

Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill

Commentary on the Bill

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Minister of Revenue

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CONTENTS

Review of New Zealand’s international tax rules – first stage of reforms	1
Overview of proposed amendments	3
Active business test for controlled foreign companies	5
The definition of passive income for controlled foreign companies	18
Calculation of attributable income for controlled foreign companies	28
Interest allocation rules for outbound international investment	31
Foreign dividend exemption for companies	34
Other international tax measures – changes to conduit tax relief and the grey list	37
Taxation of life insurance business	43
Tax treatment of relocation payments and overtime meal allowances	59
Payroll giving	69
Reforming the Income Tax Act definitions of “associated persons”	75
Other policy matters	95
Tax treatment of emissions trading units	97
Tax treatment of reimbursements and honoraria paid to volunteers	101
Film and government funding	103
Clarifying the tax status of general insurance risk margins	106
Changes to the tax treatment of petroleum mining	108
Niue development	111
Raising certain tax thresholds	113
Changes to the tax pooling rules	115
Migrant workers employed under the recognised seasonal employer policy	117
Banking continuity issues	118
Charitable donee status	120
Application of the non-disclosure right	123
Tax recovery arrangements	124
Public authorities and GST	125
GST on certain loyalty transactions	126
GST and exported second-hand goods	128

Remedial amendments	131
Technical amendments to the portfolio investment entity rules	133
Technical amendments to the offshore portfolio share investment rules	139
Amendments to R&D tax credit rules	144
Tax depreciation rules	149
KiwiSaver amendments	153
Miscellaneous technical issues	159

Review of New Zealand's
international tax rules
– first stage of reforms

OVERVIEW OF PROPOSED AMENDMENTS

The government announced changes to the international tax rules in Budget 2008. The key features of the proposed new rules are an active income exemption, some accompanying measures to protect the tax base, and an exemption from tax of most foreign dividends paid to companies.

Active income exemption

- Comprehensive attribution of income from controlled foreign companies (CFCs) to New Zealand owners will be replaced by attribution of only passive income. This is intended to allow New Zealand residents with active businesses in foreign markets to compete on an equal footing with similar companies overseas and to remove incentives for residents to move their head offices offshore. Passive income, which may be easily moved between jurisdictions, will continue to be attributable to prevent a significant erosion of the tax base.
- To reduce compliance costs in situations where risks to the tax base are not excessive, there are some exceptions from the requirement to attribute passive income. There will typically be no attribution of passive income for CFCs in Australia. There will also be an exception for CFCs that pass an “active business” test – no attribution of passive income will be required for CFCs if the passive income of the CFC is less than 5 percent of total income. The test may be undertaken using tax rules, or financial accounting information. It is expected that most active businesses will pass the test, and therefore not have to undertake a full calculation of attributable CFC income.
- Passive income will include mainly interest, rent, royalties and dividends. Certain services income will be classified as passive income too, to prevent arbitrary reassignment of New Zealand earnings to an offshore jurisdiction. Income from speculative derivative instruments and derivatives that hedge passive income will also be passive income.
- The calculation of net attributable income of a CFC will be based on the definition of passive income, with deductions permitted for the costs incurred in deriving that passive income. These rules will prevent deductions being taken for expenses incurred in deriving (untaxed) active income.

Base protection measures

- Interest allocation rules will be extended to cover New Zealand residents with outbound interests in CFCs. The interest allocation rules protect the domestic tax base from erosion by preventing an over-allocation of global interest costs against New Zealand operations. There are several safe harbours in the proposed rules which allow debt-funding for a large proportion of foreign investment to be deducted against the New Zealand tax base. The rules will apply only if companies with a significant international presence choose to heavily debt-finance their domestic operations but not their foreign ones. New Zealand residents who fund their offshore operations by debt also qualify for an “on-lending” concession.

- The existing “grey list” exemption from attribution of CFC income is being replaced with the active business exemption for CFCs in all countries, with one exception – as noted above, Australian CFCs will generally continue to be exempt from the requirement to attribute any income to New Zealand residents. At the same time, the conduit relief mechanism, which exempts from tax foreign-sourced income of New Zealand companies that is destined to be paid out to non-residents, is being effectively removed. The general “grey list” exemption and the conduit relief mechanism were a necessary part of a system of comprehensive CFC taxation, but are not appropriate when active CFC income is exempt.

Foreign dividend exemption

- Most dividends paid by a foreign company will be exempt from income tax when received by New Zealand companies. Dividends that are tax-deductible for the foreign company and dividends on fixed rate shares will remain taxable; in the case of fixed rate shares, this will be achieved by treating the shares generating the dividends as debt instruments for all purposes.
- Foreign dividend payment accounts and branch equivalent tax accounts of companies will be made unnecessary under the proposed reform. It is intended that existing BETA debit balances and FDP credit balances will be able to be carried forward for two and five years respectively, with legislation at a later date to finally repeal them.

ACTIVE BUSINESS TEST FOR CONTROLLED FOREIGN COMPANIES

(Clauses 122, 123, 408 and 484)

Summary of proposed amendments

An “active business” test is being provided for CFCs engaged in active business. CFCs that pass the test will not be required to attribute any income to New Zealand residents. CFCs will pass the test if less than 5 percent of their gross income is passive income. Some insurance businesses may also qualify for a separate exemption.

Application date

2009–10 and later income years.

Key features

An “active business” test is being provided for CFCs engaged in active business. CFCs that pass the test will not be required to attribute any income to New Zealand residents. CFCs that do not pass the test will have to attribute passive income to New Zealand residents, unless the CFCs are resident in Australia.

A CFC passes the active business test if less than 5 percent of its gross income is passive income. Because the typical rate of return on assets that generate passive income is lower than the rate of return on assets generating active income, an average business could qualify for the exemption even if a substantial portion (one quarter to one-third) of its assets was generating passive income.

To reduce compliance costs, gross income and passive income may be measured using adjusted financial accounting information. Audited accounts that comply with International Financial Reporting Standards (IFRS) or New Zealand equivalents to IFRS may be used. Some smaller entities may use audited accounts prepared under pre-IFRS New Zealand financial reporting standards (“old GAAP”).

CFCs in the same jurisdiction can in most cases be consolidated for the purposes of active business test calculations.

Where suitable accounting information is not available, gross income and passive income can be calculated using tax principles.

A CFC might also pass the active business test if it is an insurance business that applies to the Commissioner of Inland Revenue for a determination that its business is active.

Background

The active business test is a key element of the proposed international tax reforms. A detailed proposal for an active business test was included in the October 2007 issues paper *Developing an active income exemption for controlled foreign companies*. The test is intended to significantly reduce compliance costs for the majority of residents with CFCs. It allows financial accounting information to be used to demonstrate that the CFCs are primarily engaged in active business. If this can be demonstrated, the CFCs will not be required to attribute any income, nor to undertake detailed calculations of net attributable income.

Detailed analysis

CFCs can pass the active business test if one or more of the following conditions are met:

- their passive income is less than 5 percent of their gross income; or
- they are an insurance business that applies for a determination that their business is active, and the determination is made that the business is active.

Passive income less than 5 percent of gross income

A CFC is not required to attribute income to New Zealand residents if the amount of its passive income divided by the amount of its gross income is less than 5 percent. The amount of passive income is referred to in this document as the “numerator” and the amount of gross income as the “denominator”.

For the purposes of the calculation, either an adjusted financial accounting basis or a tax basis, but not both, may be used to calculate amounts of passive income and gross income.

To use accounting information:

- the CFC’s accounts must be audited and comply with International Financial Reporting Standards (IFRS); or
- the CFC’s accounts must be included in consolidated accounts that are audited and comply with IFRS or New Zealand equivalents to IFRS or pre-IFRS New Zealand financial reporting standards (“old GAAP”).

The intention is that accounting information will be drawn directly from the audited accounts. However, the requirements of the legislation must still be met, and the ability to use accounting information does not remove the requirement to ensure the information is correct for that purpose.

If suitable accounting information is not available, or if the taxpayer chooses not to use it, then tax concepts are always available for calculating passive income and gross income.

The following sections provide more detail about the situations in which accounting information may be used, and the required calculations when using this information or the tax-basis information.

When the IFRS basis may be used (IFRSE)

The calculation may be undertaken using information from accounts that comply with IFRS (referred to in the legislation and henceforth in this commentary as “IFRSE”). International Financial Reporting Standards are standards (International Financial Reporting Standards and International Accounting Standards) issued or adopted by the International Accounting Standards Board, and revised from time to time.

To use this option, the CFC must prepare audited accounts that comply with IFRSE, or its accounts must be part of audited consolidated accounts that comply with IFRSE. In the latter case, it is expected that information relating to the CFC will be drawn from consolidation worksheets and other similar sources.

“Audited” in this case means audited by a member of the New Zealand Institute of Chartered Accountants who is a Chartered Accountant, or by a person with similar overseas accreditation. If the audit has resulted in anything other than an “unqualified” or “except for” opinion, then the IFRSE option cannot be used. In the absence of an unqualified opinion, there is a strong likelihood that information drawn from the accounts would not meet the requirements of the legislation anyway. (As noted above, the ability to use accounting information does not override the requirement that it be correct for the purposes of the legislation.)

When the NZIFRS basis may be used (IFRS)

The calculation may be undertaken using information from accounts that comply with New Zealand equivalents to IFRS (for historical reasons these are referred to in the legislation as “IFRS”, and this terminology will be used henceforth). IFRS is a defined term in the Income Tax Act 2007, and means “a New Zealand Equivalent to International Financial Reporting Standard, approved by the Accounting Standards Review Board, and as amended from time to time or an equivalent standard issued in its place”.

To use this basis, the CFC’s accounts must be part of audited consolidated accounts that comply with IFRS. It is expected that information relating to the CFC will be drawn from consolidation worksheets and other similar sources. (For the meaning of audited, see *When the IFRS basis may be used (IFRSE)*.)

A person who qualifies for and uses exemptions under the framework for differential reporting under IFRS, which applies only in New Zealand, cannot claim compliance with IFRS. Nevertheless, if the accounts would comply with IFRS but for such legitimate use of these exemptions, the IFRS basis may still be used. The reason for allowing this is that the exemptions primarily relate to disclosure requirements rather than measurement of amounts. This does not alter the requirement that the accounts be audited.

When the Old GAAP basis may be used (OGAAP)

The calculation may be undertaken using information from accounts that comply with pre-IFRS New Zealand Financial Reporting Standards (referred to in this document as OGAAP, and in the legislation as *generally accepted accounting practice without IFRS*). These standards include currently applying Financial Reporting Standards (not international standards) issued by the Accounting Standards Review Board, and Statements of Standard Accounting Practice issued by the New Zealand Institute of Chartered Accountants, as amended from time to time.

The OGAAP option is provided because certain small companies are not required to comply with IFRS until a review of reporting requirements for small and medium-sized enterprises is completed by the government. It is intended to be a temporary option and, depending on the outcome of the review, the option is expected to be removed or altered in future. Where IFRS accounts are available, they are preferred and are required to be used.

To use the OGAAP option, the CFC's accounts must be part of audited consolidated accounts that comply with OGAAP. It is expected that information relating to the CFC will be drawn from consolidation worksheets and other similar sources. (For the meaning of audited, see *When the IFRS basis may be used (IFRSE)*.)

This option is available only to the small or medium-sized companies that are not required to comply with New Zealand Equivalents to International Financial Reporting Standards (IFRS) because of the forthcoming government review. The consolidated accounts in which the CFC's accounts are included must be accounts of an entity that is in this situation.

The Accounting Standard Review Board has indicated that for an entity not to be required to comply with IFRS for the time being, it must be a company that:

- Is not an issuer, as defined in section 4 of the Financial Reporting Act 1993, in either the current or the preceding accounting period.
- Is not required by section 19 of the Financial Reporting Act 1993, to file its accounts with the Registrar of Companies.
- Is not large, as defined in section 19A(1)(b) of the Financial Reporting Act 1993. (Broadly speaking, a company is large if it has more than two of: consolidated assets of \$10 million, consolidated turnover of \$20 million, and consolidated employment of 50 people.)
- Does not have an insurance business.
- Does not prepare audited accounts, and is not required to prepare accounts (whether or not there is a requirement to audit) that comply with IFRS or IFRSE.
- Is not a subsidiary of a company that prepares and audits, or is required to prepare (whether or not there is a requirement to audit) consolidated accounts that include the accounts of the subsidiary and that comply with IFRS or IFRSE.

Entities that qualify for and apply differential reporting exemptions under OGAAP may be able to use this option. If the accounts would comply with New Zealand generally accepted accounting practice and applicable financial reporting standards but for such legitimate use of these exemptions, the OGAAP basis may still be used. Many smaller firms are likely to qualify for differential reporting exemptions. This does not alter the requirement that the accounts be audited.

Measurement of passive income under accounting-based methods

Both the numerator and denominator to be calculated for the active business test are defined in section EX 21E, with reference to the applicable accounting standards. Which standards are the applicable accounting standards depends on the choice of accounting method (IFRS, IFRSE or OGAAP), which may be restricted, as above.

The numerator is **reported passive + added passive – removed passive**. Within each of the three components of the numerator, no amount should be included more than once.

Reported passive is intended to include passive income that arises under the applicable accounting standards. This includes interest, dividends, rent, royalties, income from a finance or operating lease, gains arising from financial assets other than derivatives (whether in profit and loss or in equity), insurance premiums and gains from property used to back insurance assets (whether in profit and loss or equity).

Gains arising from financial assets other than derivatives may be fair value gains, gains on de-recognition (alienation) of the assets or foreign exchange gains from holding assets denominated in a foreign currency. These may be recorded, for accounting purposes, as items of income (in profit and loss) or directly as changes in equity. For the purposes of the test, gains are measured on a gross basis (not netted off against losses on similar assets or other losses of a similar nature). Losses on non-derivative financial assets are not included.

Under IFRS and IFRSE, interest, dividends and royalties will typically arise under NZIAS 18 or IAS 18 (Revenue) but will still be in **reported passive** even if they do not. Lease and rental income will typically arise under IAS 17 (Leases). Insurance income, including gains from property used to back insurance assets, will arise under IFRS 4 (Insurance Contracts, which also refers to IAS 39). Gains arising from financial assets will typically arise under IAS 39 (Financial Instruments: Recognition and Measurement) or IAS 21 (The Effects of Changes in Foreign Exchange Rates).

Example: Reported passive under IFRS/IFRSE

The table below shows an example, for a hypothetical set of accounts, of the components of income that would be included in **reported passive** if using an IFRS or an IFRSE basis. Interest and dividends arising under IAS 18 are included in this item, though ordinary sales revenue is not. Finance income (interest) that is not revenue under IAS 18 for some reason is also included. Foreign exchange and fair value gains on a non-derivative financial asset are both included, even though one appears as an item that is part of profit and loss and the other affects equity directly.

Revenue

Sales revenue (sale of manufactured goods)	Not passive
Interest	Passive
Dividends	Passive

Other income

Finance income	Passive
Foreign exchange gain on financial asset	Passive

Movements in equity

Gain from increase in fair value of financial asset	Passive
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Under OGAAP, interest, dividends, royalties and rent will typically be reported as part of operating revenue under FRS 9 (Information To Be Disclosed In Financial Statements). Gains arising from financial assets may also be included in operating revenue, or may be recorded directly in equity. FRS 21 (Accounting For the Effects of Changes in Foreign Currency Exchange Rates) is the relevant standard for assessing foreign exchange gains. The OGAAP basis may not be used if the CFC has insurance business, and there should therefore be no income from insurance premiums or gains on property that is backing insurance assets.

Example: Reported passive under OGAAP

The table below shows an example, for a hypothetical set of accounts, of components of income that would be included in **reported passive** if using an OGAAP basis.

Operating revenue

Sales revenue (sale of manufactured goods)	Not passive
Interest	Passive
Dividends	Passive
Finance income	Passive
Foreign exchange gain on financial asset	Passive

Movements in equity

Gain from increase in fair value of financial asset	Passive
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It is intended that the items which make up **reported passive** will be interpreted under the relevant accounting standards, unless otherwise noted.

For example, interest, dividends and royalties have a particular meaning under IAS 18 (Revenue) when an IFRS basis is being used, and may (though are unlikely to) have a different meaning when an OGAAP basis is being used.

However, as another example, whether an IFRS or an OGAAP basis is being used, “non-derivative financial asset” is to be interpreted using the definitions of “financial asset” and “derivative” in NZIAS 32 and NZIAS 39 respectively, since this is explicitly stated. If using an OGAAP basis, the relevant assets are identified using the definitions in the NZIASs, but amounts relating to those assets are then measured using OGAAP.

Terms without a specific meaning under the relevant standards should be given their ordinary meaning under the accounting standards.

Added passive is intended to include items that are not in **reported passive** but which are, in nature, passive income. For example, some services income may be from services performed in New Zealand, and therefore passive “base company” income. Income from some derivative instruments is also included. The items in **added passive** are measured using tax concepts and are (or would be) components of the **attributable CFC amount** under section EX 20B. These items are included only to the extent they are not already in **reported passive**.

Removed passive is intended to include items that are also included in **reported passive**, as adjusted by **added passive**, but would not normally be part of passive income for tax purposes. Most of these items are measured using tax concepts under EX 20B. Income from a share that is not held on revenue account, whether a fair value gain or gain on de-recognition is also part of **removed passive**, because equities that are not held on revenue account are not typically taxed on an accrual basis or on sale. “Revenue account property” is to be interpreted using tax concepts and “de-recognition” is to be interpreted using NZIAS 39, no matter which accounting basis is used, but measurement of resulting income takes place under the relevant standards. The items in **removed passive** are included only to the extent they are already in **reported passive** as adjusted by **added passive**.

