadership. The government is currently examining a wide range of non-tax measures for reinforcing and encouraging a culture of giving and philanthropy in New Zealand. This work is being led by the Office for the Community and Voluntary Sector.

Recommendation

That the submissions be noted.

Issue: The company deduction should be extended to sole traders

Submission
(91 – New Zealand Institute of Chartered Accountants)

The limitation on the amount a company can deduct for charitable donations should be the same for an individual who conducts a business as a sole trader. This would ensure that sole traders and companies are treated the same.

Comment

Under the proposed change to the company deduction for charitable donations, the deduction would be limited by the amount of the company's net income before taking into account the donation, while under the proposed change to the rebate for individuals, charitable donations would be limited to an individual's taxable income.

The difference between net income and taxable income for an income year is any tax losses that a taxpayer is allowed to carry forward from an earlier income year and offset against the current year's net income. As a result of this difference, if losses are brought forward from an earlier income year, an individual would obtain a smaller tax advantage than a company in identical circumstances. It is because of this difference that the submission argues that the charitable donations rules are inequitable according to the legal form through which a business is undertaken.

We note that this difference is present in the current law, although the tax consequences are markedly accentuated by the amendments.

Officials consider that the submission raises a valid concern which should be considered further. It is recommended that the issue be considered in the ongoing review of tax incentives for charitable giving.

Recommendation

That the submission be considered in the ongoing review of tax incentives for charitable giving.

Issue: Limit the rebate to individuals who are not required to file a tax return

Submission
(91 – New Zealand Institute of Chartered Accountants)

If the company deduction is extended to individuals (such as sole traders), then the rebate claim process should only apply to those individuals who are subject to section 33A of the Tax Administration Act 1994 – that is, individuals who are not required to file income tax returns. Individuals who file a return should be able to claim the deduction automatically through the tax return.

Comment

As this issue is closely related to the issue of extending the company deduction to apply to other individuals including sole traders, officials recommend that it too should be considered in the ongoing review of tax incentives for charitable giving.

Recommendation

That the submission be considered in the ongoing review of tax incentives for charitable giving.

Issue: Ability of charities to use imputation credits

Submissions
(5 – Philanthropy New Zealand, 27 – Presbyterian Support New Zealand, 58 – Trustee Corporations Association of New Zealand)

Charities should be able to use the imputation credits they receive on dividends from their equity investments in the same way as other investors. *(Philanthropy New Zealand, Presbyterian Support New Zealand)*

Comment

Charities are unable to make use of their imputation credits because of their tax-exempt status. The inability of charities to use their imputation credits is a significant concern for the charitable sector. There have been many calls from the charitable sector for the government to deal with this problem. It was noted in the October 2006 government discussion document, *Tax incentives for giving to charities and other non-profit organisations*, that the issue would be examined in the context of a wider review of who should be entitled to use imputation credits. The government is in the process of putting together its tax policy work programme for the coming year and the priority of the wider imputation credit review will be determined in that context.

Recommendation

That the submissions are noted.

Issue: Donations in excess of an individual's "net income"

Submission
(91 – New Zealand Institute of Chartered Accountants)

The bill should be amended so that individuals who make donations in excess of the level of their net income can claim tax relief on any excess donations.

Comment

Officials recommend that this submission be considered in the ongoing review of tax incentives for charitable giving.

Recommendation

That the submission be noted.

RETIREMENT SCHEME CONTRIBUTIONS WITHHOLDING TAX (RSCWT)

Issue: The retirement scheme withdrawal rules are too restrictive

Clause 133

Submission
(68 – Te Rūnunga o Ngāi Tahu and Whai Rawa)

For the retirement scheme contributions withholding tax (RSCWT) rules to be applied, a scheme receiving contributions must meet the criteria to be a "retirement savings scheme". These criteria include circumstances in which withdrawals may be made, which are limited to the same circumstances as KiwiSaver withdrawal rules, except that the age of retirement may be set lower, and withdrawals may be made to repay student loans.

These rules are too restrictive. They should be amended to allow retirement-oriented schemes with more permissive rules than KiwiSaver, provided the Commissioner approves the distribution rules as fair and reasonable. This would enable Whai Rawa to apply to use the RSCWT rules.

Comment

The rules for retirement savings scheme withdrawals are modelled on KiwiSaver withdrawal rules. The KiwiSaver rules are highly restrictive, in part because there are concessionary tax rates associated with contributions to KiwiSaver – for example, employer contributions are exempt from SSCWT up to a cap. However, the tax rates on contributions to retirement savings schemes are not concessionary, so it is reasonable for the withdrawal rules to be less restrictive. While there are some social assistance and tax administration concessions for retirement savings schemes, provided the Commissioner accepts the rules in the scheme's trust deed as fair and reasonable, schemes should be able to apply to use the RSCWT rules, without having withdrawal rules that are as restrictive as KiwiSaver rules.

Recommendation

That the submission be accepted, and the withdrawal conditions be amended so that the key criterion is that the savings scheme is set up as a trust or unit trust and the Commissioner approves the withdrawal rules as fair and reasonable. "Fair and reasonable" withdrawal rules would include rules which allow for withdrawals in the following circumstances:

- retirement, at an age specified in the agreement;
- housing, where the person making the withdrawal does not already own a home;
- paying for tertiary education;
- any withdrawals that would be permitted under KiwiSaver rules;
- where the Commissioner approves the withdrawal as fair and reasonable.

Issue: RSCWT rates

Clause 135 (47)

Submission

(68 – Te Rūnunga o Ngāi Tahu and Whai Rawa, 91 – New Zealand Institute of Chartered Accountants)

The tax rates on retirement scheme contributions should be set at the same level as portfolio investment entity (PIE) tax rates, or capped at 33%, like SSCWT.

The 39% rate is inequitable because individuals cannot opt out of the scheme.

Linking the rates to PIE rates, or capping the rate at 33% will reduce compliance costs and minimise exposure to penalties as a result of choosing an incorrect rate.

Linking RSCWT rates to PIE rates would reduce compliance costs because scheme members would only need to declare one rate which would cover tax on both PIE income and RSCWT.

Comment

Income that is received in the form of retirement scheme contributions is income that would ordinarily be received as dividends or Māori authority distributions. Dividends and Māori authority distributions are taxed at individuals' marginal tax rates, and the proposed RSCWT rates in the bill are consistent with individual marginal tax rates. The ability of individuals to opt in or out of the scheme does not affect marginal tax rates, so RSCWT rates are not inequitable.

PIE rates are used to tax the income earned by investors through portfolio investment entities, not contributions to PIEs. Contributions to PIEs come from income that is taxed at investors' marginal tax rates (except for employer contributions to KiwiSaver schemes and complying superannuation funds which are taxed through SSCWT). Using PIE tax rates for RSCWT would be concessionary compared with individual marginal rates. Linking RSCWT rates to PIE rates would require tighter lock-in rules, so that the difference between RSCWT rates and individual marginal tax rates could not be exploited. However, according to Te Rūnunga and Whai Rawa, the tight lock-in rules will not meet their needs when setting up a savings scheme for their members.

The treatment of taxpayers who elect an incorrect rate for RSCWT purposes is the same as that for taxpayers who elect an incorrect rate for PIE purposes. These taxpayers may be required to complete a tax return, which means that the income may affect any social assistance entitlements and the taxpayer may be required to pay use-of-money interest from the date at which terminal tax would have been due, until the date that any tax owing is paid. However, there are no penalties for declaring an incorrect rate for RSCWT other than the general penalties that may apply to any taxpayer who knowingly uses incorrect information for tax purposes.

Recommendation

That the submission be declined.

Issue: Basis on which RSCWT rates are chosen

Clause 135 (47)

Submission
(68 – Te Rūnunga o Ngāi Tahu and Whai Rawa)

Like PIE rates, RSCWT rates should be based on the lowest marginal tax rate of the member over the previous two years, not the marginal tax rate in the preceding income year alone. This would reduce compliance costs.

Comment

Officials agree that compliance costs may be reduced by allowing RSCWT rates to be based on the lowest marginal tax rate of the member over the previous two years. Members would not need to look up one set of information for PIE purposes and another set for RSCWT purposes.

Recommendation

That the submission be accepted.

Issue: RSCWT rate on distributions to non-resident scheme members

Clause 135 (47)

Submission
(68 – Te Rūnunga o Ngāi Tahu and Whai Rawa)

The 39% rate on distributions to non-resident scheme members is too high. Given that the bulk of recipients are likely to be on the lowest marginal tax rate, 19.5% would be more appropriate, but in any case, the rate should not exceed the middle marginal tax rate of 33%.