Measurement of gross income under accounting-based methods

The denominator in the active business test under EX 21E is **reported revenue + added revenue – removed revenue**. Within each of the three components of the denominator, no amount should be included more than once.

Reported revenue includes operating revenue under OGAAP (defined in FRS 9). Under IFRS and IFRSE it includes revenue (for which IAS 18 or NZIAS 18 are the relevant standards), income from finance or operating leases (for which IAS 17 is the relevant standard), and income from an insurance business (for which IFRS 4 is the relevant standard).

Under IFRS, IFRSE and OGAAP, **reported revenue** also includes gross gains arising from non-derivative financial assets, whether in the form of increases in fair value, gains on de-recognition or foreign exchange gains. “Non-derivative financial assets” and “de-recognition” are to be interpreted using the relevant definitions in NZIAS 32 and NZIAS 39 for both IFRS/E and OGAAP. But once assets and de-recognitions have been identified, measurement of the gains uses the relevant standards (which will not be IFRS for OGAAP).

Added revenue adds certain amounts that might have the character of taxable income for tax purposes but may not be included in the measure of reported revenue. These amounts are determined using tax concepts rather than accounting definitions or measurement. Amounts are added only to the extent that they are not already in **reported revenue**.

Removed revenue includes certain amounts that were removed from the numerator under tax or accounting concepts, such as payments of passive income from an active CFC in the same jurisdiction. These should also be removed from the denominator.

Removed revenue also includes:

- income received from other CFCs which could be consolidated for the purposes of the active business test (also see *Consolidation of CFCs for the purpose of the active income test*); and
- payments from CFCs which could not be consolidated if those payments were made with the purpose of increasing the denominator.

These rules are designed to prevent the inflation of the denominator by, for example, repeated sales between associated CFCs. Where CFCs have been consolidated for the purposes of the test, many of these amounts will be removed in the consolidation and do not need to be removed again. Two CFCs will be treated, for the purposes of calculating removed revenue, as able to be consolidated even if they cannot actually be consolidated because appropriate accounts are not available.

Further items included in **removed revenue** are:

- Income from a derivative, if the derivative is not one referred to in section EX 20B(4)(b) and the derivative is not part of a hedging relationship or the income from the derivative is from the ineffective portion of a hedge.
- Income from a derivative, if the derivative is one referred to in section EX 20B(4)(b), to the extent the amount included in **reported revenue**, as adjusted by **added revenue**, was less than the amount that would be calculated under EX 20B(4)(b). (Also see *Treatment of derivative income when using IFRS, IFRSE or OGAAP*.)
- Gains on a liability, if the accounting basis is OGAAP, unless the gain is sales or service revenue in the normal course of business. Because of the broad nature of “operating revenue” under OGAAP, reductions in liabilities may sometimes be recorded as revenue. It is not intended that these be included in the denominator. An exception is made for sales or service income – this contemplates the situation in which an unearned income liability is reduced as a service is performed, leading to recognition of revenue.
- Gains on a non-financial asset that is not revenue account property, if the accounting basis is OGAAP. Gains on non-financial assets that are not revenue account property, such as plant and equipment, may be included in “operating revenue” under OGAAP, but should not be included in the denominator. Such gains would not generally be taxable under tax principles.

Items are included in **removed revenue** only to the extent they are in **reported revenue**, as adjusted by **added revenue**.

Measurement of passive income under the tax method

Both the numerator and denominator to be calculated for the active business test under a tax basis are defined in section EX 21D.

The numerator is the amount that would be calculated as the attributable CFC amount under section EX 20B, if the CFC was not a non-attributing active CFC.

Measurement of gross income under the tax method

The denominator under a tax basis is **annual gross – adjustments**.

Annual gross is the gross annual income that would be calculated for the taxpayer under part C of the Income Tax Act 2007, excluding subpart CQ (Attributed income from foreign equity). The rules in section EX 21 apply when calculating this gross annual income, with the exception of the normal currency rules. (See *Currency conversion when using the tax basis*.)

Adjustments include certain amounts received from associated CFCs:

- interest, rental income or royalty income received from an associated active CFC in the same jurisdiction (also removed from the numerator);
- royalty income received from any CFC, to the extent it is removed from the numerator;
- sales and service income received from an associated CFC if the CFC could be consolidated for the purposes of the active business test; and
- payments for sales and services received from an associated CFC that could not be consolidated for the purposes of the active business test, if the payments were made with the purpose of increasing the denominator.

The last two items should be excluded from the denominator to prevent the denominator being artificially increased by trading between associates.

Consolidation of CFCs for the purpose of the active income test

To reduce compliance costs and provide flexibility, some or all CFCs within the same jurisdiction may be consolidated for the purposes of the active income test. Consolidation is permitted only for the purposes of the test; if a CFC does not qualify for an exemption from the requirement to attribute income, the calculation of attributable CFC income is always undertaken at the level of the individual CFC.

There are pre-requisites for such consolidation. These differ depending on the basis used for the calculation.

For IFRS and IFRSE, consolidation is permitted when the CFCs are in the same jurisdiction and:

- the accounts of all the CFCs are required by NZIAS 27 or IAS 27, as applicable, to be consolidated together; and
- audited and consolidated accounts are actually prepared that comply with IFRS or IFRSE standards, as applicable; and
- the taxpayer holds voting interests of 50 percent or more in each of the CFCs.

For OGAAP, consolidation is permitted when the CFCs are in the same jurisdiction and:

- the accounts of all the CFCs are required by FRS-37 to be consolidated together; and
- audited and consolidated accounts are actually prepared that comply with applicable OGAAP standards; and
- the taxpayer holds voting interests of 50 percent or more in each of the CFCs.

For the tax basis, consolidation is permitted when the CFCs are in the same jurisdiction and the taxpayer holds voting interests of 50 percent or more in each of the CFCs. If consolidation is carried out using the tax basis, uniform accounting policies for like transactions and other events in similar circumstances should be used. All intragroup balances, transactions, income and expenses should be eliminated in full. The consolidation that is undertaken for this purpose is distinguished from the “consolidation rules” that are defined in section YA 1 and apply to wholly owned consolidated groups.

When a group of CFCs is consolidated for the purposes of the test, the group (a “test group”) is effectively treated as a single CFC. This means that, for example, exemptions from attributable CFC income for interest, rent or royalty payments between CFCs are to be interpreted as exemptions only for transactions between the test group and CFCs that are not part of the test group.

When a CFC in which the taxpayer has less than 100 percent interest is consolidated, any minority interest in the consolidation will be removed. Without this requirement, the income of the minority interest in an active CFC, which is not income in any sense of the taxpayer, could be used to shelter passive income attributed to the taxpayer. The requirement to remove any minority interest applies regardless of whether the accounting-based or tax-based versions of the test are being used.

Example: Removal of minority interest.

NZ Ltd has a 60 percent interest in CFC 1 and a 100 percent interest in CFC 2, which are both Japanese residents. NZ Ltd prepares consolidated and audited accounts that comply with IFRS, and CFC 1 and CFC 2 are included in the consolidation. NZ Ltd chooses to group CFC 1 and CFC 2 in a test group for the purposes of the active income test.

The top half of the table below shows that CFC 1 (if treated on its own) would have reported revenue, under EX 21E(10), of \$3 million. CFC 2 would have reported revenue of \$1 million. In the consolidated accounts prepared by NZ Ltd, \$1 million of transactions between CFC 1 and CFC 2 that would be part of reported revenue are eliminated, giving reported revenue on a consolidated basis of \$3 million (\$3 million + \$1 million – \$1 million).

The bottom half of the table shows how the requirement to remove the minority interest affects the consolidated revenue figure that would appear in consolidated financial statements. The \$2 million figure at the bottom-right of the table is the one that should be used for the purposes of the active business test.

	CFC 1	CFC 2	Eliminations	Consolidated
Revenue from CFC 1		\$500,000	-\$500,000	\$0
Revenue from CFC 2	\$500,000		-\$500,000	\$0
Other revenue	\$2,500,000	\$500,000	\$0	\$3,000,000
Total revenue	\$3,000,000	\$1,000,000	-\$1,000,000	\$3,000,000

	CFC 1 × 60%	CFC 2 × 100%	Eliminations	Consolidated
Revenue from CFC 1		\$500,000	-\$500,000	\$0
Revenue from CFC 2	\$300,000		-\$300,000	\$0
Other revenue	\$1,500,000	\$500,000	\$0	\$2,000,000
Total revenue	\$1,800,000	\$1,000,000	-\$800,000	\$2,000,000

Treatment of derivative income when using IFRS, IFRSE or OGAAP

Derivative instruments may be hedging instruments, in which case they may be partly or wholly effective, or not.

In general, it is intended that income from derivative instruments that are not hedging instruments, as well income from the ineffective portion of hedges, will be included in the numerator for the purposes of the active business test (since they have the character of passive income). In addition, it is intended to include all income from instruments that hedge (or effectively hedge) passive income.

Income from hedges of active income is not generally intended to be included in the numerator. For example, if a company takes out a forward exchange rate contract when an export sale is made, to hedge any currency movements before settlement, income from the contract will generally not be included in passive income.

The approach taken in the legislation is generally not to count derivative income at all when using accounting concepts, and then to adjust the accounting measure by adding in just the appropriate income from (passive) derivatives using tax concepts.

In practice, income from a cash flow hedge is usually included with income from the hedged item in IFRS or OGAAP accounts. For example, where export sale is hedged against exchange rate movements, the sale will typically be recorded at the forward exchange rate, implicitly including both the actual receipt from the sale and any gain on the forward contract.

In the case of most hedges, this is appropriate. For a typical active hedge, revenue can be smoothed using hedges, and the smoothed figure can be used for the test. For a passive hedge of, say, interest, implicit inclusion of the hedge income in interest revenue will ensure it is counted as part of both the numerator and denominator, as intended.

Revenue risks may arise if hedge income that should be passive income arises in the denominator under accounting concepts but not the numerator. For example, if hedge income from an interest rate swap is recorded separately from the interest income that is being hedged, but both are recorded under revenue in IFRS accounts, then the hedge income will be measured using accounting concepts in the numerator but will only be brought into the denominator using tax concepts. When combined with the ability to use the expected value method under tax concepts rather than the fair value method prescribed by IFRS, this may bias the test in favour of an “active” result.

To prevent this, to the extent that income from a passive derivative instrument included in the denominator exceeds income from that derivative instrument calculated under tax concepts, the excess must be removed from the denominator.

Currency conversion when using IFRS, IFRSE or OGAAP

When using the accounts of the CFC to calculate the numerator and denominator, the functional currency of the CFC must be used. The term “functional currency” is interpreted using, and must meet the requirements of, the definition in IFRS (notably in NZIAS 21), whether an IFRS, IFRSE or OGAAP basis is being used. It is intended that if CFCs are being consolidated for the purposes of the active business test, all CFCs in the test group must have the same functional currency.

When amounts are required to be translated from other foreign currencies to the functional currency of the CFC, such as when the CFC makes an export sale in the currency of the buyer, the exchange rate rules in the applicable standards must be used, with one exception (discussed in the following paragraph). In IFRS and IFRSE this requirement includes compliance with IAS 21 or NZIAS 21 (The Effects of Changes in Foreign Exchange Rates). In OGAAP, it includes compliance with FRS 21 (Accounting for the Effects of Changes in Foreign Currency Exchange Rates) and SSAP 21 (Accounting for the Effects of Changes in Foreign Currency Exchange Rates).

The exception to the normally applicable exchange rate rules is that exchange rate differences arising on a monetary item that forms part of a reporting entity’s net investment in a foreign operation will be ignored for the purposes of the active business test. The relevant accounting standards in both IFRS/IFRSE and OGAAP explain that a monetary item forms part of a reporting entity’s net investment in a foreign operation when it is receivable from or payable to a foreign operation (the CFC) but settlement is neither planned nor likely to occur in the foreseeable future, so that the item is, in substance, part of the parent’s net investment in the foreign operation.

When using consolidated accounts that include the accounts of the CFC to calculate the numerator and denominator, the currency in which the audited financial statements are presented must be used. Amounts expressed in the functional currency of the CFC must be converted to amounts in the presentation currency using an average exchange rate for the accounting period, rather than following the rules for conversion to presentation currency in the applicable standards. In any conversion to functional currency that takes place before conversion to presentation currency, the exchange rate rules in the applicable standards are used, with the same exception noted in the preceding paragraph: exchange rate differences arising on a monetary item that forms part of a reporting entity's net investment in a foreign operation should be ignored.

Currency conversion when using the tax basis

When using the tax basis, all calculations will be done in the functional currency of the CFC. The meaning of "functional currency" is in line with the meaning under accounting standards.

Once a "functional currency" is determined, it may not be changed without notifying the Commissioner of Inland Revenue.

The choice of functional currency is restricted to prevent a currency being chosen to manipulate the active business test. There are similar (existing) restrictions on the choice of foreign currency when attributable CFC income is calculated; these were added following the discovery of schemes designed to reduce taxable income.

Other than the requirement to use the functional currency of the CFC, the normal tax rules for exchange rate conversion apply when calculating the numerator and denominator, just as if the functional currency were New Zealand dollars.

Determination of active insurance business

New section 91AAQ of the Tax Administration Act provides a facility for insurance companies with offshore insurance CFCs to apply for a Commissioner's determination. This determination can deem the insurance CFC to have passed the active business test (and thus to be treated as a non-attributing CFC under section EX 21B). A set of qualitative criteria will be used to gauge whether the insurance CFC qualifies as an active business.

This measure is necessary as most types of insurance income will be regarded as passive income even when they are earned by an active insurance business. The Commissioner's determination is intended as an interim measure until further work is done to consider the extension of the active income exemption to accommodate financial institutions.

Financial CFCs are a special case because the types of income they generate from their core business activities (interest, premiums and investment income) are the same sorts of income that can be used to shift profits out of the New Zealand tax base (passive income). The government plans to consider special rules that would extend the active income exemption to active offshore insurance and financial businesses as part of the second stage of the reforms.

THE DEFINITION OF PASSIVE INCOME FOR CONTROLLED FOREIGN COMPANIES

(Clauses 119 and 408)

Summary of proposed amendment

The amendment introduces a definition of “passive income”.

Application date

2009–10 and subsequent income years.

Key features

The proposed amendment inserts a definition of passive income (referred to in the legislation as the *attributable CFC amount*), which is central to the new CFC rules. This definition may apply, in the first instance, in the active business test to decide whether a CFC is active or passive and thus whether the CFC should be exempt from attribution. (As noted above, a CFC may calculate whether or not it is under the 5 percent active business test threshold for passive income using tax concepts – see *Measurement of passive income under the tax method*). It is primarily used when a CFC fails the active business test. If this occurs, the CFC has to attribute its passive income as defined in the legislation (unless the CFC is resident in Australia) and will be subjected to New Zealand tax on that income.

The broad categories of passive income are as follows:

- dividends;
- interest;
- royalties;
- rents;
- other passive income (income from offshore insurance businesses, life insurance policies, personal services and the disposal of revenue account property);
- certain income related to telecommunications services; and
- base company services income.

Background

New Zealand currently taxes its residents on their share of all income (active and passive) earned by CFCs as that income accrues. Under the proposed international tax reforms, active income earned by a controlled foreign company (CFC) will be exempt from New Zealand tax.

In order to apply the exemption, a definition of passive income is required. The proposed definition of passive income is intended to cover types of income which are not location-specific and which can be easily moved across jurisdictions for tax purposes. The definition is relatively limited compared to that used in other countries, as it contains several important exclusions. This is expected to make it easier to pass the active business test and should help simplify the test for most companies.

Detailed analysis

Dividends (subsection EX 20B(3)(a))

Most types of dividends received by CFCs are excluded from being passive income and are therefore exempt from New Zealand tax. This mirrors the way in which these dividends would be treated if received directly by a New Zealand company.

Dividends received by CFCs from foreign fixed-rate shares or dividends that are deductible in a foreign jurisdiction will be treated as passive income, as the non-taxation of these dividends would create risks to the tax base.

Dividends received by CFCs from non-attributing portfolio FIFs will continue to be taxed, because otherwise there would be no tax on these investments. There are no grounds to tax these portfolio investments more lightly than other portfolio investments (for which a fair dividend rate of 5 percent must be paid).

Dividends received by CFCs from New Zealand companies will also be treated as passive income to the extent that they are unimputed.

Financial arrangement income and interest (subsections EX 20B(4), EX 20B(8))

The definition of passive income includes income from financial arrangements held by a CFC. Income from a financial arrangement that is not a derivative instrument is not passive income if the financial arrangement is:

- a loan provided by the CFC to an associated active CFC in the same jurisdiction; or
- an agreement for the sale or purchase of property or services or a hire purchase agreement that is entered in the ordinary course of business by the CFC or for property or services produced or used in the CFC's business.

Income from financial arrangements that are derivative instruments is passive if the derivative instrument is held for the purpose of dealing in the derivative instrument, is not entered in the ordinary course of the CFC's business or is a hedge instrument for passive income or for a transaction that produces passive income.

Financial arrangement income is included on a gross basis – if there is income under the financial arrangement for the accounting period it is included, but if there is expenditure it is not. There is no “netting off” of expenses incurred, nor of expenditure on similar classes of financial arrangement (but note that these may be allowed as deductions under other provisions – see *Calculation of attributable income*).

Dividends on fixed rate shares issued by a foreign company are treated as financial arrangement income, and are therefore included as passive income.

Dividends that are deductible in a foreign jurisdiction are not financial arrangement income, unless they are dividends on fixed rate shares. However, they are treated as interest (see section CD 36B) and are part of passive income if received by a CFC.

Royalties (subsections EX 20B(3)(d), EX 20B(5), EX 20B(9))

The proposed rules for the treatment of royalty income balance a number of competing considerations. On the one hand, it is desirable to minimise the impact the rules will have on legitimate commercial activity. On the other hand, there is a need to protect the domestic tax base and to take account of the lack of a general capital gains tax, a distinctive feature of the New Zealand tax system.

The general rule provides that royalties (as defined in section CC 9 of the ITA 2007) are included within the definition of passive income unless they fall into one of four exceptions. These exceptions are as follows:

1. Third party active royalties

This refers to royalties received by a CFC from a third party where:

- the CFC has created, developed or added substantial value to the intellectual property;
- the CFC is regularly engaged in that activity; and
- the property does not have a prior link to New Zealand.

2. Same jurisdiction active royalties

This refers to royalties received by a CFC from a related CFC where:

- the related CFC is within the same jurisdiction as the CFC;
- the related CFC would pass the active business test; and
- the property does not have a prior link to New Zealand.

3. Related-party active royalties

This refers to royalties received by a CFC from a related CFC where:

- the CFC has created, developed or added substantial value to the intellectual property;
- the CFC is regularly engaged in that activity;
- the royalties are an arm's length amount under transfer pricing rules; and
- the property does not have a prior link to New Zealand.

4. Royalties from property owned by a New Zealand resident

This refers to royalties received by a CFC from a third party where:

- the intellectual property is owned by a New Zealand resident and licensed to the CFC; and
- it is licensed between the New Zealand owner and the CFC for an arm's length amount applying transfer pricing rules.

Explanation

Royalties are not regarded as passive income in situations where it is considered that there are genuine commercial reasons for the intellectual property to be owned by a CFC, that is, where the CFC has created, developed or added substantial value to the property. There is a further requirement that the CFC be regularly engaged in the creation or development of intellectual property to help ensure that it is located in the jurisdiction for genuine commercial reasons.

Additionally, the intellectual property should not have a prior link to New Zealand. While there may be genuine commercial reasons for transferring intellectual property offshore from New Zealand, given that intellectual property by its nature is highly mobile and can be easily transferred and held offshore, royalties relating to intellectual property that was previously connected to New Zealand are treated as passive income under the proposed rules.

Intellectual property will be considered as having a prior connection to New Zealand if it:

- was owned by a New Zealand resident, or owned by a non-resident for the purposes of a business carried on in New Zealand through a fixed establishment in New Zealand;
- was created or developed in New Zealand or to which substantial value was added in New Zealand;
- has given rise to a deduction in New Zealand for any expenditure or loss incurred in acquiring the property;
- is property that is created or developed through the extension, continuation, development or completion of activities that also resulted in knowledge that has given rise to a deduction in New Zealand for expenditure or loss incurred in acquiring the knowledge;
- is based on knowledge that has given rise to a deduction in New Zealand for expenditure or loss incurred in acquiring the knowledge and was acquired with a purpose of creating or developing the property.

However, royalties may be exempt where they are derived from intellectual property that is retained in New Zealand and licensed to a CFC, which may then sublicense the property to a third party offshore. This is because the intellectual property remains within the New Zealand tax base (and the business carried on by the CFC is assumed to be active).

There is a further “same jurisdiction” exception which is designed to ensure that the active income exemption is not clawed back when active royalties are paid to holding companies in the same jurisdiction as the CFC. The intellectual property from which the royalties are derived must not have a prior link to New Zealand in order for this exception to apply.

Rents (subsections EX 20B(3)(e), EX 20B(6))

The general rule is that rent earned by a CFC will be treated as passive income.

However, it is recognised that rent is often associated with the carrying on of an active business. For example, a CFC may be in the business of letting or it may hold property used by related CFCs for the purposes of carrying on an active business and receive rental income from those CFCs. Moreover, in practice, it can be difficult to distinguish between active and passive rental income.

Therefore rent from third parties will be treated as active income if it is derived from a lease of real or personal property in the same jurisdiction as the CFC. The principle underlying this exclusion is that there should be a nexus between the jurisdiction in which the CFC is located and the source of income (in this case, the property from which the rents are derived). This is to prevent sheltering of profits from taxation by shifting profits from the rental property either from New Zealand to a low-tax jurisdiction or another high tax jurisdiction to a low tax jurisdiction.

Additionally, rent received by a CFC from a related CFC is not included in the definition of passive income when the related CFC would pass the active business test, as long as both CFCs are resident in the same jurisdiction.

The rules above apply to rents from:

- a lease or sublease of land;
- a lease or sublease of personal property;
- a licence to use intangible property;
- a hire or bailment.

Payments under hire purchase agreements and finance leases and payments that fall within the definition of “royalty” under section CC 9 of the ITA are not considered as rent under the definition of passive income, but may be – and are likely to be in some cases – passive income under other provisions.

Other passive income

The definition of passive income includes types of income other than dividends, interest, royalties and rents. These types of income relate to:

- offshore insurance businesses;
- life insurance policies;
- personal services;
- the disposal of revenue account property.

It is necessary to treat these income categories as passive to prevent New Zealand income from being shifted offshore. Other comparable jurisdictions, such as Australia and the United States, also include these categories of income as passive under their CFC rules.

Income from offshore insurance business (subsection EX 20B(3)(f))

There are two types of insurance income: premiums from insurance contracts and investment income (change in revenue account property). Both of these are types of income are included in passive CFC income as insurance contracts can be used to shift New Zealand-sourced income offshore and CFCs can be used to hold investments on behalf of a New Zealand investor.

However, in many cases these types of income will form a core part of an active offshore insurance business. For this reason a Commissioner's determination process has been provided (see *Determination of active insurance business*) to enable active insurance CFCs to be deemed to have passed the active business test (and be treated as a non-attributing CFC). This is intended as a temporary measure until special rules are considered for extending the active income exemption to financial institutions.

Income from life insurance policies (subsection EX 20B(3)(g))

Life insurance policies are typically treated as passive assets under CFC rules that have an active/passive distinction.

Accordingly, income a CFC derives from holding a life insurance policy is treated as passive under the proposed rules. Additionally, net gains from the disposal of a life insurance policy are also passive to the extent that these policies are on revenue account.

Income from life insurance policies that are FIF interests is not treated as passive under the CFC rules, as that income is already attributed under the FIF rules. Net gains from the disposal of such interests will continue to be passive where the net gain is not taxable under the FIF rules.

Income from personal services (subsection EX 20B(3)(h))

Sections GB 27 to 29 of the Income Tax Act 2007 contain an attribution rule for income from personal services that applies domestically to ensure that individuals pay the 39% tax rate in respect of annual income exceeding \$60,000 that arises from their personal effort when they use an intermediary to shelter that income. The rule attributes income earned by an interposed entity to the individual ("working person") who provides the personal services when five criteria are met:

- The working person and the entity are associated persons.
- At least 80 percent of the entity's gross income from personal services during the tax year is derived from one buyer.
- At least 80 percent of entity's gross income from personal services during the tax year relates to services personally performed by the working person (or a relative of the person).

- The working person's net income for the tax year in which an attribution would be made is over \$60,000.
- Substantial business assets are not a necessary part of the business structure that is used to derive the income from personal services.

The domestic rule should already cover the situation where a New Zealand-resident individual provides personal services offshore through a CFC. However, the criteria above have been modified to deal with the problems that arise in the cross-border context.

The domestic attribution rule is aimed primarily at situations where an entity is interposed into a de facto employer/employee relationship between a buyer and a working person in order to avoid the 39% personal income tax rate. In the context of reformed CFC rules, the concern is that a New Zealand resident uses a CFC to avoid tax on income from personal effort. The threshold for the top rate of personal income tax and the existence of employer/employee relationship are less relevant.

Accordingly, income from personal services will be treated as passive where:

- The individual and the CFC are associated persons under section YB 5 (Company and non-corporate 25 percent interest holder) or the individual is a relative of a person associated with the CFC under section YB 5 at the time the services are performed. (The references to YB 5 will become references to YB 3 when new associated persons rules commence.)
- At least 80 percent of the CFC's gross income from personal services during the tax year relates to services personally performed by the individual (or a relative of the individual).
- Substantial business assets are not a necessary part of the business structure that is used to derive the income from personal services. (By this it is meant that, to derive the income, the CFC uses depreciable property that, at the end of the accounting period, has a total cost of more than either \$75,000 or 25 percent or more of the CFC's total assessable income from services performed in that period.)

The individual is exempt from attribution under the domestic personal services rule in certain cases, as specified under subsection GB 27(3). The only exception that is relevant in the CFC context is when the services personally performed by the individual are essential support for a product supplied by the associated entity. This is because the provision is not intended to apply to income earned from services that are provided in relation to the sale of goods by a CFC. Therefore income from personal services is not treated as passive if the services are essential support for a product supplied by the CFC.

Income from the sale of shares (subsection EX 20B(3)(i))

The general principle is that income from the sale of shares held by CFCs should have the same tax treatment as if those shares were held directly by a New Zealand company.

New Zealand generally does not tax capital gains. For this reason income from the sale of shares on capital account is excluded from CFC income. Income from the sale of shares that are on revenue account is passive CFC income, although there are some exceptions to this. Revenue account gains are disregarded when a CFC sells an interest in a FIF whose income is calculated using either the comparative value, the deemed rate of return, the fair dividend rate or the cost method. This is consistent with the way in which these gains would be treated if held directly by a New Zealand company.

Income from the disposal of revenue account property (subsection EX 20B(3)(j))

Gains from the disposal of revenue account property held by a CFC that is not used in an offshore active business will be treated as passive income.

However, this rule does not apply to income from the disposal of revenue account property if the property is a share, financial arrangement or life insurance policy, as these items are dealt with specifically in other parts of the definition of passive income.

Base company income (subsection EX 20B(3)(k))

It is not intended that the active income exemption be used to reclassify what is essentially New Zealand-sourced income as foreign-sourced income. Arrangements which interpose a CFC between a service-performing entity in New Zealand and the party purchasing the service could be used to achieve such a reclassification. The “base company” income rule is designed to prevent this.

Under the “base company” income rule, income derived by a CFC for a service that is wholly or partly performed in New Zealand is passive income of the CFC. The proposed base company rule is significantly less restrictive than the version announced for public consultation in 2007.

International telecommunications services are excluded from the base company income rule because of the difficulty of determining where a telecommunications service is performed, and because international telecommunications services have a logical connection with at least two jurisdictions.

Income from telecommunications services (subsections EX 20B(3)(l)–(m))

Certain income from telecommunications services is passive income.

Income from the use of a telecommunications asset outside any country

Income derived from the use of a telecommunications asset that is wholly or partly located outside any country will be passive income. Such income shares with other types of passive income the characteristic that it can be assigned to an arbitrary jurisdiction.

This rule will only apply if the asset is owned by the CFC or an associate, and that where only part of the asset is located outside any country, apportionment will be required.

Assets that would be subject to the new rule include (but are not limited to) telecommunications cables, satellites, and associated plant, equipment and facilities. It is not intended that a cellphone handset or transmitting equipment located on board a ship or aircraft would be subject to the rules.

The types of income that would be derived from the use of a telecommunications asset include (but are not limited to) income from the transmission of telecommunications data using the asset; the lease of the asset; and the license or sale of rights – whether direct or indirect – to use the asset.

Income when telecommunications services performed in New Zealand

Income from the provision of telecommunications services is excluded from the application of the base company income rule if the CFC or a person holding a 50 percent or greater interest in the CFC is a network operator for the purposes of the Telecommunications (Interception Capability) Act 2004. This means that, in general, income from providing telecommunications services will not be passive income even if some of the service is performed in New Zealand.

However, the income will still be passive income if the service is not the delivery of telecommunications traffic from the CFC's jurisdiction to New Zealand. This is to prevent activities being reclassified to avoid the base company rule.

The income will also be passive income, whether or not traffic is being delivered between the CFC's jurisdiction and New Zealand, to the extent that the service is performed using equipment or staff of the CFC or of an associated CFC, that are located in New Zealand. Note that the residence or "source" rules may in any event apply in this situation to tax the income derived.

Exclusions for rent, royalties and interest received from an associated CFC in the same jurisdiction

As noted in the sections above, certain rent, royalties and financial arrangement income from associated active CFCs in the same jurisdiction as the CFC is excluded from passive income.

There is a possibility that the status of the associated CFC cannot be determined, because the associated CFC itself needs to apply the same exclusions.

Example: inability to determine active status of associated CFC

CFC A and CFC B are 100 percent commonly owned and are both resident in the same jurisdiction.

When it applies the active business test, CFC A has a numerator of \$49,990 and a denominator of \$1 million, but only if it can exclude royalties of \$50,000 received from CFC B. CFC B has a numerator of \$99,980 and a denominator of \$2 million, but only if it can exclude interest of \$100,000 received from CFC A.

CFC A can only exclude the royalties if CFC B is active, and CFC B can only exclude the interest if CFC B is active, but neither CFC is active until it applies the exclusion.

To provide a resolution, when a CFC (CFC A) determines the status of an associated CFC (CFC B), it will do so without applying any of the exclusions to CFC B. That is, for this purpose only, CFC B's status is to be determined assuming that any rent, royalties or interest it receives from an associated CFC in the same jurisdiction is passive income.

In the example above, CFC A would determine that CFC B's numerator was \$199,980 and its denominator was \$2,100,000, meaning that CFC B would not be active for this purpose. CFC A would then have to recognise the \$50,000 of royalties as passive income. Similarly, CFC B would be required to recognise the \$100,000 of interest as passive income.

CALCULATION OF ATTRIBUTABLE INCOME FOR CONTROLLED FOREIGN COMPANIES

(Clauses 25, 66, 117-119, 121, 122, 191, 220, 221, 253 and 408)

Summary of proposed amendment

Several amendments concern the mechanics of calculating and attributing a CFC's income or loss to its New Zealand-resident shareholders holding non-portfolio income interests. They make changes to the rules about income and expenditure to reflect the fact that, under the new system, income derived by a CFC from the conduct of an active offshore business will no longer be subject to attribution.

Application date

The amendments will apply for 2009–10 and later income years.

Key features

The proposed amendments replace existing references to, and rules about, the branch equivalent income of a CFC with new rules about the calculation of net attributable CFC income. Net attributable CFC income is the income of a CFC that will be subject to attribution to New Zealand shareholders under the new rules. Some CFCs will not be subject to attribution on any of their income (including any net attributable CFC income).

The starting point for calculating net attributable CFC income is to determine the *attributable CFC amount*. (This term is discussed elsewhere in the commentary. In broad terms, it refers to the CFC's gross passive income plus any net income from financial arrangements. It is generally referred to in this document as "passive income".) The amount is then reduced to reflect expenditure incurred by the CFC. Generally speaking, deductions for expenditure will be allowed for these purposes only if it is incurred by the CFC in deriving an attributable amount.

Special rules apply to interest expenditure incurred by a CFC because of difficulties associated with matching debt to particular income streams. Expenditure incurred by CFCs under financial arrangements that provide funds to the CFC will be subject to apportionment. Expenditure incurred under financial arrangements that do not provide funds to the CFC, such as derivative instruments, will be either deductible or non-deductible, according to whether any income derived from the arrangement would be included as an attributable CFC amount.

Transitional rules will apply to attributed CFC net losses and foreign tax credits under subpart LK carried forward from 2008–09 and earlier years into the new rules. The effect of the transitional rules is intended to be to continue to reduce these historical amounts by reference to total CFC net income (including non-attributable income).

Background

Under existing law, the branch equivalent income or loss of a CFC is attributed to its New Zealand shareholders in proportion to their income interest in the CFC. Broadly, branch equivalent income is calculated by applying the provisions of the Act as though the CFC were New Zealand-resident, subject to certain modifications.

Similar rules will apply under the new system. Modifications are needed, however, because only a subset of a CFC's income will be subject to attribution. In addition, some CFCs will not be subject to attribution on any of their income.

Transitional rules will apply to historical losses and foreign tax credits carried forward into the new rules, on account of the fact that these historical amounts reflect a broader measure of attributable income than that which will apply under the new system.

Detailed analysis

Sections CQ 2 and DN 2 are amended, replacing references to branch equivalent income or loss with references to the narrower concept of net attributable CFC income or loss. This narrower measure of income will be the basis for attribution under the new rules. These sections are also amended to provide that attributed CFC income or loss does not arise for a taxpayer when a CFC is a non-attributing active CFC (being a CFC that satisfies the active business test) or a non-attributing Australian CFC.

New section EX 20C (*Definition of net attributable CFC income or loss*) is inserted. Net attributable CFC income or loss provides the basis for attribution to resident shareholders under the new rules, much as branch equivalent income or loss does under the existing system. Net attributable CFC income or loss is the CFC's attributable CFC amount (calculated under new section EX 20B) less the CFC's allowable expenditure.