Comment

Interest, dividends and royalties received by non-residents is normally subject to non-resident withholding tax. Retirement savings scheme contributions are dividends or Māori authority distributions, and they do not lose their character as dividends or Māori authority distributions even if they are paid as retirement savings contributions. Accordingly, contributions made to non-residents' accounts in retirement savings schemes should be subject to tax in the normal way for dividends and Māori authority distributions that have been distributed to non-residents.

Recommendation

That the submission be accepted in part, by amending the bill so that instead of being subject to RSCWT and taxed at 39%, contributions paid to non-residents should be subject to non-resident withholding tax in the usual way for dividends and Māori authority distributions.

Issue: Circumstances in which retirement scheme contributions are not treated as excluded income

Clause 24

Submission
(91 – New Zealand Institute of Chartered Accountants)

The drafting of the exceptions from excluded income is not clear.

Comment

The colon between subsections CX 42B(2)(a) and CX 42B(2)(b) indicates that if either or both of the circumstances in those clauses occur, retirement scheme contributions are no longer treated as excluded income. This reflects the policy intent accurately.

Recommendation

That the submission be declined.

ACC ATTENDANT CARE PAYMENTS

Issue: ACC attendant care rules

Submission
(91 – New Zealand Institute of Chartered Accountants)

The ACC attendant care tax provisions are far too complex and should be deferred for at least another full income year to allow a simpler system to be designed.

Comment

Provisions to tax ACC attendant care payments were enacted in the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006. The provisions were to come into effect on 1 April 2008. However, this bill repeals those provisions and re-enacts them with modifications to clarify their intent and to delay the application date to 1 July 2008. The reason for the change in the application date is to give the Accident Compensation Corporation sufficient time to introduce a new claim management system.

The amendments are intended to resolve problems of uncertainty in the law and non-compliance by people providing attendant care services, and to remove employer responsibilities from the ACC claimant.

Many ACC claimants fully use their payment to purchase caregiver services. In this situation the amount received by the claimant will be treated as exempt income and the withholding tax deducted allowed as a credit against the caregiver's tax liability. If the caregiver's income is $9,500 or less, the caregiver's tax liability will be the same as the withholding tax rate of 15 cents in the dollar.

However, if the ACC claimant does not fully use the payment, the provisions in the bill apportion the payment and the tax credit between the ACC claimant and the caregiver according to the amounts retained and paid. Because the amounts received and on-paid will be net of the withholding tax, provisions are necessary to ensure that each party's income includes the pre-tax amount and the correct portion of the tax credit. This adds some unavoidable complexity to the legislation. However, the provisions will be fully explained in a *Tax Information Bulletin* item once the bill is enacted. The Accident Compensation Corporation will also be providing information on the change to ACC claimants and caregivers.

Recommendation

That the submission be declined.

Issue: Extending the cover over ACC rehabilitation payments

Submission

(Matter raised by officials)

The bill should be amended to extend the withholding tax that will apply to attendant care payments made by ACC from 1 July 2008 to other similar rehabilitation payments and the tax applied to all payees. The payments subject to the tax would be: attendant care, home help, child care, training for independence, and escorted travel.

Comment

ACC pays a variety of entitlements to people who have had a personal injury to assist in their rehabilitation. Some of these payments are used to purchase services such as attendant care, home help and child care. This bill subjects attendant care payments to a withholding tax to deal with uncertainty in the law regarding the obligations placed on ACC claimants to deduct tax. It also addresses non-compliance, with respect to tax obligations, by the people providing the services. The intention was that the withholding tax apply only to independent caregivers as the issues mentioned above are not a problem with providers that are contracted to ACC.

Subjecting only attendant care payments for independent caregivers to the withholding tax has the following problems:

- it will create administrative difficulties for ACC in having to tax only attendant care payments that are paid as part of a package that also includes elements of home help and/or child care;
- it could create incentives to re-characterise attendant care payments into other categories of rehabilitation payment that are not subject to the withholding tax; and
- it will lead to difficulties for ACC in deciding who should be subject to the tax as there is no formal definition of an "independent caregiver".

To overcome these problems, we recommend that social rehabilitation payments that are for attendant care, home help, child care, training for independence or escorted travel be subject to a withholding tax, and that the tax should apply to all payees.

Recommendation

That the submission be accepted.

TECHNICAL AMENDMENTS TO BRANCH EQUIVALENT TAX ACCOUNT RULES

Clauses 117(1), 118, 119(1), 120, 256 and 257

Issue: BETA debits for DWP on grey list investments

Submissions
(71 – PricewaterhouseCoopers, 91 – New Zealand Institute of Chartered Accountants)

Provision should be made to prevent the possibility of double taxation resulting from the proposal that debits to branch equivalent tax accounts (BETAs) should no longer arise when dividend withholding payment (DWP) is imposed on dividends received from unqualified grey list controlled foreign companies.

The purpose of a BETA is to prevent double taxation of foreign income which might otherwise occur as a result of the accrual taxation of controlled foreign companies (CFCs) and foreign investment funds (FIFs), in combination with the imposition of DWP on foreign dividends received by New Zealand companies. The Commentary to the bill pointed out that the generation of BETA debits when DWP is paid on certain dividends received from unqualified grey list CFCs is anomalous because there is no corresponding accrual taxation of the underlying profits. Accordingly, clauses 117(1) and 119(1) would prevent debits arising in these circumstances.

PricewaterhouseCoopers points out that a New Zealand resident may have an indirect income interest, through an unqualified grey list CFC, in a foreign entity that is subject to accrual taxation. In that case, the denial of BETA debits relating to profits repatriated to New Zealand via the unqualified grey list CFC may give rise to double taxation, particularly given the operation of tracking accounts under Subpart LF of the Income Tax Act 2004 (underlying foreign tax credits). The submission states that a mechanism should exist to ensure that double taxation does not arise.

The New Zealand Institute of Chartered Accountants notes that similar problems may arise if an unqualified grey list CFC becomes a tax-concession grey list CFC. The submission says that there should continue to be an ability to debit any DWP paid on dividends from an unqualified grey list CFC if profits distributed have been subject to accrual taxation.

Comment

Officials consider the concerns raised to be largely theoretical. In practice, taxpayers with controlling interests in foreign companies should generally be able to plan around the problems described. In particular, the proposed denial of BETA debits on dividends from unqualified grey list CFCs would give rise to the possibility of double taxation only when dividends are paid before profits are taxed on accrual. If foreign subsidiaries are under the control of a New Zealand taxpayer, the taxpayer ought to be able to arrange for that subsidiary to attribute income before paying dividends. BETA credits would then continue to be available to offset any DWP liability.

As explained in the Commentary, the current availability of BETA debits for certain distributions from unqualified grey list CFCs can leave a company with a pool of surplus debits. Officials consider there to be a material risk that companies may seek to use these surplus debits to offset or defer tax inappropriately, with potential consequences for the tax base.

Nevertheless, in view of submissions received, and given that the BETA rules may be affected by the International Tax Review, we recommend that clauses 117(1) and 119(1) be omitted from this bill. We note, however, that the government may wish to return to this issue in a later bill if further examples of surplus debits being used inappropriately are identified.

Recommendation

That clauses 117(1) and 119(1) be omitted from the bill.

Issue: Necessity of changes introduced by clauses 118, 120, 256 and 257

Submission
(91 – New Zealand Institute of Chartered Accountants)

Section MF 5(6) of the 1994 and 2004 Income Tax Acts already limits the amount of the BETA debit balance that can be offset under subsection (4). New subsections (5B) and (5C), introduced by clauses 118 and 256, seem to achieve nothing more than this existing provision. If, on the other hand, subsections (5B) and (5C) are considered necessary, the two provisions should be merged.

Comment

The assumption underpinning the existing provision about elections in sections MF 5 and MF 10 is that debits can only be converted into a loss to the extent necessary to offset income tax on attributed CFC income in the absence of New Zealand losses. However, we consider it better to put the matter beyond doubt.

New subsection (5B) in section MF 5 is distinguishable from existing subsection (6) because the former deals expressly with the scope of elections under subsection (4) whereas subsection (6) is drafted in terms of the set-off of debits against income tax liability. New subsection (5C)(b) describes the consequences of subsection (5B) in terms consistent with subsection (6). We see no advantage in merging subsections (5B) and (5C) as suggested.

Recommendation

That the submission be declined.

BLACK-HOLE EXPENDITURE

Submission
(33 – Corporate Taxpayers Group)

The submission expresses disappointment that there is no legislative relief for taxpayers from black-hole expenditure. Concerns around black-hole expenditure were discussed as part of the Business Tax Review measures. The submission requests that black-hole expenditure be given a high priority on the next tax policy work programme.

Comment

The subject of black-hole expenditure is outside of the scope of the bill.

Recommendation

That the submission be noted.

COMMISSIONER'S ACCEPTANCE OF A TAXPAYER'S NOTICE OF PROPOSED ADJUSTMENT

Issue: Limiting Commissioner's ability to override acceptance of a taxpayer NOPA

Clause 163

Submissions

(71 – PricewaterhouseCoopers, 85 – Minter Ellison Rudd Watts, 91 – New Zealand Institute of Chartered Accountants)

The proposed change is supported.

Comment

The bill includes a proposed amendment to the Tax Administration Act 1994 to clarify when the Commissioner of Inland Revenue can begin a new tax dispute. The change will make it clear that the Commissioner cannot issue a notice of proposed adjustment (NOPA) on the same issue after accepting (or being treated as having accepted) a taxpayer NOPA except when the taxpayer:

- was fraudulent;
- wilfully misled the Commissioner; or
- failed to supply the Commissioner with relevant information.

The change will ensure that the disputes procedures have their intended effect. However, to protect the revenue base, the timeframe may be overridden in cases of misrepresentation, material omission or fraud.

The submissions support the change as it will provide more certainty to the disputes process.

Recommendation

That the submissions be noted.

Issue: Exception for failing to provide relevant information

Clause 163

Submissions
(71 – PricewaterhouseCoopers, 91 – New Zealand Institute of Chartered Accountants)

Further guidance needs to be provided on what constitutes "relevant information".

The proposed exceptions to the taxpayer NOPA response period – and in particular the exception for failing to supply relevant information, should require an application to the High Court.

Comment

The proposed amendment to the disputes rules includes three new exceptions where the Commissioner of Inland Revenue will still be able to override the time limits to respond to a taxpayer NOPA. The exceptions proposed apply when a taxpayer has:

- been fraudulent;
- wilfully misled the Commissioner; or
- failed to supply the Commissioner with relevant information.

The New Zealand Institute of Chartered Accountants has submitted that the Commissioner should be required to apply to the High Court in order to apply these new exceptions. NZICA considers that the proposed exceptions will widen the Commissioner's powers and, in particular, that failing to supply the Commissioner with relevant information is a relatively low threshold. It also considers that this low threshold is not in line with the importance placed on completing the disputes process and could lead to a lack of equity between the requirements for taxpayers and those for the Commissioner.

Officials have reviewed the proposed exceptions to the time limit for responding to a taxpayer NOPA. The exceptions for fraudulent or wilfully misleading taxpayer behaviour are identical to the exceptions for non-application of the time-bar. In respect of the time-bar, no application is required to the High Court and officials consider that the same process should apply to the new exceptions under the disputes rules.

However, officials agree that the proposed exception for failing to supply relevant information could create uncertainty. A taxpayer NOPA is already required to have sufficient detail. If it does not meet this requirement, it does not constitute a NOPA and the Commissioner is not subject to the deemed acceptance rule. Therefore, officials consider that the third exception is a duplication of existing requirements within the disputes procedures and should be removed.

Inland Revenue *Standard Practice Statement 05/04* provides guidance on the meaning of "sufficient detail".

Recommendation

That the submissions be accepted in part by removing the proposed exception for failing to provide relevant information.

Issue: Adjustments to assessments

Clause 163

Submission
(85 – Minter Ellison Rudd Watts)

The wording of the amendment should specifically prohibit the Commissioner from proposing an adjustment to the assessment on the same issue.

Comment

Minter Ellison Rudd Watts has submitted that the current wording of the proposed amendment does not prevent the Commissioner from ignoring a taxpayer proposed adjustment by proposing an adjustment to the assessment on the same issue.

Officials consider that the proposed wording does prevent such an action as it also refers to any further notice of assessment or further amended assessment issued to the disputant.

Recommendation

That the submission be declined.

GST AND EXPORTED GOODS – NEW ITEM

Clause 248

Overview

An amendment is sought in connection with the application of the GST Act to exported goods when the purchaser takes possession or delivery of the goods in New Zealand. The situation in question involves the goods being exported and shipped on "free-on-board" (FOB) terms when the purchaser uses their own assets to ship the goods. Currently, the GST Act requires GST to apply to such supplies at the standard rate of 12.5%.

Officials agree that a narrowly defined rule should be inserted into the GST Act to allow certain goods supplied on a FOB basis to be zero-rated.

This is a new item for the Committee to consider and officials request that the change be included in the bill.

Issue: Widen the scope of clause 248 to zero-rate goods supplied on free-on-board terms

Submission

(6 – Bell Gully)

The Goods and Services Tax Act 1985 does not allow zero-rating in situations when goods are sold in New Zealand and title passes to the purchaser before export – such as goods shipped under free-on-board (FOB) terms of sale using the purchaser's own assets. In this situation, it is the purchaser and not the seller that undertakes the physical export of the goods. Provided, however, that there is sufficient certainty that the goods will leave New Zealand and that no consumption occurs in New Zealand, there is no good reason for the goods to be taxed at 12.5% rather than zero percent (or zero-rated).

Commonly, the problem is overcome using arrangements that treat the purchaser as the seller's agent. These arrangements are considered undesirable as they impose unnecessary costs to achieve an outcome that should, in principle, be allowed under the legislation.

Comment

The commodity motivating the submission concerns the supply of oil extracted from New Zealand's natural field reserves. The first supplies of this product under FOB terms are expected to start in August 2007.

The submission notes that the Australian GST system has a zero-rating rule that permits FOB terms of sale to be zero-rated. The absence of a similar provision in New Zealand's GST Act may result in a loss of commercial opportunity or profit for New Zealand exporters – for example, the supplier may have to potentially carry an unreasonably high GST exposure (if the supplier is forced to supply on terms acceptable only to the purchaser), or even the potential loss of sales.

To ensure that New Zealand can offer competitive terms of supply compared with those offered by Australian exporters, the submission recommends an amendment to section 11 of the GST Act which would have the effect of allowing purchasers to take delivery of zero-rated goods in New Zealand, provided that those goods leave New Zealand within 28 days of the time of supply; subject to:

- the goods being entered for export under the Customs and Excise Act 1996;
- sufficient documentation as evidence that the purchaser has exported the goods; and
- the goods in question have not been altered or used except to the extent necessary to prepare them for export.

The suggested amendment is not intended to change or alter GST existing rules in relation to personal items or duty-free shopping provisions.

The problem

The current zero-rating rules in the GST Act in relation to export do not generally apply to goods shipped on FOB terms of sale because a requirement of zero-rating is that the supplier must export the goods. FOB terms of sale means that the purchaser agrees to incur the cost of transporting the goods from New Zealand. If the purchaser undertakes the physical export of the goods, GST will usually apply.

GST is not intended to tax consumption that occurs outside New Zealand. "Consumption" is, however, a difficult concept to define with any degree of precision. As a second-best practical solution, the GST Act treats the physical possession of goods in New Zealand as approximating consumption. Therefore, when a non-resident takes possession of goods in New Zealand, those goods are considered as being consumed in New Zealand and subject to GST at the rate of 12.5%.

The submission suggests that the current framework is imposing unnecessary costs on exporters by requiring them to engage in unnecessary contractual arrangements. It recommends an amendment to allow exporters to zero-rate goods in commercial transactions even if the export is not undertaken by the supplier. The transactions of particular concern involve supplies of oil extracted from New Zealand's natural field reserves.

Officials agree with the submission as it applies to the supply of goods for commercial use. However, we do not consider that a similar change is required for goods acquired by tourists in New Zealand because, other than in limited situations such as the use of the "sealed-bag" system, these supplies should be treated as final consumption and therefore subject to GST.

The proposed solution

Officials recommend an amendment be made to the bill to allow exported goods supplied by GST-registered persons and shipped by the purchaser (who is a non-resident) on an FOB basis to be zero-rated provided the following cumulative requirements are met:

- the goods are physically exported by the purchaser;
- the goods are not intended for reimportation for use other than making taxable or exempt supplies;
- the goods are not used or altered in any way by the purchaser, except to the extent necessary to prepare them for export;
- the supplier and recipient agree, at or before the time of supply, on the arrangements under which the goods will leave New Zealand;
- the goods do not accompany a passenger or crew departing from a New Zealand airport or seaport; and
- the supplier retains sufficient information supporting the fact that the goods have left New Zealand.

These conditions are similar to the equivalent provisions that apply in Australia. They will apply in addition to the standard requirements imposed by the GST Act which require the supplier to enter the goods for export and for the goods to leave New Zealand within 28 days of the time of supply. The zero-rating restrictions imposed on exported second-hand goods for which an input tax deduction has been obtained will also apply.

Application date

Officials understand that activities connected with the extraction of oil have been in place for some time but production is unlikely to begin until August/September 2007 because of temperature concerns which could affect the quality of the oil. Supply contracts have, however, been in place since the middle of the year. To ensure that the amendment has application to these supply contracts, and to provide certainty about the GST treatment, officials recommend that the amendment apply to goods supplied on and after the date the bill was introduced – 17 May 2007.