Expenditure incurred under financial arrangements is discussed below. Other expenditure will be deductible for the purposes of calculating net attributable CFC income if it satisfies the usual criteria about deductibility under Part D of the Act, applied as if the CFC were a New Zealand resident. In addition, there must be a nexus between the expenditure and an attributable CFC amount. Accordingly, expenditure incurred by a CFC in deriving non-attributable (active) income will not be deductible, even if it would otherwise be allowed.

Expenditure incurred under financial arrangements that provide funds to the CFC will be deductible according to the proportion, by value, of the CFC's assets that produce an attributable CFC amount. Thus, a CFC that uses, say, half its assets to earn passive income will be able to set half its interest expenditure against that income when calculating net attributable CFC income.

As a backstop against structures concentrating debt in mainly passive CFCs to maximise allowable deductions, interest apportionment for CFCs that are excessively debt funded will be undertaken by reference to the assets of all the CFCs of the taxpayer under new section EX 20D (*Adjustment of fraction for excessively debt funded CFC*). A CFC will be regarded as excessively debt funded if its debt percentage is greater than 75 percent and also greater than 110 percent of the worldwide group debt percentage, under rules similar to the general interest allocation rules in subpart FE.

Transitional rules

There are transitional rules for the treatment, under the new system, of attributed CFC net losses and foreign tax credits arising under the existing (pre-2009–10) rules. As indicated in the officials' issues paper published in December 2007, the intended effect to those rules is generally to set historical losses and credits against total branch equivalent income from CFCs, rather than just passive income, consistent with the approach that obtained when these amounts were accumulated.

INTEREST ALLOCATION RULES FOR OUTBOUND INTERNATIONAL INVESTMENT

(Clauses 154-174 and 408)

Summary of proposed amendments

Amendments are made to subpart FE of the Income Tax Act 2007 to extend the existing interest allocation rules to New Zealand residents.

Application date

The proposed amendments will apply for the 2009–10 and later income years.

Key features

Interest allocation rules have been extended to New Zealand residents that have an income interest in a CFC, unless they have:

- 90 percent or more of their assets in New Zealand; or
- less than \$250,000 of interest deductions.

The interest allocation rules for New Zealand residents are integrated into the existing rules that apply to non-residents. New Zealand residents are required to apportion their interest deductions if their New Zealand group debt percentage ratio is greater than 75 percent, or 110 percent of their worldwide group debt percentage, whichever is higher.

Amendments are made to the definition of “debt” and “assets” for the purpose of calculating the New Zealand group debt percentage and the worldwide group debt percentage. Under the amended rules:

- fixed rate shares issued to New Zealand taxpayers are treated as debt and investments in CFCs are not counted as assets for the purpose of calculating the New Zealand group debt percentage; and
- the definition of debt for the worldwide group has been aligned with the definition of debt for the New Zealand group

Background

The government announced in the 2007 Budget that interest allocation rules would be an integral part of the international tax review package. These rules are intended as a base protection measure to prevent New Zealand residents with international businesses from allocating an excessive amount of their global interest costs against the New Zealand tax base.

The interest allocation rules for New Zealand residents have been designed to have an adverse impact only on businesses that have allocated excessive amounts of their global interest costs to New Zealand. New Zealand resident companies that are primarily domestic or have a small interest deduction are exempt from the rules. The rules also contain a number of safe harbours and an “on-lending” concession, which allow businesses to avoid any potential adverse impact of the rules by shifting debt to their foreign operations.

Detailed analysis

Who has to apply the interest allocation rules

Amendments have been made to extend the existing interest allocation rules to New Zealand resident companies, individuals and trustees that have an income interest in a CFC (that is, the outbound entities). However, these New Zealand residents are exempt from the rules if:

- their total New Zealand group assets are 90 percent or more of their worldwide group assets; or
- their New Zealand group’s interest deduction is less than \$250,000 and they do not have any income interest in a CFC that derives rent from land in the country or territory in which the CFC is resident.

The other safe harbours that apply to non-residents under the existing rules will also apply to the outbound entities. The outbound entities will not have to apportion their interest deductions if they have a New Zealand group debt percentage ratio that is within the 75 percent safe harbour. Outbound companies and trustees that exceed the 75 percent threshold will be further protected if their New Zealand group debt percentage ratio is less than 110 percent of their worldwide group debt percentage ratio.

Determination of New Zealand group

The outbound entities will apply the interest allocation rules on the basis of their “New Zealand group”. The New Zealand group of outbound individuals and trustees includes all associated persons who are residents in New Zealand or carrying on business in New Zealand through a fixed establishment in New Zealand or that have New Zealand source income that is taxable in New Zealand.

Outbound companies will determine their New Zealand group by reference to their New Zealand parents. New Zealand parents of outbound companies are identified by tracing ownership interests up the chain of upper-tier companies on a tier-by-tier basis. The tracing stops when no other New Zealand resident company has a 50 percent or more direct ownership interest in the company at the top of the chain. The New Zealand-resident company at the top of this chain is the New Zealand parent of the outbound companies. Ownership interests include direct and indirect ownership interests as defined in sections FE 38 to FE 41 of the Income Tax Act 2007.

The New Zealand group of an outbound company contains those companies for which control can be traced from the company's New Zealand parent company. In accordance with existing rules, the New Zealand parent can choose "more than 50 percent" or "66 percent or more" as the control threshold. "Control" is defined in section FE 27 of the Income Tax Act 2007.

Outbound individuals and trustees are not included in the New Zealand group of outbound companies. However, special rules are provided to require outbound companies or groups of companies that are owned by the same person to be included in the same New Zealand group.

Determination of worldwide groups

Outbound companies and trustees may need to determine their worldwide group to determine their worldwide group debt percentage. The worldwide group of outbound companies is made up of the companies, the companies' New Zealand group and all non-residents who are required to be included with the company in consolidated financial statements under generally accepted accounting practice. The worldwide group of outbound trustees includes the trustees, the trustees' New Zealand group and all non-residents who are required to be included with the trustees in consolidated financial statements under generally accepted accounting practice.

Measurement rules

The existing measurement rules will apply to the outbound entities for the purpose of calculating total group debt and total group assets of their New Zealand group and worldwide group. In particular, the New Zealand group debt percentage ratio can be calculated on different measurement dates (section FE 8) and different valuation bases can be used to measure total group assets (section FE 16). The on-lending concession in section FE 13 will also apply to any arm's length debt provided by the outbound entities to its CFCs.

Amendments are made to the definition of debt and assets for the purpose of calculating the New Zealand group debt percentage and the definition of debt for the purpose of calculating the worldwide group debt percentage. These amended rules will apply to the outbound entities and non-residents that are covered by the interest allocation rules:

- Fixed rate shares issued by an outbound entity and held by New Zealand residents will be treated as debt for the purpose of the amended interest allocation rules. As a result, any dividend from these fixed rate shares will also be subject to apportionment under section FE 6 of the Income Tax Act 2007.
- The definition of "total group assets" has been amended to exclude equity investments in CFCs. These investments would not be counted as New Zealand assets under the amended interest allocation rules.
- The definition of debt for the worldwide group has been aligned with the definition of debt for the New Zealand group. As such, non-interest bearing liabilities and liabilities that do not provide funds will no longer be treated as debt even if they are included as debt under generally accepted accounting practice.

Minor remedial amendments have also been made to ensure that the rules operate properly for non-residents with New Zealand-source income.

FOREIGN DIVIDEND EXEMPTION FOR COMPANIES

(Clauses 5, 6, 13, 16, 19, 30, 32, 53, 54, 55, 98, 122, 126, 132, 176-178, 184, 189, 190, 192, 195, 199, 200, 254, 273, 277, 286-288, 290-295, 299-304, 306, 316-322, 330, 332, 340, 342-348, 350, 352, 353, 361-367, 370, 373-376, 391, 392, 396, 398, 408, 409, 433, 434, 452, 468, 469, 483, 486, 487, 489, 496, 497, 500, 501, 505-507, 512, 514 and 515)

Summary of proposed amendments

The bill provides an exemption from tax when most foreign dividends are received from companies. This simplifies the taxation of foreign dividends.

Application date

The amendments will apply for 2009–10 and later income years.

Key features

Most foreign dividends will be exempt from tax when received by companies.

Dividends on fixed-rate shares and deductible dividends will be regarded as interest payments and continue to be taxed.

Dividends from non-attributing portfolio FIFs will also be taxed.

The foreign dividend exemption will not be available to qualifying companies because they will not be permitted to hold attributing interests in CFCs or non-portfolio FIFs.

BETA and FDP memorandum accounts will become unnecessary over time, and the government intends to introduce legislation at a later date to repeal them completely.

Background

Under the current rules, dividends from CFCs and non-portfolio foreign investment funds (FIFs) are taxed, but a BETA credit is provided where the income has already been taxed on accrual in order to prevent double New Zealand taxation of the same income.

Under the proposed changes, BETA credit accounts of companies will be replaced by a dividend exemption for most types of foreign dividends, and the reclassification of foreign fixed rate share and deductible dividends as interest. This prevents double-taxation of income without the need for complex apportionment accounts for companies (currently known as branch equivalent tax accounts and foreign dividend payment accounts). This allows for simplification of the international tax rules.

Detailed analysis

The bill replaces the existing taxation of foreign dividends (which allows a credit for tax paid on attributed foreign income and underlying foreign tax) with an exemption for most types of foreign dividends received by New Zealand companies.

Foreign dividend payments and the underlying foreign tax credit are being abolished – this involves repealing provisions in subparts LL and RG, and modifying other parts of the Act.

Dividends received by companies from foreign fixed-rate shares or where the dividend is deductible in a foreign jurisdiction will continue to be taxed as the non-taxation of these dividends would create opportunities for tax planning.¹

New section CD 36B redefines dividends received by companies from foreign fixed-rate shares and dividends which are deductible in a foreign jurisdiction as interest payments. This means that these payments will continue to be taxed but the CFC or (in certain cases) FIF making the payment will be allowed a deduction for the amount of the payment for New Zealand tax purposes. This eliminates the potential for double New Zealand taxation. In addition, foreign fixed rate shares will come into the financial arrangements rules, so will be effectively treated as debt for tax purposes (including interest allocation), as opposed to equity.

Dividends from non-attributing portfolio FIFs will become subject to income tax. It is appropriate to continue to tax these dividends as otherwise there would be no tax on these investments. There are no grounds to tax these portfolio investments more lightly than other portfolio investments (for which a Fair Dividend Rate of 5 percent of the share value must be paid). Section CW 9 is modified so that dividends from non-attributing portfolio FIFs become subject to income tax.

The foreign dividend exemption will not be available to qualifying companies. This is in line with existing rules, under which a qualifying company does not receive underlying foreign tax credits. This is to be achieved in the new rules by terminating the “qualifying” status of companies that hold non-portfolio interests in CFCs or FIFs.

Memorandum accounts

Numerous provisions in Part O of the Act are repealed or amended in order to limit the application of FDP accounts and company BETA accounts with debit balances. The effect of these amendments will be to prevent further BETA debits and FDP credits being generated, and to prevent BETA credits being used to reduce any liability for tax on foreign dividends.

¹ For example, fixed rate shares could be used as a loan substitute to avoid New Zealand tax on interest received from a (non-attributing) foreign firm.

Remaining credit balances in company BETA accounts will be cancelled immediately, but company BETA debit balances can be carried forward and used for a period of two years. FDP credit balances can be utilised for five years, after which any remaining FDP credits will convert to imputation credits. The transitional period for BETA debits is intended only to prevent double taxation in the rare cases in which dividends have been paid significantly in advance of attributed passive income arising. BETA debits will be applied against total branch equivalent income (not just passive income), consistent with the approach that applied when the debits were accumulated.

The government intends that legislation to finally repeal FDP and BETA accounts after the transitional period will be introduced as part of a later tax bill.

OTHER INTERNATIONAL TAX MEASURES – CHANGES TO CONDUIT TAX RELIEF AND THE GREY LIST

(Clauses 17, 25, 26, 60, 66, 67, 80, 118, 122, 124, 125, 138, 147, 175, 193, 251, 255, 269, 308-315, 354-360, 408 and 488)

Summary of proposed amendments

The bill effectively prevents further conduit tax relief arising under the conduit mechanism. The conduit mechanism currently removes income tax on income that a New Zealand company receives from its foreign direct investments to the extent that the New Zealand company is owned by non-residents.

The bill also removes the grey list tax exemption for CFC income in eight countries as this is being replaced by an active business test (see *Active business test*) and an Australian exemption.

Application date

The amendments will apply for the 2009–10 and later income years.

Key features

Sections LQ 1-LQ 4 are being repealed to prevent further conduit relief arising.

Numerous provisions in section OD and subpart FF are being repealed or amended to ensure that no new conduit tax relief (CTR) credits are generated and to remove the tax liability that arises from CTR debits.

CTR companies will be able to continue to attach CTR credits to any dividends they distribute to their non-resident shareholders, for a period of two years.

The government intends that the legislation to remove the remaining vestiges of the conduit relief mechanism after two years will be included in a future tax bill.

The current exemption for CFCs resident in eight grey list countries is removed and an exemption for a CFC resident in Australia is introduced.

The eight-country grey list for 10 percent or greater interests in FIFs will be retained for the time being, while extending the active income exemption to these entities is considered.

Background

New Zealand currently taxes New Zealand residents on their worldwide income. This includes any income earned by a foreign company that is controlled by New Zealand residents (a CFC). The only exceptions are that all income of a CFC in one of eight “grey list” countries is exempt and that “conduit” companies can get tax relief on their foreign-sourced income to the extent that they are owned by non-residents.

The grey list and conduit exemptions were intended to reduce compliance costs and provide relief in the context of a system where there was full accrual all types of foreign-sourced income. With the introduction of an active income exemption and accompanying active business test as a compliance-saving filter for CFCs with less than 5 percent passive income, CFCs will attribute only passive income. Passive income comprises those types of income which are not location-specific and which can be easily moved across jurisdictions for tax purposes. For this reason there is a much weaker argument to retain the conduit and grey list exemptions for passive income only.

Detailed analysis

Repeal of conduit tax relief

The bill effectively prevents further conduit tax relief arising under the conduit mechanism.

Conduit tax relief in its current form

The conduit rules remove income tax on income that a New Zealand company receives from its foreign direct investments to the extent that the New Zealand company is owned by non-residents. Conduit income is still subject to non-resident withholding tax when distributed by the New Zealand company to its non-resident shareholders.

The conduit rules become unnecessary for active income, since the conduit exemption is, in effect, being replaced by the active income exemption and the exemption for dividends from CFCs and FIFs. The policy arguments for relieving tax on active income do not extend to passive income. Moreover, our experience shows that tax base risks arise from conduit treatment in relation to passive income.

A major reason for introducing conduit rules was to allow a New Zealand-based subsidiary to act as the regional headquarters for subsidiaries in other jurisdictions without adverse tax consequences. This provides economic benefits to New Zealand by creating and retaining management expertise and valuable head office functions in New Zealand. The same cannot generally be said about a passive investment held by a New Zealand subsidiary.

Retaining conduit rules for passive income would expose the tax base to significant risk.

Conduit tax relief accounts

Every company that elects to become a “conduit tax relief company” must maintain a conduit tax relief credit account (CTRA). The purpose of the CTRA is to ensure that conduit tax relief is passed through to the non-resident owners of the New Zealand company. It achieves this result by tracking the amount of conduit tax relief provided to the conduit tax relief company, by way of conduit credits. A company’s conduit credit balance is reduced when the company distributes the conduit relieved income to the foreign shareholders by way of a dividend.

Consequently, a positive balance in the CTRA reflects the fact that income has been relieved from income tax but not yet been paid through to the foreign shareholders of the conduit tax relief company. That credit balance can crystallise into a current year tax liability (in whole or in part) if the New Zealand entity significantly increases its level of New Zealand shareholders. That is because it would be contrary to the policy objectives underpinning conduit for the tax relief to be accessible to New Zealand shareholders.

Submissions by taxpayers have demonstrated that the immediate cancellation of the CTR balances could, in some cases, increase taxes paid by non-resident shareholders on dividends paid out of conduit relieved income. This was not the policy intent.

Therefore CTR accounts are to be maintained for the time being to allow taxpayers to use up their existing credit balances (although no new credits or liabilities will arise).

Changes made

Sections LQ 1-LQ 4 are being repealed to prevent further conduit relief arising.

Section OD provides an account mechanism for tracking the amount of conduit relief. Numerous provisions in section OD are being repealed or amended to ensure that no new CTR credits are generated and to remove the tax liability that arises from CTR debits. The liability was an anti-avoidance measure which allows conduit relief to be clawed back in situations where a significant portion of the CTR company’s retained earnings became the property of New Zealand residents. The liability is no longer required now that companies can get no further conduit relief.

CTR companies will be able to continue to attach CTR credits to any dividends they distribute to their non-resident shareholders, for a period of two years, as removing this facility would lead, in some cases, to an unintended increase in the tax paid on distributions to non-resident shareholders.

With the removal of the liability that CTR credits represent, there may be incentives for conduit companies to build up CTR balances over the period before the application date of the new international tax rules, or to employ other means to maximise the value of cancelling the liability. To prevent this, an anti-avoidance rule will deny conduit relief and impose income tax when an arrangement has the purpose of inappropriately providing a tax benefit to New Zealand residents (section GZ 2).

The government intends that the legislation to remove the remaining vestiges of the conduit relief mechanism after two years will be included in a future tax bill.

Conduit companies that wish to remove their liabilities at an earlier stage can elect to cease being a conduit company at any time after the beginning of the 2009–10 income year, in which case their conduit credits will be cancelled at the end of the income year in which the election is made.