Recommendation

That the submission be accepted. Officials recommend that the scope of clause 248 be extended to permit goods supplied on FOB terms to be zero-rated in defined circumstances.

It is recommended that the changes apply to goods supplied on and after the date the bill was introduced, 17 May 2007.

GST AND CONSUMABLE STORES

Clause 248

Issue: Support for the proposed amendment

Submission
(6 – Bell Gully, 10 – Deloitte, 33 – Corporate Taxpayers Group, 91 – New Zealand Institute of Chartered Accountants)

Submissions agree with the proposed changes to clarify the zero-rating rules as they apply to the supply of consumable stores to vessels and aircraft departing New Zealand.

Comment

Clause 248 amends the GST Act by clarifying the circumstances when the supply of consumable stores to departing aircraft and commercial ships may be zero-rated.

Recommendation

That the submission be noted.

Issue: Application date

Submission
(10 – Deloitte, 33 – Corporate Taxpayers Group)

The amendment highlights inadequacies that exist with the current rules. Despite these inadequacies, industry practice has been to zero-rate the supply of consumable stores covered by the amendment as the goods are consumed outside New Zealand. If the amendment applies prospectively, then arrangements that Inland Revenue have not previously questioned could be reviewed and challenged. To prevent this situation from happening, the amendment should apply from 1 October 1986 – the date GST started.

Comment

The bill currently specifies that clause 248 applies from the date of enactment. Submissions argue that because the clause clarifies an area of law to ensure that it is consistent with the wider policy intent of the GST Act, it should have retrospective application. The original legislation governing the treatment of consumable stores applied from 24 March 1988.

While there is a general presumption against making legislation retrospective, possible grounds for justifying retrospective application include:

- the law as written is manifestly unjust under the circumstances; or
- the law as written has given rise to clear expectations about how it would apply, but it does not apply in the expected manner.

By themselves, however, these arguments do not justify retrospective changes in the law.

Clause 248 introduces new legislation affecting the treatment of consumable stores supplied to ships (known as motherships) that are designed to transport consumable stores for the purpose of re-supplying fishing vessels that are operating outside New Zealand's exclusive economic zone (new section 11(1)(l)(iib)). Further, clause 248 amends the definition of "consumable stores", inserted into the GST Act on 24 October 2001, and the definition of "foreign-going ship" (which was amended at the same time).

Officials note that section 11 was restructured and rewritten as part of the Taxation (GST and Miscellaneous Provisions) Act 2000. Section 11(1)(l), which is being amended by clause 248, was further amended with effect from 24 October 2001 as part of changes that inserted the definition of "consumable stores" and widened the application of the section to departing visiting pleasure craft. Retrospectively applying clause 248 to 1 October 1986 is therefore likely to require additional drafting to take these earlier changes to section 11(1)(l) into account.

The outcome sought by the submissions is the protection of tax positions taken by taxpayers in earlier taxable periods. In light of the fact that the Commissioner cannot increase an assessment after the expiration of the four-year time-bar (except in cases of fraud), officials consider that clauses 248(1) to (3) should apply from 24 October 2001, the date that section 11(1)(l) was last amended.

Recommendation

That the submission be accepted in part. Clauses 248(1) to (3) should apply from 24 October 2001, the date section 11(1)(l) was last amended.

Issue: Drafting changes

Submission
(Matter raised by officials)

To improve the readability of the section it is recommended that subparagraph (iib) be redrafted to remove unnecessary words.

The subparagraph currently reads:

> "… a foreign-going ship, or a fishing ship, if the fishing ship meets the requirements in subparagraph (ii);"

It is recommended that the subparagraph reads:

> "… a foreign-going ship or to a fishing ship that meets the requirements in subparagraph (ii)."

Recommendation

That the submission be accepted.

GST AND SHARED TAX INVOICES

Clauses 246, 250 and 251

Issue: Broadening the scope of GST shared invoicing

Submissions
(13 – Vodafone, 33 – Corporate Taxpayers Group, 71 – PricewaterhouseCoopers, 74R – Deloitte, 91 – New Zealand Institute of Chartered Accountants)

The proposal should be widened to enable shared tax invoices to be issued by independent entities which are not members of a GST group, or do not have a statutory obligation to do so.

Vodafone and PricewaterhouseCoopers have also made a number of recommendations on how the government could overcome some of the risks associated with widening the scope of the shared invoicing proposal.

Comment

The proposal allows two or more suppliers to invoice a customer using one tax invoice. The change is intended to apply to members of the same GST group or those suppliers who have a statutory obligation which makes it practical to use a single invoice.

Submissions expressed concern that the proposed changes are too narrow and propose that the shared tax invoices rules apply to a broader range of circumstances.

Officials accept that the proposed changes are narrow. This is because allowing one supplier to issue a tax invoice on behalf of multiple suppliers may decrease the chances of Inland Revenue identifying taxpayers who have failed to account for GST, thus increasing the potential for GST-base abuse.

However, officials recognise that with appropriate safeguards, there may be potential for the proposed shared tax invoicing rules to apply more broadly. For that to occur, officials would need to examine closely all the issues involved, including considering who should be eligible to use shared tax invoices and what kind of mechanisms are necessary to reduce the possibility for GST-base abuse. Because of the risks involved in relaxing the requirements for tax invoices, this process will take time and will not be completed in sufficient time to meet this bill’s deadlines.

Recommendation

That the submissions be declined.

Issue: Inclusion of groups of persons under section 55(8) of the GST Act

Submission
(91 – New Zealand Institute of Chartered Accountants)

The amendment needs to be extended to include a group of persons under section 55(8) of the Goods and Services Tax Act 1985.

Comment

Officials consider it unnecessary to make any amendments to the clause to include a group of persons under section 55(8) of the GST Act. The proposal in the bill already refers to "the representative member of a group of companies for the purposes of section 55". Therefore, groups of persons identified by the submission are already covered by the current proposal.

Recommendation

That the submission be declined.

Issue: "Grandfathering" current users of shared invoices

Submission
(71 – PricewaterhouseCoopers)

The proposals should be amended to "grandfather" shared invoices issued before the enactment date, where the supplying companies satisfy the necessary requirements.

Comment

Officials consider the current rules to be clear on the use of shared tax invoices. Where these invoices have been used in the past, they have been allowed at the discretion of the Commissioner of Inland Revenue under section 24(6) of the GST Act.

The proposal to allow shared tax invoicing is meant to change the current law and result in future compliance cost reductions for certain taxpayers by not requiring taxpayers to apply to the Commissioner when they wish to use a common tax invoice to bill their clients.

In the absence of any ambiguity, officials see no justification for making the proposed legislation retrospective.

Recommendation

That the submission be declined.

CHILD SUPPORT INFORMATION SHARING BETWEEN INLAND REVENUE AND CUSTOMS

Issue: Definition of "serious default"

Submission
(91 – New Zealand Institute of Chartered Accountants)

The definition of "serious default" needs to be subject to proper public consultation, as set out in the generic tax policy process. "Serious default" should be specifically defined by legislation, or by way of regulation or determination, rather than the proposed changes that would allow satisfying criteria to be determined by Inland Revenue and the Office of the Privacy Commissioner (in consultation with the Chief Executive of the New Zealand Customs Service).

Comment

The definition of "serious default", as proposed, means "the state of having an amount of financial support debt due and owing to the Commissioner of Inland Revenue and satisfying criteria agreed by the Commissioner and Privacy Commissioner in consultation with the Chief Executive".

It is the specific role of the Privacy Commissioner's Office to examine new legislation for its possible impact on individual privacy, monitor data matching programmes between government departments on an ongoing basis, and also inquire into any matter where it appears that individual privacy may be affected. Officials therefore consider that the requirement for Inland Revenue to consult with and agree criteria with the Privacy Commissioner's Office will ensure that the interests of all parties concerned will be sufficiently considered and dealt with. Further, officials consider that the proposed definition of serious default will introduce a degree of flexibility by allowing for periodic reviews to ensure that criteria previously agreed upon between Inland Revenue and the Privacy Commissioner's Office remain appropriate, equitable and workable.

While administratively there is likely to be a threshold under which debt will generally not qualify as giving rise to serious default, we do not consider a specific fixed level of financial support debt in legislation to be a preferable option as it would prevent cases being considered on an individual basis.

Recommendation

That the submission be declined.

Issue: Financial support debt should not include penalties or interest

Submission
(91 – New Zealand Institute of Chartered Accountants)

The definition of "financial support debt" should not include any penalties or interest under the Child Support Act 1991, as penalties and interest under the Child Support Act are excessive, accumulate quickly, and have the effect of making the liable parent's situation look much worse than it actually is.

Comment

The purpose of the proposed information sharing between Inland Revenue and the New Zealand Customs Service is to allow Inland Revenue to identify when individuals with outstanding child support debt are entering or leaving New Zealand. In the first instance, this will be to allow Inland Revenue to contact liable parents when they are in New Zealand to discuss their child support debt and, where possible, come to a voluntary arrangement with them. It is relevant to note that penalty rules have recently been amended to allow relief from penalties when an individual enters into an instalment arrangement with Inland Revenue.