The conduit interest allocation rules in section FF are no longer necessary as there will be no further conduit relief – this eliminates the potential for conduit companies to erode the New Zealand tax base by funding their (exempt) offshore investments with excessive New Zealand interest deductions. Because of the introduction of an active income exemption for CFCs, the general interest allocation rules (see *Interest allocation rules for outbound international investment*) are extended to cover New Zealand residents with outbound interests in CFCs.

Replacement of grey list exemption for CFCs with active business test and Australian exemption

The bill removes the grey list tax exemption for CFC income in eight countries as this is being replaced by an active business test (see *Active business test*) and an Australian exemption.

The current grey list

The current grey list exempts the income of CFCs in eight countries from New Zealand tax on the grounds that the tax systems of those countries were broadly comparable to ours. The grey list made sense as a pragmatic mechanism for reducing compliance costs in the context of a system that otherwise taxed both active and passive income of CFCs on accrual. It does not make sense under the new rules, which provide an exemption for active CFCs in all jurisdictions, using the active business test as a filter to minimise compliance costs for businesses with less than 5 percent passive income.

Retaining a grey list would be problematic for the following key reasons:

- It would perpetuate an undesirable preference in the international tax rules for investment into traditional, high tax jurisdictions as opposed to encouraging New Zealand firms to expand into non-traditional markets.
- Ensuring the overall integrity of the grey list, to protect the domestic tax base, would require on-going monitoring of the tax systems of the listed countries.
- A grey list assumes comparable taxation of income in a listed country. This was a reasonable assumption to make when active income was taxed, but is not valid for passive income because of the differences in tax systems between countries.

The case for an Australian exemption

The removal of the grey list has raised concerns about increasing the compliance costs faced by smaller businesses looking to expand offshore. Many of these businesses could face a largely “one-off” increase in compliance costs from having to learn the new international tax rules and how to apply the active business test. In order to minimise these costs an exemption is being introduced for CFCs resident in Australia. An Australian exemption is justified for the following reasons:

- Australia is the first point of offshore expansion for most small to medium-sized enterprises – as they move beyond Australia they are likely to become increasingly sophisticated and so should more easily be able to apply the active business test.
- New Zealand has a full exchange of information with Australia and Inland Revenue has a close working relationship with the Australian Tax Office. This makes monitoring the Australian tax system more practical than for other jurisdictions.

Changes made

The current exemption for CFCs resident in eight grey list countries is replaced with an exemption for a CFC resident in Australia. This is achieved by a modification of section EX 22.

A CFC is currently ineligible for the grey list exemption if its income tax has been reduced by a concession listed in Part B of Schedule 24. This condition is retained for the new Australian exemption, but the relevant Australian concessions from Part B are now listed in section EX 22.

In addition, when the government made the decision to provide an exemption for Australian CFCs, it intended that appropriate anti-avoidance rules would apply. For the time being, this is achieved by adding a requirement that a CFC must be subject to tax in Australia in order to qualify for the exemption in EX 22.

Section EX 23, which applied when a grey list CFC had its income reduced by a Schedule 24 tax concession, is no longer required. It is expected that taxpayers with Australian CFCs that receive Australian concessions (that is, are ineligible for the section EX 22 Australian exemption) would be better off using the active business test or attributing only active income, because section EX 23 would require attributing all of the CFC's income, as opposed to just the passive amounts.

The eight country grey list for 10 percent or greater interests in FIFs will be retained until the active income exemption is extended to these entities.

Taxation of life insurance business

TAXATION OF LIFE INSURANCE BUSINESS

(Clauses 2(22), 28, 44, 50(1), 56, 68, 98(2) & (6), 140-143, 146, 149, 150, 205(1) & (2), 216(1) & (4), 217, 222, 225, 238-240, 264, 267, 268(3), 272, 273(1) & (5), 274, 278, 279(1) & (3), 283, 285, 287(1) & (4), 289, 297, 324, 330(2) & (3), 331(1) & (3), 333-335, 336(1), (2) & (4), 338, 341, 342(2), 343(1) & (4), 344(2), 353(2), 368, 369, 372, 408(6), (11), (19), (45), (75), (77), (81), (102-105), (110), (113 & 114), (126 & 127), (130), (135), (140), (148), 421(1) and 493)

Summary of proposed amendments

Significant changes are being made to the taxation of life insurance business as a result of the proposals outlined in the government discussion document *Taxation of the life insurance business: proposed new rules*, released in December 2007.

The new rules for the taxation of life insurance business are designed to introduce an integrated framework that:

- taxes life risk business on actual profits in a manner similar to the way other businesses are taxed; and
- extends the tax benefits of the portfolio investment entity (PIE) rules to all savers in life products.

Under the new rules, life insurers will be taxed on two bases: the shareholder base (representing income derived for the benefit of shareholders) and the policyholder base (representing income derived for the benefit of policyholders). Detailed provisions apply to taxing participating policy income between the shareholder and the policyholder bases.

Application date

Most of the changes affecting the taxation of life insurance business, including the benefits of the PIE rules, will apply from the life insurer's first income year, beginning on or after 1 April 2009.

The new rules also provide, at the election of the life insurer, a lead-in period for up to five years for existing term life policies sold up to 31 March 2009. Full grand-parenting applies for term life policies sold up to 31 March 2009 for single premium policies or to the extent the premiums are locked in.

Key features

The rules governing the taxation of life insurance business are being replaced with the following changes:

The taxation base

Changes to subparts CR and DR of the Income Tax Act 2007 outline the tax basis for life insurance business.

Life insurers will be taxed on two bases, a shareholder base (representing income derived for the benefit of shareholders) and a policyholder base (representing income derived for the benefit of policyholders). Subpart EY is substantially replaced with new detailed rules for apportioning amounts relating to income, expenditure or loss between the two bases.

The shareholder base will consist of:

- profits from the risk component of premiums less risk claims net of reinsurance;
- net investment income from shareholder funds;
- shareholder share of participating policy profits;
- fees from investment management and other services;
- income from annuities; and
- income determined under ordinary principles from any other sources;
- *less* risk expenses
- *plus/less* changes in risk reserves.

Ordinary provisions apply to shareholder base losses carried forward or subject to grouping, as well as to imputation credit and other remaining memorandum account balances carried forward.

The policyholder base will consist of:

- net investment income from policyholder funds; and
- policyholder share of investment income (*less* expenses) from participating policies.

Section CX 55 extends the PIE tax base benefits of non-taxation of Australasian equity trading gains to all policyholder investment income.

Excess imputation credits on the policyholder base income will convert and be carried forward as a policyholder base loss. Any policyholder base losses at the end of the income year can be carried forward without any requirement for continuity.

Sections EY 17-18 and EY 21-22 and EY 28 contain detailed rules on the allocation of income, expenditure or loss from profit-participation policies between the shareholder base and policyholder base.

Rates of tax

The shareholder base will be taxed at the prevailing corporate rate. The policyholder base will ordinarily be taxed at 30%, although life insurers will be permitted to elect to attribute investment income from investment-linked products to policyholders at their PIE marginal tax rates.

Reinsurance

Section EY 12, which deals with reinsurance, is amended. Only life reinsurance (as defined) premiums paid will be deductible from premiums paid, and life reinsurance claims received will be deductible only from claims paid by life insurers if the reinsurance contract is offered or entered into in New Zealand

Life financial reinsurance premiums will be subject to tax under the financial arrangement rules.

The new reinsurance rules will apply only to reinsurance contracts entered into for the first time on or after 1 April 2009. For contracts entered into before that date, section EZ 63 provides that the existing rules will apply for the later of the duration of the contract (without renewal) or to 31 March 2014.

Transitional rules

Sections EZ 53-63 contain a range of transitional and terminating provisions to deal with entry into the new rules

All investments held by life insurers on behalf of policyholders will be treated as sold and re-acquired at the market value on the last day of the income year prior to the life insurer being subject to the new rules (section EZ 61).

Section EZ 62 provides that what is commonly known as the life office base (LOB) tax loss, after any offsets remaining at the end of the life insurer's income year that ends on or includes 31 March 2009, can be carried forward by the life insurer for application against the shareholder base, and also by election against the policyholder base in subsequent income years (subject to a number of limitations). Any loss carried forward is subject to ordinary shareholder continuity rules.

Imputation and other remaining memorandum account balances will be carried forward into the shareholder base.

The rules in section EY 29 preserve the current tax treatment for the following term policies sold before 1 April 2009:

- for single premium policies, the current taxation rules will effectively apply for the life of the policy;
- for level premium and guaranteed premium policies, the current taxation rules will apply for the longer of five years or the period for which the premium is guaranteed; and
- for all other policies, the current taxation rules will effectively apply for five years.

If the amount of cover does not increase in the relevant year by the greater of an annual CPI adjustment and 10 percent in the amount covered, the eligibility of the life policy under the transitional rules is unaffected. The life insurer can elect out of the transitional rules for any policy.

Background

Under the current rules, life insurers are taxed on a two-tier basis. The LOB taxes the income earned for the benefit of both shareholders and policyholders of the life insurer as a whole, and consists of investments income less expenses, and underwriting income. Underwriting income comprises mortality profit, discontinuance profit and premium loading, determined by a formula set out in tax legislation that reflects the income derived from providing risk services.

Income accruing to policyholders is taxed to the life insurer on a proxy basis as policyholder income (PHB). Income is calculated by a formula to arrive at the before-tax amount necessary to provide the after-tax benefit implicit in the policy. Tax paid on the LOB generates imputation credits that can then be used to meet the PHB liability.

The current rules present the following problems:

- Individuals who save through life insurance products face a higher tax burden than other savers who invest directly or through managed funds that become PIEs. This effect may distort consumer decisions about the type of saving vehicle they use and place life insurance policies at a competitive disadvantage.
- Term insurance, which is now a major part of life insurance business, is under-taxed. The premium loading formula (which was not designed with term insurance products in mind) results in profitable term insurance business generating artificial tax losses, with, in many cases, a higher accounting profit that results in a larger tax loss. These tax benefits were unintended and cannot be justified on tax policy grounds.

The new rules ensure that life insurance business is subject to tax under the same general tax consequences as other businesses in New Zealand. The new rules ensure that tax paid by life insurers corresponds to their profitability and that life-based savings products qualify to be taxed under the PIE rules.

Detailed analysis

Overview of the new rules – sections CR 2, DR 1, DR 2 and subpart EY

The new rules create separate calculation methods for imposing a tax liability on the stakeholders who derive an economic benefit from life insurance business. These are referred to as the shareholder base (representing income net of certain reinsurance derived for the benefit of shareholders) and the policyholder base (representing income derived for the benefit of policyholders). Detailed rules apply to the taxation of participating policies. Sections DR 1(3) and DR 2(4) provide the new rules are codes for the deductions of life insurers in respect of their life insurance business. Section EY 1(2) prevents double counting of income, expenditure, or loss.

The calculation of income and tax credits received by shareholders and policyholders for each class of life insurance policies will be based, under section EY 4, on their respective share of taxable income earned by the life insurance business.

Under the new rules, ordinary principles will determine whether an asset is held on revenue account by the life insurer and whether any expenditure or loss incurred is deductible.

Treatment of the shareholder base under the new rules – sections CR 2, DR 2, EY 1, EY 3-4, EY 19-22, EY 28, EY 30, EZ 59(2), Schedule 1 Part A

The shareholder base will reflect the economic return earned and available for distribution to the equity owners of the life insurance business. It will be subject to tax at the corporate rate. The shareholder base will be an aggregation of the following elements:

- ***Risk income:*** The risk component of life insurance products (excluding annuities) will be taxed on the basis of their actual profits (premiums less claims and expenses). Premiums for traditional participating business are not treated as income under the new rules, as these are, in substance, principal amounts invested. Similarly, claims paid under these products are not deductible.
- ***Fees:*** Fee income from investment management or managing life insurance policies is treated as taxable income, whether it is explicitly charged or implicitly included in premium income (to the extent that the fees are not already included as risk income). Expenses incurred in deriving fee income are deductible.
- ***Share of participating profits:*** The net return from participating policies is shared between shareholders and policyholders. Because of the complicated nature of these products, the allocation method is discussed under the heading “participating policies”.
- ***Income earned from annuities:*** Net annuity income will continue to be effectively determined under the current basis (see sections EY 30 and EZ 53 to EZ 60) and net investment income arising from annuity premiums will be taxed at 30%. Further work to integrate the treatment of annuities within the context of the new rules for life insurance is on the tax policy work programme.
- ***Other income and expenses:*** Other income and expenses determined under ordinary tax concepts are included.

Allocation of net investment income under the new rules – sections EY 4, EY 15-16, and EY 19-20

Investment income and expenses and credits have to be allocated to either the shareholder base or policyholder base, depending on whose benefit the investment income is derived. The new rules prescribe default methods of allocation, but allow the life insurer to use a different basis of apportionment if it is “actuarially determined” and is more equitable and reasonable. It is anticipated that many life insurers would apportion in manner consistent with financial reporting where relevant.

Treatment of reserves – sections EY 23-27

To reflect the unusual cashflows connected with certain life products – for example, premiums are received upfront with large claim payments possibly occurring later, life insurers use complicated reserving methods to match revenue and expense recognition and to smooth profits.

The new rules provide for a specific treatment of these reserves. At the option of the life insurer, a reserving formula for tax called a premium smoothing reserve (PSR) can be used for:

- products which have premiums that are level (or substantially level for more than one year); or
- products which, in the view of the insurer, could result in a material mismatch in any one year between the incidence of risk and the premium payable (for the period of the mismatch).

The rules for the premium smoothing reserve are illustrated in example 1.

Products for which the life insurer does not elect to use the PSR will be treated using the unearned premium reserving (UPR) method.

Example 1: Premium smoothing reserve

LifeInsurer issues a level premium 10-year term life insurance policy for a level premium of \$852.96 per annum. The sum insured is \$500,000.

The expected claim payments each year (based on the underlying mortality table) increase every year as the probability of dying increases with age. Having a level premium means that the premium more than covers the risk (and expenses) in the early years, so some of the premium needs to be set aside to cover the higher risk in later years. By using the premium smoothing reserve, the insurer is taxed on the premium in the year which more closely resembles the actual risk for the year. It allows the insurer to set aside the excess premiums in the early years and bring them into the tax base at the time that they are being used to meet the risk.

Year	Expected premium	Expected claims	PSR at end of year	Premiums less claims	
				Without PSR	Including change in PSR
1	852.61	410.50	144.29	442.11	297.82
2	851.89	432.14	274.47	419.75	289.57
3	851.13	457.73	385.62	393.40	282.25
4	850.33	487.73	472.01	362.60	276.21
5	849.46	523.12	526.58	326.34	271.77
6	848.54	563.88	541.84	284.66	269.40
7	847.54	611.46	508.35	236.08	269.57
8	846.44	666.82	415.15	179.62	272.82
9	845.25	729.89	250.62	115.36	279.89
10	843.95	803.08	0.00	40.87	291.49

In this example the profit carrier is gross premiums

For capital guarantee products not elected to be treated as profit participation policies, transfers from reserves that support the capital guarantee from/to shareholders will be allowed as a deduction/income for shareholder income and as income/deduction to policyholder income. Deferred acquisition costs, which are expenses connected with the sale of life policies – for example, commissions, will continue to be deductible under ordinary principles.

The combined effect of the rules discussed to this point is illustrated in example 2.

Example 2: Taxation of term-risk life business under the new rules

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Premiums	1,500	1,500	1,500	1,500	1,500	7,500
Claims	-870	-780	-960	-890	-900	-4,400
Acquisition expenses	-700					-700
Renewal expenses	-200	-200	-200	-200	-200	-1,000
+/- Reserves	-300	250	100	-100	-125	-175
Taxable income	-570	770	440	310	275	1,225
Tax @30%	-171	231	132	93	83	368

- The premiums are for pure-risk policies and so are taxable for the full cash amount when received. Any UPR or PSR is included in the reserves calculation.
- Deductions are allowed for pure-risk policies. Any outstanding claims reserve (OCR) is included in the reserves calculation.
- Acquisition costs are deductible upfront. Renewal expenses are deducted as incurred.

Treatment of the policyholder base under the new rules – sections CR 1, CX 55, DB 23, DR 1, EY 1-2, EY 4, EY 15-18, Schedule 1 Part A

The policyholder base will consist of investment income earned on behalf of policyholders, less expenses. The PIE rules currently exclude realised New Zealand and listed Australian equity gains from tax. The amendments in this bill extend this benefit to policyholders in all life insurance savings products. Under the new rules, life insurers can also elect to attribute income in investment-linked products to policyholders at their individual PIE rates); otherwise the income is taxed at 30%. The policyholder base can carry forward unused tax losses but these will not be subject to any continuity rules.

Policyholder net taxable investment income cannot be offset with losses or credits from the shareholder base, except in the case of transitional losses, which is discussed later.

Participating policies under the new rules – sections EY 17-18, EY 21-22, EY 28 and YA 1

Specific rules deal with the treatment of income and expenditure arising from “profit participation policy” (as defined) business. A typical profit participation policy involves a group of members (policyholders) who pool their money together, generate income, self-insure (possibly with some outside reinsurance) and periodically formally increase their vested entitlement to the pool, usually by way of bonus allocations. Expenses associated with running the pool are met from within the pool.