Officials consider that the circumstances that have given rise to penalties and interest can often be relevant when considering whether an individual is in serious default. Penalties and interest should not therefore be excluded from criteria to be considered by Inland Revenue and the Privacy Commissioner's Office when determining whether a person liable to pay financial support under the Child Support Act 1991 is in serious default.

Recommendation

That the submission be declined.

Issue: The child support penalty structure should be changed

Submission
(91 – New Zealand Institute of Chartered Accountants)

The Child Support Act 1991 should be amended to change its penalty structure, and to reduce initial and incremental late penalty rates.

Comment

The submission is outside the scope of the bill.

Recommendation

That the submission be declined.

TAX EXEMPTION FOR HOSPITALS OPERATED AS CHARITIES

Clauses 19, 20, 21, 253 and 254(3)

Issue: Support for proposal

Submissions
(42 – Auckland City Council and Metrowater, 71 – PricewaterhouseCoopers)

The submissions support the proposal that council-controlled organisations (CCOs) which operate hospitals as charities should be exempt from income tax.

Recommendation

That the submissions be noted.

Issue: Broadening or extending the exemption

Submissions
(34 – Toovey Eaton & Macdonald Ltd, 42 – Auckland City Council and Metrowater, 71 – PricewaterhouseCoopers)

The exemption should be broadened so that any CCO that has a charitable purpose, as defined under the Charities Act 2005, will qualify as a charity to which the income tax exemption applies. *(Toovey Eaton & Macdonald Ltd)*

The income tax exemption should be extended to cover any CCO that is a public benefit entity established for charitable purposes. *(Toovey Eaton & Macdonald Ltd, Auckland City Council and Metrowater, PricewaterhouseCoopers)*

Comment

When the Local Government Act was amended in 1989 to permit councils to establish local authority trading enterprises (now called CCOs) it was intended that these council-controlled businesses would face the same commercial pressures as any other firms – including the requirement to pay tax. However, it became apparent that, because of the very broad legal meaning of “charity”, most activities carried out by CCOs could be structured to obtain tax-exempt status.

Accordingly, the Income Tax Act was amended to exclude CCOs from the charitable tax exemption.

Allowing hospitals operated by CCOs to claim the tax exemption is correct because District Health Boards are exempt from income tax.

Extending the exemption to all CCOs that have a charitable purpose, or meet the "public benefit" charity tests is not correct. This is because of the wide range of commercial activities that are conducted within CCOs.

Recommendation

That the submissions be declined.

Issue: Charitable CCOs that are not operating in competition

Submission
(34 – Toovey Eaton & Macdonald Ltd)

The proposed legislation should be amended to allow charitable CCOs that are not operating in competition with private sector organisations to use the charities income tax exemption.

Comment

The general policy is that CCOs that undertake a business activity, whether charitable or not, should be taxpayers. The specific exemption for CCOs that are hospitals is because government owned hospitals (district health boards) are tax exempt and there is no reason to not apply this treatment to local authority-owned hospitals.

Recommendation

That the submission be declined.

Issue: Definition of the term "hospital"

Submission
(34 – Toovey Eaton & Macdonald Ltd)

The term "hospital" should be defined to provide clarity in the scope of its meaning.

Comment

When terms are not defined in statute, they take their common meaning. For example, the Concise Oxford Dictionary meaning of "hospital" is:

> "An institution providing medical and surgical treatment and nursing care for ill or injured people."

Officials are aware of only one hospital that is operated by a CCO. We consider that there is little risk of confusion occurring over when the exemption should apply and when it should not.

Recommendation

That the submission be declined.

Issue: Subsidiaries of CCOs

Submission
(34 – Toovey Eaton & Macdonald Ltd)

The proposed legislation should clarify whether subsidiaries of CCOs will qualify for the exemption.

Comment

The definition of "council-controlled organisation" in the Income Tax Act 2004 includes:

> "(b) a company that is a council-controlled organisation, under paragraph (a)(i) of the definition of council-controlled organisation in section 6(1) of the Local Government Act 2002".

Paragraph (a)(i) of the definition of council-controlled organisation in the Local Government Act includes:

> "(a) a company –
>
> (i) in which equity securities carrying 50% or more of the voting rights at a meeting of the shareholders of the company are –
>
> (A) held by one or more local authorities; or
>
> (B) controlled, directly or indirectly by one or more local authorities;"

A subsidiary of a CCO would generally be a CCO itself, by virtue of paragraph (a)(i)(B) of the definition above. This is because it would be controlled directly or indirectly by one or more local authorities. If it did not satisfy the definition of a CCO – say, because it was not controlled by one or more local authorities, it should not, and would not qualify for the exemption.

Officials consider that the amendment currently reflects the policy intention.

Recommendation

That the submission be declined.

TAXATION REVIEW AUTHORITY COSTS

Submission
(91 – New Zealand Institute of Chartered Accountants)

The small claims jurisdiction of the Taxation Review Authority presents a very good forum for people with smaller tax disputes to have their case determined in front of an independent arbitrator. A filing fee of $400 may represent a significant barrier to these people.

Comment

The proposed empowering provision in the bill would allow the government to make regulations to prescribe circumstances in which any fees may be refunded, remitted, or waived. The government already has the power to make regulations to prescribe the amount of any fees to be paid under section 30(2)(d) of the Taxation Review Authorities Act 1994.

The decision on the amount of the proposed filing fee was made by the government following recommendations from the Working Party on Civil Court Fees. The Working Party made its recommendations on courts' and tribunals' fees after consulting a large number of stakeholders. The $400 set for the Taxation Review Authority is the same as that proposed for a number of other tribunals.

Officials do not consider that the increased fee would reduce the attractiveness of the Taxation Review Authority for people with smaller tax disputes. The cost of bringing proceedings in the Taxation Review Authority will still be less than in higher courts and, under the proposal, some litigants will be eligible to have their fee waived if they are unable to pay or if it is warranted by the public benefit of the case. It should also be noted that the disputant taxpayer may be able to receive the fee back as an award of costs if the dispute is decided in their favour.

Recommendation

That the submission be declined.

PROGRESSIVE TAX RATES ON BANK ACCOUNTS

Submission
(2 – John Fittock)

The progressive tax rates applying to interest paid on bank savings accounts act as a disincentive to saving. A flat tax rate should apply instead.

Comment

Progressive taxation is a fundamental feature of the New Zealand tax system. Deducting tax at a flat rate from interest received on bank accounts would undermine horizontal equity in taxation, where people earning the same income are taxed at more or less the same average rate, no matter what form the income is received in. Officials also note that this is outside the scope of the bill.

Recommendation

That the submission be declined.

Remedial amendments

ALIGNMENT OF PROVISIONAL TAX PAYMENTS WITH GST

Issue: Support for provisional tax payment frequency

Clauses 101 and 249

Submissions
(91 – New Zealand Institute of Chartered Accountants)

NZICA supports the proposed change in the bill to make it clear that taxpayers will only have to make two provisional tax payments when they cease using the GST ratio method and move to paying GST six-monthly.

NZICA also agrees with the changes to provide additional time to file special GST returns over the Christmas and Easter periods.

Recommendation

That the submissions be noted.

Issue: Determining ratio percentage based on earlier years' information

Clause 102

Submission
(91 – New Zealand Institute of Chartered Accountants)

When the legislation aligning provisional tax payments with GST was enacted, taxpayers that had not filed last year's return could have their GST ratio based on information from two years earlier. The current bill extends this to three years when there is an extension of time to file an income tax return. NZICA agrees with the amendment but suggests that the provision should be extended to instances where the taxpayer is in a dispute with Inland Revenue.

Comment

Officials agree that taxpayers who are in dispute with the department over a return should have their ratio based on information from three years earlier. If the amendment is not made then taxpayers in dispute would not be able to use the ratio until the dispute was resolved.

Officials have also identified two other sections which require amendment, sections MB 7(7) and MB 15(11) of the Income Tax Act 2004. Both of these sections deal with basing the GST ratio on figures from two years ago when last year's return has not been filed. These sections should also be amended to enable information from three years ago to be used if later information is not available as a result of an extension of time to file, a dispute with the department, or in relation to section MB 7(7), when a later year is a transitional year (in which the taxpayer changed their balance date).

Recommendation

That the submission be accepted and that related amendments to sections MB 7(7) and MB 15(11) also be made.

Issue: Sale of assets

Clause 106

Submission
(91 – New Zealand Institute of Chartered Accountants)

Taxpayers who account for GST on a payments basis and who use the GST ratio method are able to exclude asset sales if they have received payment for the asset, when basing provisional tax payments on a percentage of their GST-taxable supplies.