A manager (the shareholder) provides all the services associated with running the pool and may underwrite some of the risks of the pool. The manager is rewarded for carrying out its functions and bearing the risks by periodically transferring money from the pool. Typically, the reward is linked to the vesting of the increases in the entitlements for the members.

The new rules are designed on the principle that net investment income should be taxable but that policyholders should not be taxed on any other sources of gains when they are derived by policyholders trading among themselves. Therefore apportionment of investment income between policyholders and shareholders recognises that part of the investment income is connected with policy liabilities (regarded as belonging to the policyholders) and part is connected with the existing surpluses (regarded as a source of future bonuses).

Under the new rules, investment income less all participating pool expenses will be taxed to both policyholders and shareholders in the proportion in which they are eventually allocated.

Any excess of premiums and claims may include bonus loading and mortality and discontinuance profits. Shareholders’ share of the excess is treated as profit and included in shareholder base income. Policyholders, however, will not be taxed on the excess as it effectively comprises reallocations of their own contributions from after tax income.

Imputation and other credits will be apportioned between the shareholders and policyholders bases using the same ratio. Example 3 illustrates how the new rules will apply to participating policies.

Example 3: Taxation of participating life business

LifeInsurer has a profit participation policy (called here a “with profit pool”) block of business. The portion of the insurer’s investment assets which are apportioned to that business can be readily identified, as can the proportion of each asset type. This enables the determination of investment returns which are attributable to the pool and also the determination of the taxable investment income under both ordinary rules and as modified by the PIE rules. The insurer has a documented policy of transferring to the shareholder’s account 25 percent of the present value of bonus additions to policies which are declared from time to time.

The relevant data for the year for the pool are:

	\$m
Market value of the with profit pool assets at the start of the year – F(0)	82.365
Policy liabilities at the start of the year – L(0)	49.326
Taxable investment income under ordinary rules – Is	5.066
Taxable investment income under PIE rules– Ipie	4.053
Expenses attributed to the with profits pool – E	0.609
Valuation premiums expected in the year, net of reinsurance – P’	3.599
Actual premiums brought into account in the year, net of reinsurance – P	8.117
Death and maturity claims expected in the year, net of reinsurance – C’	0.605
Actual death, maturity, and surrender claims in the year, net of reinsurance – C	3.370
Expected policy liabilities at the end of the year – L’(1)	54.103
Actual policy liabilities at the end of the year – L(1)	51.384
Market value of the with profit pool assets at the end of the year, before payment of tax and shareholder transfer – F(0)	91.569

The average value of the assets over the year = $(82.365+91.569)/2 = 86.967$

The average policy liabilities over the year = $(49.326+51.384)/2 = 50.355$

The proportion of the pool attributed to policy liabilities (p) = $50.355/86.967 = 0.5790$

The with profit gate (g) = 0.25

Policyholder base

$$\begin{aligned}
 \text{Policyholder investment income} &= I_{pie}x(1+pxg)/(1+g) \\
 &= 4.053x(1+0.5790x0.25)/(1+0.25) \\
 &= 4.053x1.14475/1.25 \\
 &= 3.712 \\
 \text{Policyholder expenses} &= Ex(1+pxg)/(1+g) \\
 &= 0.609x1.14475/1.125 \\
 &= 0.558 \\
 \text{Policyholder taxable income} &= 3.712 + 0.558 \\
 &= 3.154
 \end{aligned}$$

Shareholder base

$$\begin{aligned}
 \text{Shareholder investment income} &= Isx(1-p)xg/(1+g) \\
 &= 5.066x(1-0.5790)x0.25/(1+0.25) \\
 &= 5.066x0.4210x0.20 \\
 &= 0.427 \\
 \text{Shareholder expenses} &= 609x0.4210x0.20 \\
 &= 0.051 \\
 \text{Shareholder minimum income} &= 0.427 - 0.051 \\
 &= 0.376 \\
 \text{Other profit (OP)} &= (P-P') - (C-C') + L'(1) - L(1) \\
 &= (8.117-3.599)-(3.370-0.605)+54.103-51.384 \\
 &= 4.518-2.765+2.719 \\
 &= 4.472 \\
 \text{Shareholder other income} &= OPxg/(1+g) \\
 &= 4.472x0.20 \\
 &= 0.894 \\
 \text{Shareholder taxable income} &= 0.376 + 0.894 \\
 &= 1.270
 \end{aligned}$$

Life reinsurance – sections EW 5(8), EY 12 and EZ 63

The definition of “life insurance” includes reinsurance. Reinsurance is a way by which insurers manage risks. These risks include underwriting risk, timing risk (in settling claims), investment risk (low return or asset defaults), expense risk (higher than expected expenses) and credit risk (risk that the reinsurer will default on its payments). By reinsuring, the risk is transferred from one insurer to another. A transfer of premiums will also occur, proportionate to the risk being transferred.

“Life reinsurance” premiums will be deductible from premiums and reinsurance claims will be deductible from claims paid when the reinsurance policies are offered or entered into in New Zealand.

Table 1 shows the effect of reinsurance transactions on a life insurer’s taxable income.

TABLE 1: EFFECT OF REINSURANCE ON TAXABLE INCOME

Transactions	Gross income
Reinsurance commissions of \$500,000 received under a contract of reinsurance. The total amount relates to the risk components of the claims paid.	+500,000
Life insurance premium paid under a contract of reinsurance of \$1,500,000.	-\$1,500,000
\$600,000 received under a profit sharing arrangement in relation to a contract of reinsurance.	+600,000
\$300,000 recovered as a refund of premiums paid under a contract of reinsurance.	+300,000

“Life reinsurance” is defined in section EY 12(1) and does not include a contract that secures against a “financial risk” unless, in the contract, the risk is incidental to securing against life risk or is or is part of tax avoidance arrangement.

Section EZ 63 provides that premiums for a reinsurance contract that is life financial reinsurance will be non-deductible to the life insurer, and the investment income is brought to tax by the life insurer under the financial arrangement rules.

The new rules regarding life reinsurance will not apply to existing reinsurance contracts for five years or longer (if the contract period extends as far).

Provisional tax

Life insurers will be subject to tax on the basis of the shareholder base and the policyholder base, as illustrated in example 4. Life insurers will be subject to provisional tax on the aggregate amount calculated.

Tax paid on the shareholder base will generate imputation credits but tax paid on the policyholder base will not (section OB 4(3)(c)). Imputation credits attached to dividends received by the life insurer will generate a credit to the ICA when received. However, an end-of-year adjustment will be required on the life insurer's balance date to debit received credits which have been allocated to the policyholder base (section OB 47).

Example 4: Provisional tax payments

A life insurer has a 30 June balance date. Provisional tax payments for tax are due on 28 November, 28 March, and 28 July. It has profit participation policies and estimates its provisional tax by allocating 90 percent of its expected investment income to the policyholder base.

Date	Provisional tax payments		ICA	
	Shareholder	Policyholder	Dr	Cr
28 November 2008	200	2,000		200
28 March 2009	200	2,000		200
28 July 2009	200	2,000		200
Total at 28 July 2009	600	6,000	0	600

The company calculates its tax liabilities for the year ended 30 June 2009. It finds its liability for shareholder tax was actually \$540 and its liability for policyholder tax was actually \$7,000. The imputation credit account should be adjusted to reflect payments made on the correct tax bases.

Date	Provisional tax payments		ICA	
	Shareholder	Policyholder	Dr	Cr
28 November 2008	200	2,000		200
Adjustment	(20)	20		(20)
28 March 2009	200	2,000		200
Adjustment	(20)	20		(20)
28 July 2009	200	2,000		200
Adjustment	(20)	20		(20)
Total at 28 July 2009	540	6,060	0	540

On 28 July the company has a net ICA balance of \$540. It still has a terminal tax liability of \$940, which it should pay as soon as possible to stop interest accruing.

Non-resident life insurers – section EY 48

Section EY 48 incorporates the new taxation framework for life insurance business in connection with life insurance policies that are offered in New Zealand and life reinsurance policies connected with New Zealand life insurance policies.

Actuarial advice and guidance, “actuarially determined” and “best estimate assumptions” – sections EY 6 and YA 1

A large part of the calculation and apportionment of amounts required by subpart EY, particularly in connection with reserves, require the use of actuarial determinations and judgement – provided by the definition “actuarially determined”. A new definition of “best estimate assumptions” is also inserted to provide that such judgements are consistent with professional actuarial judgement and that the assumptions underlying such judgements are not deliberately overstated or understated.

Section EY 6 allows Inland Revenue to seek the advice of the Government Actuary or any other actuary on matters that are required to be actuarially determined under the new rules.

Memorandum account balances – sections LA 8B, LE 2(1), LE 2B, LE 3, OB 3B, OB 32, OB 35B, OB 47, OC 2B, OC 6, OC 20, OP 30, OP 33B, OP 44, OP 74 and OZ 18

ICA and other memorandum account balances will need to be maintained for the shareholder base. Credits will be apportioned to shareholder and policyholder income as illustrated in example 5. Ordinary imputation credit rules will apply. Imputation and withholding payment credit account balances held by the life insurer will be carried forward to the shareholder base credit accounts provided ordinary continuity rules are met.

The current rules for policyholder credit accounts are repealed. Any balance remaining in the policyholder credit account after satisfying the tax liability under the current rules will be automatically transferred back as at year end to the life insurer’s ICA.

Imputation credits attached to dividends received during the year are credited to the ICA on the dates the dividends are paid to the company. The credits must be apportioned between the shareholder base and the policyholder base. Only credits apportioned to a particular category of income may be credited against tax on that income – see new section OB 3B. In addition, on the 31 March following the end of the income year, the ICA must be debited by the amount of imputation credits received that were apportioned to the policyholder base.

Other definitions – section YA 1

New definitions are provided for terms that are not defined elsewhere in subpart EY. These terms include “asset base”, “life risk”, “policyholder base”, “present value”, “profit participation policy”, “savings product policy”, “shareholder base”, and “surrender value”. A number of definitions related to the current life rules are repealed.

Example 5: Imputation credits

Following on from example 4, assume that in addition to making the provisional tax payments the life insurer received \$5,000 in imputation credits attached to dividend in its income year ended 30 June 2009. It's ICA balance at 28 July 2009 would be \$5,540.

In calculating its tax liabilities, the company determines how much of the received imputation credits are apportioned to policyholder income. If we assume that:

- for the year the net asset value of the participating fund was \$240,000; and
- the average value of policyholder liabilities for the year was \$144,000; and
- the portion of declared bonus for the year which is payable to the shareholders is 25 percent; then

the amount of imputation credits apportioned to the policyholders is:

$$\frac{\$5,000 \times (1 + .6 \times .25)}{1 + .25}$$

Which is \$4,600.

To reflect this in the ICA, on the last day of the income year (30 June 2009) the ICA of the company must be debited by \$4,600.

General transition issues

Deemed sale – section EZ 61

The current life insurance tax rules provide that investment income in one base the LOB is calculated under ordinary rules, meaning that trading gains and losses are recognised when they are realised. However, under the other base (the PHB) they are based on reserve calculations that have the effect of recognising the change in value of investments on an unrealised basis. This could cause timing differences in income recognition between the two bases.

To remove this timing difference, the new rules provide that investments taken into account in determining the policyholder reserves for the policyholder base calculation will be treated as having been sold and re-acquired at market value on entry into the new rules.

Tax losses – sections EZ 62, IT 1 and IT 2

Under the current rules, the two different bases (LOB and PHB) may have their own losses carried forward. The LOB loss is the correct amount to carry forward into the new tax rules as it better reflects the income of the entire life insurance business rather than the PHB.

The new rules allow the LOB loss that exists at the end of the income year ending 31 March 2009 to be available for carry-forward and allocated as a shareholder base loss in the new rules. This loss can be offset with the life insurers income (including by way of election, policyholder base income subject to limitations discussed below) and group company losses, subject to ordinary continuity and grouping rules.

Section EZ 62 effectively provides on an annual basis that the LOB loss carried forward must be first applied against shareholder base income, but if there is still LOB available the excess can be elected to be offset against policyholder base income. The amount that can be offset is the least of:

- the LOB available for offset;
- the PHB loss cancelled less any LOB utilised by the policyholder base; or
- the policyholder base income.

Other balances held by the life insurer or a consolidated group to which it belongs can also be carried forward to be applied against the shareholder base, provided, where relevant, ordinary continuity rules are met.

Term life products sold up to 31 March 2009 – section EY 29

Term life insurance policies sold before 1 April 2009 will be, at the election of the life insurer, subject to transitional rules for a period of up to five years. If the policy is a single premium, level premium or guaranteed premium, it can be grand-parented for the life of the policy or for the period for which the premium is guaranteed. Life insurers can elect out of transitional rules at any time.

Grand-parenting would not be affected in situations when the amount of insured cover does not increase by an amount up to the greater of an annual CPI adjustment or 10 percent of the prior year's amount. Table 2 illustrates the effects of the transition rules.

The rules applying to profit participation policies and other savings policies apply from the first income year beginning on or after 1 April 2009.

TABLE 2: SUMMARY DESCRIPTION OF THE TRANSITIONAL RULES

Product	Sold before 1 April 2009	Sold between 1 April 2009 and application date
<i>Level term</i>	Grand-parented for duration of policy.	Current tax rules then subject to the new rules from application date.
<i>Guaranteed premium</i>	Grand-parented for the greater of duration of guaranteed period or five income years.	Current tax rules then subject to the new rules from application date.
<i>Annual renewable term</i>	Grand-parented for up to five income years from application.	Current tax rules then subject to the new rules from application date.
<i>Single premium</i>	Grand-parented for duration of policy.	Current tax rules then subject to the new rules from application date.
<i>Traditional products and savings policies</i>	New rules apply from the beginning of the first income year after 1 April 2009.	Current tax rules then subject to the new rules from application date.

Note: Life insurers can elect out of the transitional rules for any product at any time.

General

A number of consequential amendments to the Income Tax Act 2007 and the Tax Administration Act 1994 arise from the repeal of the current PHB and policyholder credit account.

Tax treatment of relocation payments and overtime meal allowances

TAX TREATMENT OF RELOCATION PAYMENTS AND OVERTIME MEAL ALLOWANCES

(Clauses 34, 35, 42, 485, 545, 547-549, 616, 617 and 619)

Summary of proposed amendments

Amendments to the Income Tax Acts 1994, 2004 and 2007 specifically ensure that payments by employers when relocating their employees, and providing them with overtime meal allowances are exempt from income tax and fringe benefit tax if certain criteria are met. These changes were signalled in an officials' issues paper released in November 2007, and are designed to remove uncertainty about whether and when these payments are tax-free.

Application date

The amendments will apply from the 2002–03 income year.

Key features

Relocation payments

For these payments to be tax-free, all of the following criteria must be met:

- The employee's relocation must be as a result of:
 - taking up employment with a new employer;
 - taking up new duties at a new location with their existing employer; or
 - continuing in their current position, but at a new location.
- The employee's existing home must not be within reasonable travelling distance of the new workplace (unless accommodation is provided as an integral part of the job).
- The expense must be on the proposed list of eligible relocation expenses.
- The payment must reflect the expenditure incurred.
- The expenditure must be incurred within certain time limits.

Tax has been paid on some past relocation payments. Because the legislative changes are being backdated, some employers and employees may be entitled to tax credits. Employers, rather than employees, will receive the tax credits that arise in relation to past relocation payments that were subject to PAYE deductions if the employer has grossed up a payment to reflect the tax liability.

Overtime meal payments and allowances

For these payments to be tax-free, all of the following criteria must be met:

- Either the employee's employment contract must specify that the employee is eligible for a payment in relation to overtime hours worked, or an employer must have a policy or practice of paying an overtime meal allowance.
- The allowance must reflect the actual expenditure incurred by the employee or, alternatively, be a reasonable estimate of the expected costs likely to be incurred by the employee or group of employees.

A specific definition of "overtime" is proposed.

Background

Over recent years there has been uncertainty over the tax treatment of employer payments for relocations and overtime meals, and whether these payments should be considered as income of the employees who receive them. For many years these two types of payment have been generally treated as non-taxable by both taxpayers and Inland Revenue. Developments over time have, however, complicated the situation.

Before 1995, taxpayers required approval from Inland Revenue if a particular payment was to be treated as non-taxable but since then, taxpayers have self-assessed whether a payment is taxable or non-taxable.

In November 2007, Inland Revenue attempted to identify more generally the circumstances under current tax law, including case law, when amounts paid by employers in relation to employee-related expenses would be exempt from income tax. These circumstances were outlined in draft Interpretation Guideline (IG03162), which was released for public comment on 24 October 2007. The Interpretation Guideline specifically focused on those situations covered by section CW 13 of the Income Tax Act 2004. Following public comment, this guideline is likely to be finalised in the near future.

The draft guideline concluded that the following three criteria must be met²:

- the employee was performing an obligation under the contract of service at the time the expenditure was incurred;
- the obligation served the purpose of the income-earning process of deriving income from employment; and
- the expenditure incurred by the employee was necessary as a practical requirement of the performance of the obligation.

² The criteria would not apply to payments that already have their own rules in legislation; for example, the rules relating to reimbursement of additional transport costs are already set out in section CW 14 of the Income Tax Act 2004 (and section CW 18 of the Income Tax Act 2007).

Apart from relocations, application of these criteria also has implications for overtime meal allowances as these would be taxable under those criteria, whereas traditionally, in practice, they have been treated as non-taxable.

In response to these developments, the government decided it would introduce amendments to the Income Tax Act to ensure that these payments are exempt from income tax and, where relevant, fringe benefit tax, subject to clear limitations to prevent their use for purposes of salary substitution. This was announced in a joint media statement released by the Minister of Finance and the Minister of Revenue on 24 October 2007.

There are several reasons why these two employer payments should be non-taxable:

- The element of private benefit involved is considered to be small.
- The degree of private benefit is hard to measure.
- There is relatively little risk of recharacterisation of taxable salary and wages as non-taxable payments for relocation or as overtime meal allowances.

The changes will also help employers and employees to make efficient employee relocation decisions by ensuring that tax considerations do not distort their decisions. This is particularly important given the mobility of skilled labour.

To further reduce uncertainty, the government announced that the changes should apply to payments made over the past four years, as well as to future payments. By statute, Inland Revenue is generally unable to re-assess an income tax liability beyond four years.

The changes were outlined in detail in the officials' issues paper, *Tax-free relocation payments and overtime meal allowances*.

Detailed analysis

What payments are covered

The changes focus on employer payments that cover the costs that employees have incurred as part of carrying out their employment obligations. The circumstances in which such payments are considered tax-free have been traditionally covered by section CW 17 of the Income Tax Act 2007 and its predecessors, section CW 13 of the Income Tax Act 2004 and subsection CB 12(1) of the Income Tax Act 1994.

The payments may be made in several ways. Employers may directly pay an account that is in the name of an employee. Alternatively, employees might seek reimbursement of an amount they have already paid, or the employer might provide them with an allowance to cover the estimated costs they are expecting to incur. The legislative changes cover all these situations.

These situations differ from those covered by the fringe benefit tax rules, although ideally the outcomes should be similar. Accordingly, some changes are also being made to the fringe benefit tax rules.

What legislation needs to be amended?

Because the changes are being back-dated to the 2002–03 income year, the changes will be replicated in the three income tax acts that cover the period:

- the Income Tax Act 1994, which applied up to and including the 2004–05 income years;
- the Income Tax Act 2004, which applied for the 2005–06 to 2007–08 income years; and
- the Income Tax Act 2007, which came into force from 1 April 2008, with application generally from the 2008–09 income year.

However, for the purposes of the discussion below on individual section changes, we refer only to the 2007 Act unless otherwise stated. Although the wording changes to the other two Acts may differ because of the language used in those Acts, the changes are intended to have the same effect as those in the 2007 Act.

Relocation payments

New subsection CW 17B(1) provides the specific income tax exemption for payments that cover expenses in connection with a “work-related relocation”, with new subsection CW 17(4) making it clear that the more general provisions set out in section CW 17 do not apply to amounts covered by new section CW 17B.

An equivalent change is being made to section CX 19 to cover any fringe benefits that arise from a work-related relocation.

This means that provided the various requirements are met, the relocation payment will be exempt from income tax and fringe benefit tax, irrespective of how the employer makes the payment.

Requirements

Subsection CW 17B(2) requires that the amount paid must be no more than the actual eligible relocation expenses that the employee incurs from the work-related relocation. To be an eligible expense, it must be one of those listed in a determination issued by the Commissioner of Inland Revenue. Subsection CW 17B(6), in conjunction with new section 91AAR of the Tax Administration Act, enables the Commissioner of Inland Revenue to issue such determinations.

Although the draft legislation refers to actual expenses, the definition is sufficiently wide to allow employers to provide an advance to an employee in anticipation of relocation expenditure being incurred, provided there is ultimately a square-up. Estimates of costs will not be allowed, on the basis that it is not unreasonable to expect employees and employers to keep track and provide evidence of actual expenditure given the relatively small number of employees involved and the magnitude of the costs associated with a relocation.

Subsection CW 17B(3) places a time limit on when the expenses must be incurred, which is within the period starting from the income year in which the employee relocates or undertakes work in the new location up to the end of the next income year. Although the requirements in general do not distinguish between temporary and permanent relocations, some flexibility is provided when a temporary secondment becomes permanent. The temporary move would be ignored for the purposes of determining when the time limit period began if the temporary move had not been already claimed as a work-related relocation.

Subsection CW 17B(4) defines what is meant by “work-related relocation”. Under this provision, relocation must be as a result of an employee:

- taking up new employment with a new employer;
- taking up new duties at a new location with the existing employer; or
- continuing in their current position, but at a new location.

Furthermore, the relocation of the employee’s residence must be necessary to carry out the job. If the employee could have commuted to the new job from an existing residence there would appear to be a clear monetary private benefit involved when the employer pays for the relocation costs, and, in principle, this should be taxable. The specific legislative test is that the employee’s existing residence must not be within reasonable daily travelling distance of the new workplace (the distance test). Guidelines on what is meant by “reasonable travelling distance” will be provided separately. For example, traffic density could be a factor in limiting the distance that could be reasonably travelled.

Subsection CW 17B(5) provides an exemption from the distance test when a person’s accommodation forms an integral part of their work. This exemption recognises that some employees may be provided with a house as a necessary part of their job and that when they are required as part of that job to move to a new location, their residence automatically changes irrespective of the distance.

Overtime meal payments

New subsection CW 17C(1) provides the specific income tax exemption for overtime meal payments, with new subsection CW 17(4) making it clear that the more general provisions set out in section CW 17 do not apply to amounts covered by new section CW 17C.

The fringe benefit tax rules have not been changed. Meals provided on an employer’s premises would be exempt from fringe benefit tax. Fringe benefits arising outside of on-premises meals seem unlikely. If they do arise, they may get the benefit of subsection CX 5(3). That section states that if a benefit that an employer provides to employees in connection with their employment would have been exempt income if it had been paid in cash, the benefit is not considered to be a fringe benefit.

Subsection CW 17C(2) specifies that for the payment to be eligible for the exemption, either:

- the employee’s employment agreement must provide for pay for overtime hours worked; or
- the employer must have an established policy or practice of paying for overtime meals. (This is to cover situations when salaried staff are required to work overtime during periods of particular work pressure.)

Subsection CW 17C(3) provides that the overtime meal payment must only cover either actual expenses or a reasonable estimate of those expenses. This is similar to the options available under the more general allowances provisions in section CW 17. If actual expenses are being reimbursed, then documentation is required to verify expenditure when the meal costs more than \$20.

Subsection CW 17C(4) defines what is meant by “overtime”. This is defined as the time worked on the day beyond the person’s ordinary hours of work as set out in the employment agreement when the employee has worked more than two hours beyond his or her ordinary hours on that day.

Tax and associated adjustments

Given that the legislative changes are being backdated to the 2002–03 income year, some taxpayers will be entitled to a credit for over-paid tax if they paid tax on past qualifying payments. These adjustments will be handled through Inland Revenue’s standard administrative practices. Section 113 of the Tax Administration Act enables the Commissioner to amend the relevant assessments.

There was general agreement with the suggestion in the issues paper that employers should receive the credit for over-paid PAYE when they have grossed up the payment to compensate the employee for the tax impost. The issues paper also noted that a special legislative mechanism might be needed to achieve this. On further consideration, a special legislative mechanism is not necessary. Inland Revenue already has administrative practices in place that enable credits to be given for over-payments of PAYE. An employer can request an adjustment to a past Employer Monthly Schedule (EMS), which the Commissioner will do on the receipt of corroborating material.

Similarly, as would normally occur, employers receiving such credits should be adjusting their taxable income when they have treated the past PAYE payment as a cost of business.

Even when employers receive a credit for over-paid PAYE, employees will still be eligible for adjustments to their entitlements and liabilities that arise from readjusting their taxable income to exclude, say, a previously taxed qualifying relocation payment. These adjustments redress the fact that some employees will have received lower entitlements and had higher liabilities as a result of the payments being previously subject to income tax.

Determination

New section 91AAR of the Tax Administration Act 1994 provides some parameters around the proposed Commissioner's power to issue determinations that list the types of expenditure that qualify as eligible relocation expenses.

Subsection 91AAR(3), for example, sets out the factors that the Commissioner may take into account when considering whether a type of expenditure necessarily arises from a relocation of an employee rather than being costs that would have been incurred gradually over time, irrespective of whether an employee had relocated. In this regard, factors that may be borne in mind are whether the expenditure is really a substitute for salary and wages, whether employers generally treat the expenses as relocation expenses and the difficulty and costs of measuring any private benefit element.

Subsection 91AAR(4) provides for a determination to be altered, subject to the Commissioner giving at least 30 days notice of the implementation date of any change.

A person affected by a determination may challenge the determination under Parts 4A (disputes procedures) and 8A (challenges) of the Tax Administration Act (see new subsection 91AAR(5)).

Payroll giving

PAYROLL GIVING

(Clauses 232, 233, 235, 236, 379, 384, 402, 403, 408(23), 408(38), 408(89), 408(99), 442(1) & (3), 443, 447, 458 and 504)

Summary of proposed amendments

The bill introduces a voluntary payroll giving scheme that will allow employees to make regular payroll donations from their pay to charitable organisations of their choice. It will also enable employees to receive the tax benefit of their payroll donations each payday, in real-time, without the need to have donation receipts. People who make donations other than through payroll giving will continue to claim the charitable donation tax credit at the end of the tax year.

The proposed payroll giving scheme results from options canvassed in the government's November 2007 discussion document, *Payroll giving: providing a real-time benefit for charitable giving*.

Application date

The changes will apply from 1 April 2009.

Key features

The rules relating to payroll giving are largely contained in new sections LD 4 to LD 7 of the Income Tax Act 2007 and in new section 24Q of the Tax Administration Act 1994. The key features of the system are:

- Participation in payroll giving will be voluntary for employers and employees.
- Payroll giving is available only to employees whose employers file their employer monthly schedules electronically.
- Employees who choose to make payroll donations will receive a tax credit on the amount of those donations each payday. The tax credit is calculated on a set rate of 33 $\frac{1}{3}$ percent of the donation made.
- The tax credit is offset against the PAYE calculated on the employee's gross pay, thereby reducing the amount of PAYE payable for that period. The maximum tax credit permitted is limited to the employee's PAYE deduction on the salary or wages each pay period.
- Payroll donations must be made to a society, institution, association, organisation, trust or fund as described in section LD 3(2) of the Income Tax Act 2007 or listed in Schedule 32. Employers are responsible for ensuring that payroll donations are transferred to those organisations.
- Any payroll donations must be transferred within a three-month period.
- Employees who donate through payroll giving are not eligible for the end-of-year tax credit on those donations.

Example

The following example illustrates how payroll giving would operate:

The employee receives \$400 per week and makes regular contributions of \$10 each pay. The employee is on a 19.5 percent tax rate.

Employee's (donor) weekly gross pay	\$400.00
Less payroll donation	\$10.00
Employee's (donor) residual weekly pay	\$390.00
Less PAYE on \$400	\$78.23
Tax credit @ 33.3 percent	\$3.33
<hr/> Employee's net pay	<hr/> \$315.10
Charity receives	\$10.00
Inland Revenue receives	\$74.90

In this example, the employee will receive an immediate tax benefit of \$3.33 on his or her \$10 payroll donation. The employer must transfer the payroll donation to the chosen charitable or philanthropic cause, or to an intermediary, who passes on the donations to those causes, within a three-month period.

Background

In Budget 2007, the government announced plans to look at several measures aimed at laying the foundation for a stronger culture of charitable giving in New Zealand. Among those measures was the release of the November 2007 discussion document, *Payroll giving: providing a real-time benefit for charitable giving*.

Payroll giving enables employees to make regular payroll donations from their pay. The employer forwards these donations either directly to a charitable or philanthropic cause, or to an intermediary, who passes on the donations to those causes.

The discussion document canvassed two options for delivering tax relief on payroll donations through a before-tax payroll-giving scheme, and possible measures for supporting employers who choose to offer payroll giving to their employees. The discussion document proposed that any payroll-giving scheme introduced in New Zealand should be voluntary for employers and employees.

Two options were put forward in the discussion document for delivering tax relief through payroll giving – “the tax deduction mechanism” and “the PAYE credit mechanism” (on which the scheme of payroll giving is based).

Under the tax deduction mechanism, donations would be deducted from an employee's gross pay. This would reduce the employee's taxable income and, as a result, alter the employee's social policy entitlements and obligations. PAYE would be levied on the net amount. An immediate tax benefit would be received by way of a reduction in the amount of the PAYE required to be withheld. The tax benefit would be at the employee's marginal tax rate.

Under the PAYE credit mechanism, employees would receive a PAYE credit on the amount of their donation made each payday. Employers would offset the credit against the PAYE calculated on the employee's gross pay, and the PAYE credit would be calculated on a set rate of 33⅓ percent.

The PAYE credit mechanism was preferred over the tax deduction mechanism as being more equitable in that all employees receive the same tax benefit regardless of their marginal tax rate. Furthermore, the PAYE credit mechanism does not alter the level of an employee's taxable income, and therefore does not affect the employee's social policy entitlements and obligations that use taxation income as the basis of their calculations – for example, Working for Families, student loans, child support or KiwiSaver.

Detailed analysis

The tax credit for payroll donations (new sections LD 4 and 7 of the Income Tax Act 2007 and new section 24Q of the Tax Administration Act 1994)

New section LD 4 sets out who is eligible for the tax credit for payroll donations and describes the nature of that credit.

New section LD 4(1) specifies that the tax credit will be available only to employees whose employers file their employer monthly schedules electronically. The employee will have to choose to make a payroll donation in the pay period in which the employer monthly schedule relates to.

New section LD 4(2) calculates the amount of the tax credit according to the following formula:

$$\text{Total donations} \times 33\frac{1}{3}$$

New section LD 4(3) defines “total donations” as the total amount of all payroll donations made by the employee in the pay period.

New section LD 4(4) limits the tax credit to the amount of the employee's PAYE income payment for the period in which the donation was made.

New section LD 4(5) states that the tax credit is a non-refundable tax credit to which section LA 4(1) applies. Section LA 4(1) determines the order in which tax credits are to be offset against a person's income tax liability. Non-refundable tax credits are offset against a person's income tax liability before other tax credits.

New section LD 4(6) makes clear that an employee who makes a payroll donation cannot claim a refund on those donations under section 41A of the Tax Administration Act 1994.

New section LD 7 defines “payroll donation”. A payroll donation is an amount that a person asks their employer to transfer from the amount of the person's PAYE income payment (such as salary and wages) to an entity described in section LD 3(2) or is listed in Schedule 32.

Tax credit calculated incorrectly (new section LD 5)

If an employer incorrectly calculates the amount of an employee's tax credit, the credit is extinguished and the correct amount is to be included in the employee's tax credits for salary and wages under section LB 1 for the tax year in which the pay period falls.

Payroll donations transferred to ineligible recipient or not transferred (new section LD 6)

The tax credit is extinguished if an employer fails to transfer an employee's payroll donations to a chosen recipient or if the donation is not transferred to an organisation that is described in section LD 3(2) or listed in Schedule 32.

Priority of payroll donations (new section LD 7(2))

Employees may only make a payroll donation if they have satisfied any tax obligations that they may have or any other statutory requirement that they may be obliged to meet from their salary and wages.

Employer obligation

Delivery of the tax credit and payroll donations

New section RD 13B of the Income Tax Act 2007 requires employers or PAYE intermediaries to subtract the amount of the tax credit from the amount of PAYE payable for the employee for the pay period.

New section RP 14(ab) of the Income Tax Act 2007 requires employers or PAYE intermediaries to transfer any payroll donation to the relevant recipient within a three-month period.

Information requirements

New sections RP 8(a)(iii) and (iv) of the Income Tax Act 2007 require employers to record the amount of payroll donations and any tax credit for payroll donations in their employer monthly schedule.

New sections 22(2)(ed) and 22(2)(ke) of the Tax Administration Act 1994 require employers and PAYE intermediaries to keep sufficient records of the amount of any payroll donation deducted from an employee's pay to enable the Inland Revenue to determine that payroll donations have in fact been transferred to the correct recipient.

Liability for failure to transfer payroll donation

Section 141E(1)(c) of the Tax Administration Act 1994 is being amended so that an employer is liable to pay a shortfall penalty if the employer knowingly does not transfer the payroll donations to the correct recipient.

Reforming the Income Tax Act definitions of “associated persons”

REFORMING THE INCOME TAX ACT DEFINITIONS OF “ASSOCIATED PERSONS”

(Clauses 7, 10-13, 18, 40, 41, 57, 82, 120, 152, 182, 183, 186, 188, 201-203, 408, 414, 415, 431, 436, 477, 502, 503 and 624)

Summary of proposed amendments

The bill makes amendments to strengthen and rationalise the definitions of “associated persons” in the Income Tax Act 2007.

The definitions are mainly used in an anti-avoidance capacity to counter non-arm’s length transactions that could undermine the intent of the income tax legislation. There are a number of major weaknesses in the definitions and, in particular, that which applies to land sales.

The current weaknesses in the definitions pose a risk to the tax base, and the bill proposes amendments to the income tax legislation to address them. The main changes will:

- Address the weaknesses in the current definitions in relation to trusts. In particular, there will be new tests focussing on a trust’s settlor (that is, the person who provides the trust property).
- Provide more robust rules aggregating the interests of associates to prevent the tests for associating two companies and a company and an individual being circumvented by the fragmentation of interests among close associates.
- Implement a tripartite test associating two persons if they are each associated with the same third person, thereby making the associated persons tests as a whole more difficult to circumvent.

The changes are consistent with a key theme of the government’s tax policy work programme, which is ensuring that the tax system is robust.