The wording of the current provision dealing with adjustments for asset sales (section MB 18) is linked to the ratio calculation formula in section MB 10. However, when the amendment proposed in the bill was drafted it omitted the link to the ratio calculation formula. The submission proposes that the link be restored.

The submission also proposes that the wording of section MB 18 be redrafted to increase the clarity of the section.

Comment

Officials agree that the link to the ratio calculation formula should be reinstated but do not consider that the proposed wording would further clarify the legislation.

Recommendation

That the submission be accepted in part.

Issue: Imposition of late payment penalty on GST ratio taxpayers

Clause 177

Submission
(91 – New Zealand Institute of Chartered Accountants)

The late payment penalty should not penalise taxpayers who comply with the GST ratio method of calculating provisional tax but who end up owing money at the end of the year. Taxpayers using the GST ratio method would expect that if they have met their provisional tax obligations they would be free from late-payment penalties.

Comment

Officials agree that taxpayers who meet their personal tax obligations under the GST ratio method should not be subject to the late payment penalty. No legislative change is required to achieve this as the legislative amendment included in the bill only imposes a penalty when the taxpayer fails to pay their provisional tax liability, calculated using the ratio method, by the due date.

Recommendation

That the submission be noted.

Issue: New provisional taxpayers

Submission
(91 – New Zealand Institute of Chartered Accountants)

A drafting oversight with section MB 8(8) of the Income Tax Act 2004 has led to new provisional taxpayers being required to make provisional tax payments during their first year. This was not the original intention and NZICA has requested that the legislation be amended to remove the requirement for new provisional taxpayers to make provisional tax payments during the year.

Comment

Officials agree with the points raised in the submission and also recommend that further amendments should be made to clarify the treatment of new provisional taxpayers. The first is to remove the words "in relation to which they pay GST" from section MB 8(8) of the Income Tax Act 2004 to ensure that a provisional taxpayer who is not registered for GST would still be liable for provisional tax. The other amendments are to section MB 8(8) of the Income Tax Act 2004 and section 120KC(1)(b) of the Tax Administration Act 1994 to specify that a new provisional taxpayer who accounts for GST six-monthly is required to make two provisional tax instalments during the year.

The further amendments ensure that the provision applies to all situations where a new provisional taxpayer could be liable for provisional tax.

Recommendation

That the submission be accepted and that two further amendments proposed by officials also be made.

Issue: Exiting ratio method

Submission
(91 – New Zealand Institute of Chartered Accountants)

Taxpayers who exit the ratio method should be allowed to use the safe harbour method of calculating provisional tax instead of being required to estimate, with exposure to use-of-money interest. Also, sections MB 17(5) and MB 6(5) duplicate advice to taxpayers who stop using the ratio method to change to the estimation option. NZICA recommends that these sections be amalgamated.

Comment

The ratio method was introduced to enable tax payments to more closely align with income flows by basing provisional tax payments on a percentage of their GST taxable supplies. Also, taxpayers who use the ratio method are not subject to use-of-money interest if they comply with the ratio method.

Enabling taxpayers to transfer between the ratio method and standard methods of calculating provisional tax would provide an opportunity for taxpayers to swap between the two regulations in order to pay the least amount of tax during the year, without being liable for use-of-money interest. This was not what the government intended when it introduced the ratio method.

Neither is it possible to amalgamate sections MB 17(5) and MB 6(5). Each section takes a different approach, one section deals with estimating provisional tax and the other with exiting the ratio method. Although there is some repetition between the two sections for completeness there is a need to retain both, with relevant cross-referencing between the two sections.

Officials recommend no change be made to the legislation.

Recommendation

That the submission be declined.

Issue: Due date for payment of provisional tax

Submission

(71 – PricewaterhouseCoopers)

Legislation was enacted last year to extend the due date for March GST returns from 28 April to 7 May. The submission has identified two legislative oversights whereby the section that deals with the due date for payments of provisional tax in a transitional year has not been amended to reflect the extension of the due date to 7 May. The submission recommends that sections MB 20(2) and (3) be amended to allow an extension of the due date to 7 May.

Comment

Officials agree that these amendments are required. Officials have also identified other instances where legislation should provide for an extension of the due date – section MB 24(5) of the Income Tax Act 2004 and section 120KD(2) of the Tax Administration Act 1994. The first provision specifies the due date for the final provisional tax payment where the taxpayer changes their balance date and the other provision specifies the date that interest starts, being the day after the due date. These sections currently do not allow an extension of the due date if the final payment occurs during the Christmas or Easter period. We recommend that these two sections also be amended to ensure that where the final period ends in November or March, that the due date is 15 January or 7 May respectively.

Recommendation

That the submission be accepted.

Issue: Cancellation of registration

Submission

(Matter raised by officials)

Taxpayers that advise Inland Revenue of their intention to cancel their GST registration from a future due date should be able to change from making two provisional tax payments to the standard three payments from that future date.

Comment

When a taxpayer who accounts for GST on a six-monthly basis cancels their GST registration, they move from paying two provisional tax payments a year to the standard three payments per year.

Currently the date this occurs from is the date of notification of intention to cancel registration. However, some taxpayers notify Inland Revenue in advance that they intend to cease registration from a future date. In these situations the legislation requires that provisional tax payments change immediately even though it could be months before the taxpayer ceases registration. Officials propose that section MB 25(5) of the Income Tax Act 2004 be amended to allow the change from two payments to three provisional tax payments to occur from the later of the date the taxpayer notified Inland Revenue of the change or the date the GST registration ceases.

Recommendation

That the submission be accepted.

Issue: Use-of-money interest on payments in a transitional year

Submission
(Matter raised by officials)

To ensure that for the purpose of calculating use-of-money interest, provisional tax will be due in two instalments; when a taxpayer starts a business after the first provisional tax instalment date and up to 30 days before the second instalment date.

Comment

Currently section 120KC (1)(b) of the Tax Administration Act only imposes use-of-money interest when two provisional tax payments are made by taxpayers registered for GST six-monthly. There is another situation where a provisional taxpayer makes two provisional tax payments in a year – where they commence business after the first provisional tax instalment date and up to 30 days before the second instalment date. Officials propose that the use-of-money interest provisions cater for this situation.

Recommendation

That the submission be accepted.

Issue: Taxpayers who use the ratio method not subject to use-of-money interest

Submission
(Matter raised by officials)

Section 120KD(1) of the Tax Administration Act 1994 should be amended to ensure that use-of-money interest does not apply to ratio taxpayers in a transitional year.

Comment

One of the features of the GST ratio method for calculating provisional tax is that taxpayers who use this method are not subject to use-of-money interest. However, section 120KD(1) of the Tax Administration Act does not specifically exclude taxpayers who use the ratio method in a transitional year (the year in which they change their balance date) from the use-of-money interest rules.

Officials recommend that the section be amended to specifically exclude taxpayers from the use-of-money interest rules when they use the ratio method in a transitional year.

Recommendation

That the submission be accepted.

Issue: Drafting corrections

Submission
(Matter raised by officials)

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

- the lack of cross-reference between section MB 8(6) and the determination section;
- the reference to 15 January in the example at the end of section MB 13;
- the reference to 7 months in the third table in the Schedule 13, Part B; and
- the example in section 120KC.

Comment

The section that deals with taxpayers changing the method they use to determine provisional tax (section MB 8(6)) currently refers to the section that calculates the amount of provisional tax payable (section MB 9(1)(b)). However, the calculation section does not refer back to the determination section. Officials recommend that an amendment be made to ensure both sections cross-reference for increased clarity.

The example at the end of section MB 13 incorrectly refers to "20 January" as the due date for payments of provisional tax that would be due in December. The date should be "15 January".

The third table in Schedule 13, Part B of the Income Tax Act 2004, contains three tables. The reference in the left-hand column of the last table incorrectly refers to "7-mths". This should be amended to refer to "7-8 mths".

The example at the end of section 120KC currently refers in the section heading to 120KC. This section heading reference should be amended to correctly refer to section 120KD.

Also, the example at the end of section 120KD should be amended to change the section heading reference from 120KD to 120KE.

Recommendation

That the submissions be accepted.

Issue: Extending GST ratio method to shareholders of close companies and partnerships

Submission
(91 – New Zealand Institute of Chartered Accountants)

Currently the ratio method only applies when the GST and provisional tax are paid by the same entity. The submission proposes that the GST ratio method should be extended to shareholders in close companies and partners in a partnership.

Comment

This question has been raised before by NZICA. It is scheduled to be included in the post-implementation review of the GST and provisional tax changes which will take place in 2009 when the rules have been in operation for a year.

Recommendation

That the submission be noted.

Issue: Changing terminal tax date

Submission
(91 – 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). This would provide a consistent date and enable GST refunds to be offset against terminal tax payments.

Comment

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 to the 28th of the month would have a significant cost to the government and is outside the scope of these proposals.

Recommendation

That the submission be declined.

Issue: Extending the ratio method to new business taxpayers

Submission
(91 – New Zealand Institute of Chartered Accountants)

The ratio method should be extended so that new businesses can use the ratio in their first years in business. This would assist in getting businesses to pay tax as soon as possible to avoid the large payment trap in their second year.

To address the problem of a business not knowing what ratio to use without figures from earlier years to base the ratio on, the submission proposes that the new business should be able to use a standard default ratio or a self-select ratio (within reasonable parameters) to deter taxpayers from getting it wrong.

Comment

Currently the ratio method is limited to taxpayers who have been in business for the whole of the preceding year and for whom tax information is available on which to base the ratio for their specific business.

It is difficult to determine the ratio level without the earlier year's tax figures being available, especially when the business is starting out. Industry average rates only suit businesses which are around the middle of the distribution. However, the ratios that apply to businesses within the same industry vary significantly in their level of expenses and net profit ratios. If the ratio is set too low then too little tax will be deducted during the year, requiring tax to be paid at year-end. Deducting tax at too high a rate can be financially detrimental to the business at the very time when the business is starting out and growing.

Adopting a standard ratio may not resolve the tax-induced financial difficulties faced by some businesses and could impose these financial difficulties on other businesses that would not otherwise have faced them.

There are other mechanisms available to provide an incentive for new businesses to pay tax in their first year in business, such as the early payment discount which provides a 6.7% tax-free return on voluntary payments to Inland Revenue in their first year.

Recommendation

That the submission be declined.

Issue: Extending the filing date for November GST returns from 15 to 20 January

Submission
(91 – New Zealand Institute of Chartered Accountants)

Currently, the GST return for the November period is due on 15 January, to give taxpayers time to file the return as a result of the Christmas period. The majority of provisional taxpayers are required to make a provisional tax payment on 15 January as well. The submission states that many businesses and tax agents are on holiday during this period and it is difficult to contact clients and obtain the necessary information by 15 January. The submission proposes that the due date be moved to 20 January.

Comment

When the legislation aligning the payment of provisional tax with GST was introduced it extended the due date for the November GST return and the payment of provisional tax from 15 January to 20 January. The due date was subsequently changed back to 15 January as 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 and GST as well as terminal tax and PAYE, all of which would be due on 20 January. Retaining the 15th as the due date also enables Westpac and taxpayers to stagger the payment of GST/provisional tax and the payment of terminal tax and PAYE to smooth workflows and the financial impact on taxpayers.

It is therefore recommended that the due date for the payment of provisional tax and GST payments remains 15 January.

Recommendation

That the submission be declined.

Issue: Extending the 28 October due date to 7 November

Submission

(91 – New Zealand Institute of Chartered Accountants)

A previous legislative amendment moved the April GST and provisional tax due date to 7 May as a result of the high number of GST returns in the month of April and the difficulty this places on businesses and tax agents' workloads.

NZICA considers that a similar amendment should be made to extend the due date for September GST returns and provisional tax from 28 October to 7 November because of agents' workflow pressures in this period. Many tax practices have the majority of their clients with six-monthly GST cycles, for which returns are due in October. To add to the problems, Labour Day always falls in the latter part of the month and many clients are unable to get their GST information to their agents until the last couple of weeks, leaving little time to finalise the returns. There are only 22 working days available to prepare returns.

Comment

The April GST due date was moved to 7 May because the majority of GST taxpayers (six-monthly, two-monthly, and monthly filers) have a payment due in April. Also, the Easter holiday period and Anzac holiday resulted in up to three working days being lost in the month.

The same situation does not occur for October. Although there may be tax agents that have a high workload during this period, the majority of taxpayers do not have a GST and provisional tax payment due in October. Also, there is just one statutory holiday in October and there are other months where the number of working days available is lower than the 22 days during October.

Recommendation

That the submission be declined.

LARGE BUDGET SCREEN PRODUCTION GRANTS

Clauses 32 and 41 to 44

Issue: Costs of film production and of acquiring film rights

Submission
(31 – New Zealand Screen Council)

The opening words of proposed section EJ 4(1) (Expenditure incurred in acquiring film rights in films other than feature films) and EJ 5(1) (Expenditure incurred in acquiring film rights in films other than feature films) do not make it clear that the sections apply to both expenditure incurred in acquiring film rights and to film production. They should be amended accordingly.

Comment

Income tax legislation has recently been rewritten with the primary aim of producing legislation that clearly and unambiguously states the policy. One of the ways in which this was achieved was separating the rules for the deductibility of costs incurred in acquiring film rights from those relating to film production expenditure. With hindsight, the amendments in the bill do not recognise that distinction as well as they might.

Officials agree with the tenor of the submission, and we will reconsider redrafting the amendment to ensure that this distinction remains apparent.

Recommendation

That the submission be accepted.

Issue: Films disposed of before completion

Submissions
(31 – New Zealand Screen Council, 71 – PricewaterhouseCoopers)

At present it does not seem to be possible to claim a deduction for the cost of a film that is not completed. Before introduction of the Income Tax Act 2004, a deduction could be claimed under section EO 3(6) of the Income Tax Act 1994. *(New Zealand Screen Council)*

The ambit of section DS 2 should be expanded to include production expenditure when a film is not completed or a film right is not acquired. *(PricewaterhouseCoopers)*

Comment

Before the introduction of the Income Tax Act 2004, a deduction was available for film costs, if a film owner or an owner of a right in a film ceased to own that film, or that right, before the film was completed. This deduction should be reinstated.

However, the deduction should only be available to the current owner of any film or a right in a film.

Recommendation

That the submissions be accepted.

Issue: Drafting

Submission
(31 – New Zealand Screen Council)

The wording of section EJ 5(1) should be checked to ensure that all words currently in section EJ 5(1)(b) are intended to apply to section EJ 5(1)(b) alone.

Comment

The proposed new section EJ 5(1) reads:

> (1) A deduction for expenditure that a person incurs in acquiring a film right is allocated under this section if the film is not a feature film and –
>
> (a) the deduction is under section DS 1 (Acquiring film rights):
>
> (b) the deduction is under section DS 2 (Film production expenditure) and the film is one for which a large budget screen production grant is made.

Section EJ 5 provides for the expenditure to be written off over two years from the date of completion. This treatment applies to all acquisition costs if the film is not a feature film. However, film production costs of non-feature films can be written off over one year for New Zealand films, if a large budget screen production grant is not made.

Therefore, the words in paragraph (b) are correctly limited to paragraph (b). Whether or not a large budget screen production grant is paid, the cost of acquiring film rights can be written off over two years.

Recommendation

That the submission be accepted.

Issue: Australian imputation credit account company eligibility

Submission
(56 – Westpac)

The repeal of section ME 1(2)(a) in 2006 appears to have had the unintended consequence of restricting the ability of certain Australian-resident companies to elect to establish and maintain an imputation credit account under section ME 1A(1). The repeal of section ME 1(2)(a) should therefore be reversed.

Comment

Officials agree that the repeal of section ME 1(2)(a) had the unintended consequence of restricting eligibility to be an Australian imputation credit account company. Section ME 1(2)(a) was repealed because it was a redundant provision; it is the cross-reference to this provision in section ME 1A(1) which causes the current problem.

Instead of reinstating section ME 1(2)(a), officials consider that the problem identified by the submission can best be addressed by removing the cross-references to section ME 1(2)(a) and (b) from section ME 1A(1). The opening wording of section ME 1A(1) would therefore refer to a company that is not excluded by section ME 1(2)(c) to (i) from the obligation under section ME 1 to establish and maintain an imputation credit account.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Exclusion of land developed for owner's own business

Clauses 6 to 8

Submission
(52 – Tower, 74 – Deloitte)

The amendments to section CB 11 to exclude land developed for the owner's own business or investment purposes should be supported.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Disposals of land subject to major development

Clauses 6 to 8

Submission
(91 – New Zealand Institute of Chartered Accountants)

The ambit of section CB 11 should be restored to its state as originally enacted to include a test that the scheme or undertaking be carried on for subsequent sale.

The application date should not refer to taking a position relating to the disposal in a return.

Comment

The provision should include a test that the scheme or undertaking be carried on for subsequent sale

Officials do not agree with the submission. The policy at the time of the enactment of the land sales rules in 1973 was that profits from the sale of land should be taxed if:

- the land had been subject to schemes or undertakings involving the development or subdivision of land; and
- the scheme or undertaking gave rise to a significant change in the whole character of the use of the land.

Before enactment of the land sale rules in 1973, this policy intention was expressed in section 88(1)(c) of the Land and Income Tax Act 1954, which contained a "purpose or intention of sale test". However, the courts had consistently taken a view that this purpose or intention test could only apply to land that was held on revenue account and did not apply to disposals of land held on capital account. As a result, section 88AA(1)(e) [CB 11 – 2004 Act] was enacted to overcome these court decisions and to achieve the intended policy result.

Officials consider the language of section CB 11 accurately reflects the provision as enacted in 1973 as section 88AA(1)(e) of the Land and Income Tax Act 1954. The language of section CB 11 accurately reflects the original policy intention that the application of the provision depends on three factors, none of which includes a profit-making purpose:

- a sale of land;
- the owner of the land has carried on or carried out a scheme or undertaking involving the development or subdivision of the land; and
- the owner has incurred significant expenditure of the types referred to in the section.

However, a policy statement by the Commissioner in PIB No. 126 in 1984 shows that it was not intended for section CB 11 to apply to a sale of land that the owner had developed, subdivided or improved for the use in and purposes of:

- A business carried on by the owner (including farming and any other businesses carried on from the premises). This exception is not intended to apply to a land developer.
- A private residence for the owner and any member of his or her family living with him or her.
- The deriving by the owner of rents or similar revenues from that property.

In more recent years large-scale developments of land for the owner's own business use (such as retail malls) involve quite significant expenditures. The Commissioner now considers that these expenditures could fall within the meaning of "significant expenditure" of the types referred to in section CB 11.

Therefore, officials consider that the current drafting of section CB 11 does not adequately protect landowners carrying on a major land development for their own commercial purposes (other than a land developer) and that the business and investments exclusions should now apply to section CB 11. This approach is also consistent with the exclusions to section CB 10 for developments or subdivisions of land undertaken for the land owner's own commercial activities.

Recommendation

That the submission be declined.

The application date should not refer to taking a position relating to the disposal in a return

Officials do not agree with the submission.

Section 92 of the Tax Administration Act 1994 requires a taxpayer to self-assess their taxable income for a tax year. Officials agree with the submission that in making that self-assessment, the taxpayer must have taken a tax position on whether the profit on the sale of land subject to a major development should be included in the calculation of taxable income for a tax year.

As the Commissioner now considers section CB 11 applies to a sale of land on which a major development has occurred, the Commissioner has the discretion to reassess earlier tax years under section 113 of the Tax Administration Act 1994. This discretion applies on an unlimited retrospective basis where the taxpayer has omitted to include income from any source or is of a particular type (section 108(2) of the Tax Administration Act 1994).

Officials therefore consider it is important that this amendment provide assurance to taxpayers who have taken a tax position for prior tax years <u>not</u> to include in their taxable income calculation a profit on the sale of land on which a major development has occurred.

Recommendation

That the submission be declined.

Other matters raised by officials

Overview

Section CW 11B of the Income Tax Act 2004 was introduced, with effect from 1 October 2005, with the intention of facilitating increased offshore venture capital investment into New Zealand. The section removes a potentially significant tax obstacle to in-bound venture capital investment, by removing any risk that a qualifying non-resident venture capital investor selling shares in an eligible New Zealand company could be subject to New Zealand income tax on any gain arising from the sale.

One of the requirements of section CW 11B is that the investor must be from a jurisdiction approved by the Governor-General by Order in Council. Broadly, a jurisdiction will only be approved if effective exchange of information arrangements are in place with New Zealand. Until recently, New Zealand has only entered into exchange of information arrangements through its double tax agreements (DTAs). It is understood that most venture capital investment is structured to come through nil or low tax jurisdictions. However, New Zealand generally does not conclude DTAs with nil or low tax jurisdictions. Therefore section CW 11B has until now had little effect on encouraging venture capital investment into New Zealand.

New Zealand is now beginning to conclude tax information exchange agreements (TIEAs) with nil or low tax jurisdictions. TIEAs will satisfy the requirement for effective exchange of information arrangements. However, officials have identified two technical problems that may render section CW 11B ineffective when the relevant treaty is a TIEA rather than a DTA:

- Section CW 11B requires a determination of the investor's residence, but a technical problem with the current mechanism specified for determining residence may prevent an investor in a nil or low tax jurisdiction from qualifying for the exemption.
- Section CW 11B provides that a qualifying investor must be treated by the taxation laws of their home jurisdiction in a particular manner, depending on the category of investor. However, a nil or low tax jurisdiction will be unlikely to have the specifically required taxation laws.

In addition, officials note that, in relation to nil or low tax jurisdictions, section CW 11B could be exploited by New Zealanders through a simple structuring arrangement that would enable them to avoid New Zealand tax on gains on the sale of the shares in New Zealand companies. A technical amendment to the rules is therefore required to ensure that the original policy intention of limiting the exemption to qualifying non-resident investors is preserved.

This matter has been raised with representatives of the New Zealand venture capital industry. The industry representatives have indicated general support for any measure that might have the effect of further encouraging venture capital investment into New Zealand. Officials therefore recommend that these technical problems be addressed in the current bill.

Issue: Determining the residence of the investor

Submission

(Matter raised by officials)

Section CW 11B requires a determination of the investor's residence. Two tests for residence are prescribed: in the presence of a DTA between New Zealand and the other jurisdiction, residence is to be determined under the DTA; in the absence of a DTA, residence is to be determined under the domestic law of the other jurisdiction.

The tests for residence should be amended to provide that, notwithstanding the existence of a DTA, if residence cannot be determined under that DTA then it is to be determined under the domestic law of the other jurisdiction.

Comment

Technically, a TIEA is a DTA for the purposes of the Income Tax Act, but TIEAs do not generally include any tests for residence. Therefore an investor from a nil or low tax jurisdiction may fail to satisfy the residence requirement of section CW 11B for purely technical reasons.

Recommendation

That the submission be accepted.

Issue: Reference to "Taxation Laws"

Submission

(Matter raised by officials)

The wording of section CW 11B should be amended to ensure that investors from nil or low tax jurisdictions do not fail to qualify simply because their home jurisdiction has no applicable taxation laws.

Comment

Section CW 11B defines three separate categories of qualifying investor – "foreign exempt person", "foreign exempt entity" and "foreign exempt partnership". Each definition requires the investor to be specifically treated in a certain manner by the taxation laws of the jurisdiction concerned. Broadly, the intention is that the investor must be tax-exempt in their home jurisdiction, and hence unable to claim any relief or benefit for New Zealand tax (in other words, they have no home jurisdiction tax to credit New Zealand tax against). A nil or low tax jurisdiction may not actually impose income tax, but because there is no specific taxation law rendering the investor exempt, section CW 11B will fail to apply.

Recommendation

That the submission be accepted.

Issue: Mechanism for detecting New Zealand ownership of offshore entities

Submission

(Matter raised by officials)

A "look-through" rule should be inserted into the legislation to prevent any New Zealand direct or indirect owner or member of an offshore entity established in a nil or low tax jurisdiction from gaining the benefit of the section CW 11B exemption.

Comment

Many nil or low tax jurisdictions operate an "offshore sector", in which it is relatively simple to set up a foreign-owned legal entity such as an international business company (IBC). However, section CW 11B contains no mechanism for detecting, for example, the case of a New Zealander setting up an IBC in a nil or low tax jurisdiction to hold shares (either directly or indirectly) in a New Zealand company. Therefore, by means of a simple structuring arrangement, a New Zealander can gain access to an exemption from any gain on the sale of shares that would otherwise be taxable in New Zealand.

Recommendation

That the submission be accepted.

GREY LIST COMPANY DEFINITION: DRAFTING CORRECTION

Submission
(Matter raised by officials)

The definition of "grey list company" in section OB 1 of the Income Tax Act should be amended to include foreign investment funds (FIFs) as well as controlled foreign companies (CFCs) (section EX 33).

Comment

In 2006, the Income Tax Act was amended to allow investors in foreign hybrids to receive grey list treatment and foreign tax credits for tax they pay overseas on income earned by a foreign hybrid. A foreign hybrid is an entity that has the characteristics of both a company and a partnership. It is treated as a company for New Zealand tax purposes, but is treated like a partnership (with "flow-through" tax treatment) or a branch of the parent company under another country's tax system.

The changes were to apply to foreign hybrids that were either a CFC or a FIF. Accordingly, the grey list exemptions in sections EX 24 (CFCs) and EX 33 (FIFs) were amended to enable taxpayers to receive a grey list exemption for investments in foreign hybrids. The underlying foreign tax credit rules in subpart LF were amended to allow shareholders to receive credits to offset their foreign dividend withholding payment for tax paid in respect of the foreign hybrid.

The definition of "grey list company" in section OB 1 was also amended last year. It now refers to CFCs for the purposes of subpart LF by including a reference to section EX 24. However, it does not refer to section EX 33. This is an oversight and an amendment should therefore be made to the definition of "grey list company" to ensure it encompasses FIFs as well as CFCs.

Recommendation

That the submission be accepted.