The bill also rationalises the current income tax definition of associated persons and other income tax provisions that employ a similar concept, such as the definition of “related persons” in the dividend rules. This represents a significant simplification and makes the associated persons concept in the Income Tax Act more coherent.

Application date

The amendments will generally apply for the 2009–10 and later income years. However, for the purposes of the land provisions (as defined in section YA 1), except for section CB 11, the associated persons reforms will apply to land acquired on or after 1 April 2009. For the purposes of section CB 11 (disposal within ten years of improvement: building business), the reforms will apply to land on which improvements are begun on or after 1 April 2009. Therefore, in the case of the land provisions, the relevant date is 1 April 2009 irrespective of a person’s balance date.

Key features

The reforms generally involve replacing the definitions of associated persons in the Income Tax Act 2007 with the objective of strengthening them. The other major part of the reforms involves rationalising other income tax provisions which employ a similar concept – for example, repealing the definition of “company control” in section YC 1.

The tests of association in the new associated persons definition in subpart YB are as follows:

- two companies;
- a company and a person other than a company;
- two relatives;
- a person and a trustee for relative;
- a trustee and a beneficiary;
- trustees with a common settlor;
- a trustee and a settlor;
- a settlor and a beneficiary;
- a trustee and a person with the power of appointment or removal of the trustee;
- a partnership and a partner;
- a partnership and an associate of a partner; and
- two person who are each associated with the same third person (tripartite test).

A number of modifications will apply to these tests for the purposes of the land provisions so they cover situations under the effective control of property dealers, developers and builders, but do not apply to other situations. These modifications include ensuring that the beneficiary-based associated persons tests – the trustee-beneficiary and settlor-beneficiary tests – do not apply in the case of land sales. It is not necessary to apply these tests to catch the type of structures being used to circumvent the land sale tax rules; the structures causing concern can be caught by the other new tests – in particular, the settlor-based trust and tripartite tests.

The tripartite test, which associates two persons if they are each associated with the third person, will contain a number of modifications to ensure that it does not apply more widely than is necessary to protect the tax base. For example, partners in a partnership will not be automatically associated under the tripartite test unless they are separately associated with each other under another test such as that for relatives.

Other modifications designed to ensure that the associated persons definitions do not apply more widely than is desirable are:

- The test for associating relatives will extend to two degrees of relationship only, instead of four degrees as it does currently in the general associated persons definition.

- The definition of “settlor” that applies for the purposes of the associated persons tests will not include a person who provides services to a trust for less than market value.

The income tax rules for dividends and fringe benefits will be amended by replacing their current associated persons tests with rules providing that:

- If a company transfers value to a person and the transfer is caused by a shareholding in the company, the company has paid a dividend regardless of whether the recipient of the benefit is a shareholder.
- If an employer provides a benefit because of an employment relationship, the employer has provided a fringe benefit subject to fringe benefit tax regardless of whether the recipient of the benefit is an employee.

These reforms to the dividend and fringe benefit tax rules are considered a conceptually better approach to determining what should be subject to dividend taxation and fringe benefit taxation than the current associated persons rules.

Background

The associated persons definitions are used extensively in the Income Tax Act 2007 to determine whether persons are associated for the purposes of operative provisions in the Act. These operative provisions are often of an anti-avoidance nature, and recognise that transactions between related parties are more likely to be non-arm’s length than transactions between independent parties. These operative provisions mainly counter the non-arm’s length actions of associates by imputing the status or actions of an associated person to the taxpayer or requiring market value to be used.

The most important application of the associated persons definitions in the Income Tax Act is probably in the area of land sales. Parliament’s intent in 1973, when it enacted the current land sale tax rules, was that land dealers, developers and builders are generally taxed on all gains on property sold within ten years of acquisition, and they cannot claim to hold non-taxable investment portfolios. This legislative intent is clear from the parliamentary debate. Hon W E Rowling, Minister of Finance, who introduced the relevant legislation, said:

“Profits and gains from real property will now be assessed when ... the property was acquired by a land dealer and either was held as part of his land dealing business and later sold – in which case the profits will be assessable irrespective of the period between acquisition and sale – or, if it was not held as part of his land dealing business but is sold within ten years of acquisition, for example, claimed to be held as an investment but sold within this ten-year period.”

It was therefore a deliberate decision by Parliament that gains on land sold by property developers within ten years of acquisition are generally taxed.

There are some major weaknesses in the current associated persons definition which applies to land sales. These loopholes allow property dealers, developers and builders, who are meant to be taxed on such gains, to escape tax by operating through closely connected entities.

At present, the Income Tax Act has no coherent overall scheme for defining associated persons. There are number of shortcoming in the current definitions of associated persons. For example, some definitions do not consider some close relationships as being associated (for example, a settlor and a trustee). On the other hand, they treat some remoter relationships as being so (for example, fourth-degree relatives). The current structure of the associated persons definitions and other provisions employing a similar concept (such as the related person definition used in the dividend rules) create unnecessary complexity in the Income Tax Act.

In March 2007, tax policy officials published an issues paper on suggested changes to the income tax definitions of associated persons. The paper examined the definitions with an emphasis on identifying their shortcomings and suggesting a number of changes to resolve the problems.

The legislative changes proposed in the bill include modifications arising from the consultation process. This reform of the definition of associated persons in the Income Tax Act constitute their first comprehensive review since the inception of a definition in the income tax legislation in 1968.

The proposals in the bill are designed to substantially address the current shortcomings in the associated persons definitions in the Income Tax Act – first, by addressing their weaknesses and, secondly, rationalising these and other provisions in the Income Tax Act which employ a similar concept.

Detailed analysis

Application of subpart YB

Subpart YB, containing the associated persons definition provisions in the Income Tax Act 2007, will be substantially replaced.

New section YB 1(4) states the general rule that the various associated persons tests in subpart YB apply for the purposes of the whole Act unless a provision expressly states otherwise. The main example where certain exceptions will apply in the new associated persons tests are the land provisions, which are defined in section YA 1. For example, the beneficiary-based associated persons tests contained in new section YB 6 (trustee-beneficiary test) and section YB 9 (settlor-beneficiary test) do not apply to the associated person rules in the land provisions. Also, the narrow range of relatives (spouses, civil union partners, de facto partners, and infant children) currently applying for the purposes of the company-individual and relatives tests will continue to apply in the new associated persons definitions for the purposes of the land provisions.

New section YB 1(5) to (8) contain cross-references to several special rules that modify the associated persons definitions for the purpose of specific provisions. These special rules are contained in sections DS 4 (meaning of film reimbursement scheme), EB 13 (low-turnover valuation), EX 4 (limits to requirement to include associated person interests in the controlled foreign company rules), and LP 2 (tax credits for supplementary dividends). These special rules have not been changed as part of this reform of the associated persons definitions.

Two companies test (new section YB 2)

New section YB 2(1) contains the primary test for associating two companies. It provides that two companies are associated if there is a group of persons whose total voting interests in each company are 50 percent or more. The concept of voting interests is defined in subpart YC.

Under new section YB 2(2) two companies are associated if a market value circumstance exists for either company and there is a group of persons whose total market value interests in each company are 50 percent or more. A “market value circumstance” is defined in section YA 1 and a “market value interest” is defined in subpart YC.

Under the measurement of company ownership rules in subpart YC, a person’s interest in a company is generally measured by reference to their voting interests in the company. If these voting interests in certain circumstances – coming within the definition of “market value circumstance” in section YA 1 – do not reflect accurately the person’s economic interest in a company then the person’s interests are also measured by reference to their market value interests in the company.

Finally, under new section YB 2(3) two companies are associated if a group of persons controls both companies by any other means.

New section YB 2(4) contains an aggregation rule which provides that in determining whether two companies are associated, a person is treated as holding anything held by someone associated with them under sections YB 4 to YB 14. This aggregation rule is designed to prevent the two companies test being circumvented by the fragmentation of interests among associated persons, resulting in the 50 percent interest threshold not being reached.

Set out below is an example of how this aggregation rule would work in the context of the land provisions.



In this example the husband owns 100 percent of the voting interests in Company A, which is a property developer, and his wife holds 100 percent of the voting interests in Company B, which sells some land within ten years of acquisition. Without the aggregation rule, the two companies would not be associated despite their close community of interest. The application of the aggregation rule ensures that the two companies are associated under section YB 2(1), resulting in Company B being liable to tax on the sale of the land.

New section YB 2(5) provides that the control by any other means test does not apply to a company that is a state enterprise, Crown Research Institute, Crown health enterprise or a company that is part of the same group of companies as one of these Crown-related entities.

New section YB 2(6) provides that in the international tax rules (defined in section YA 1) two companies are not associated if one, but not both, is a non-resident.

Company and person other than a company test (new section YB 3)

New section YB 3 contains a test for associating a company and a person other than a company (typically an individual, which is the reason this test is also referred to as the company-individual test). The main test contained in subsections (2) and (3) applies for the purposes of the whole Act except the land provisions.

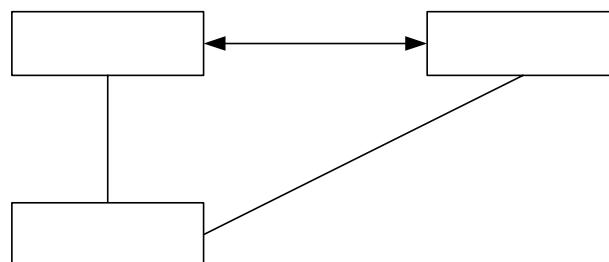
The primary test in new section YB 3(2) provides that a company and a person other than a company are associated if the person has a voting interest in the company of 25 percent or more. Voting interests are defined in subpart YC.

Under new section YB 3(3), a company and a person other than a company are associated persons if a market value circumstance exists for the company and the person has a market value interest in the company of 25 percent or more. A “market value circumstance” is defined in section YA 1, and a “market value interest” is defined in subpart YC.

An aggregation rule in new section YB 3(4) also applies for the purposes of the company-individual test. Accordingly, for the purposes of determining whether a company and an individual are associated, a person is treated as holding anything held by persons associated with them under sections YB 4 to YB 14.

As for the two companies test, the aggregation rule in the company-individual test is designed to prevent the test being circumvented by the fragmentation of interests among associated persons, resulting in the interest threshold of 25 percent not being reached.

The following example illustrates the application of the new aggregation rule in the company-individual test.



Without an aggregation rule, neither Sister A nor Sister B would be associated with Family Company under the company-individual test because their respective interests do not reach the required 25 percent threshold. However, under the aggregation rule in new section YB 3(4), both Sister A and Sister B would be associated with the company. This is because for the purposes of determining whether Sister A is associated with Family Company under section YB 3(2), she is treated as holding her sister's 15 percent voting interest in the company, which when aggregated with her own 20 percent voting interest, means that Sister A is treated as holding a 35% interest and, therefore, is associated with the company. Similarly, Sister B is treated under the aggregation rule as holding Sister A's 20 percent voting interest in the company, which when aggregated with Sister B's own 15 percent interest also makes Family Company and Sister B associated persons.

It should be noted that the aggregation rule is applied afresh to each person – as it was for each of the sisters in the example above.

A more limited version of the company-individual associated persons test applies for the purposes of the land provisions: section YB 3(5) to (7). This test has the same ambit as that contained in new section OD 8(4)(b) of the Income Tax Act 2004. In particular, a company and an individual are associated if a voting interest (or market value interest if a market value circumstance exists for the company) in the company of 25 percent or more is held by:

- the person
- the person's spouse, civil union partner, de facto partner or infant child
- the trustee of a trust under which the person, his or her spouse, civil union partner, de facto partner or infant child has benefited or is eligible to benefit
- a combination of the person and the other persons referred to above.

For the purposes of section YB 3, a person other than a company includes a company acting in its capacity as a trustee of a trust. This treatment means that the company look through rules in subpart YC applying to voting and market value interests do not apply to a corporate trustee; therefore, the voting interests or market value interests held by a corporate trustee are not traced through to the shareholders of that corporate trustee. Given the non-look-through treatment of interests held by corporate trustees, it is appropriate to treat a corporate trustee (not being a bare trustee) as a person other than a company for the purpose of the test associating a company and a person other than a company. This amendment is of a clarifying nature only and is consistent with long-standing policy (*Tax Information Bulletin*, Vol. 3, No. 7, April 1992 at page 23).

Relatives test (section YB 4)

The blood relationships limb of the new associated persons test for relatives will extend only to the second degree of blood relationship, instead of the fourth degree as the current test does. This means that the blood relationships limb of the relatives test in new section YB 4(1)(a) will extend to grandparents and siblings but not to nephews and nieces (third degree) and cousins (fourth degree) as the relatives test in current section YB 9 does.

The second limb of the associated persons test for relatives provides that two persons who are married, in a civil union or are in a de facto relationship are associated (new section YB 4(1)(b)).

The third limb of the relatives test provides that two persons are associated if one person is within two degrees of blood relationship to the other person's spouse, civil union partner or de facto partner (new section YB 4(1)(c)). This limb associates persons with their in-laws and step-children.

The first and third limbs of the general relatives associated persons test do not apply for the purposes of the land provisions (defined in section YA 1). Instead, for the purposes of the land provisions persons are associated because of a blood relationship only if one is the infant child of the other (section YB 4(2)).

For the purposes of section YB 4, a child by adoption is treated as a natural child (section YB 4(3)). This treatment of adopted children continues the current position.

The definition of "relative" in section YA 1 of the Income Tax Act 2007 will also be simplified so that it extends only to the second degree of blood relationship instead of also extending to the fourth degree of relationship. This involves omitting paragraph (c) of the current definition (which extends to the fourth degree of blood relationship) which leaves current paragraph (a) as the primary definition of "relative" in the Income Tax Act 2007. The new primary definition will include as a relative a trustee of a trust under which a relative has benefited or is eligible to benefit; this continues the effect of paragraph (c)(v) of the current relative definition.

Person and trustee for relative test (new section YB 5)

A person (first person) and a trustee of a trust under which a relative (as defined in section YB 4) of the first person has benefited or is eligible to benefit will be associated persons under new section YB 5. For example, a husband and a trustee of a trust under which the husband's wife is a beneficiary would be associated under this test.

Because it is only relatives as defined in new section YB 4 that are taken into account for the purposes of the trustee for relative test in new section YB 5, the limitations in section YB 4 that apply for the purposes of the land provisions would flow through to the test in section YB 5. Therefore, since persons are associated for the purposes of the land provisions because of a blood relationship only if one is the infant child of the other, the test in new section YB 5 would only extend this blood relationship, for the purposes of the land provisions, to associate a parent and a trustee of a trust under which the parent's infant child has benefited or is eligible to benefit.

Trustee and beneficiary test (new section YB 6)

A trustee of a trust and a person who has benefited or is eligible to benefit under the trust will be associated persons under new section YB 6. This provision will not apply for the purposes of the land provisions.

Persons have benefited under a trust if they have received a distribution under the trust.

Inland Revenue's long-standing policy on when a person is eligible to benefit under a trust will continue (*Tax Information Bulletin*, Vol. 7, No. 9, February 1996 at page 25). In particular, a person is "eligible to benefit" when the person is either:

- named by the trustee as a potential beneficiary; or
- designated as a member of a class of potential beneficiaries, for example, "the children of ..."

When trustees have a general power of appointment, persons not already appointed as beneficiaries under the power are not treated as being eligible to benefit.

Therefore, a person who is eligible to benefit under a trust (as described above) does not need to have actually received a distribution (as defined in section HC 14 of the Income Tax Act 2007) under the trust to qualify as a beneficiary.

An exception to this test for certain employee trusts is contained in new section YB 15.

Two trustees with common settlor test (new section YB 7)

Under new section YB 7, a trustee of a trust and a trustee of another trust will be associated persons if the same person is a settlor of both trusts.

New section YB 10 provides that for the purposes of the new section YB 7, "settlor" has the meaning set out in section HC 27 of the Income Tax Act 2007, but does not include a person who provides services to a trust for less than market value. One effect of this modification is that a professional advisor who provides services to a trust at no charge will not be treated as a settlor of the trust.

An exception to this test for certain employee trusts is contained in section YB 15.

Trustee and settlor test (new section YB 8)

A trustee of a trust and a settlor of the trust will be associated persons under new section YB 8.

New section YB 10 provides that for the purposes of new section YB 8, "settlor" has the meaning set out in section HC 27, with the modification that a settlor does not include a person who provides services to a trust for less than market value.

An exception to this test for certain employee trusts is contained in new section YB 15.

Settlor and beneficiary test (new section YB 9)

A settlor of a trust and a person who has benefited or is eligible to benefit under the trust will be associated persons under new section YB 9. This test does not apply for the purposes of the land provisions (defined in section YA 1).

New section YB 10 provides that for the purposes of new section YB 9, “settlor” has the meaning set out in section HC 27 with the modification that it does not include a person who provides services to a trust for less than market value.

The comments above under the trustee and beneficiary test heading in relation to the meaning of when a person is eligible to benefit under a trust also apply for the settlor and beneficiary associated persons test.

An exception to this test for certain employee trusts is contained in new section YB 15.

The settlor-beneficiary test is a new associated persons test and is being implemented because there is considered to be a sufficient connection between a settlor and a beneficiary of a trust to justify treating them as associated persons. In particular, such a test is consistent with the settlor focus of the trust taxation rules in the Income Tax Act 2007.

Trustee and person with power of appointment or removal (new section YB 11)

A trustee of a trust and a person who has a power of appointment or removal of the trustee will be associated persons under new section YB 11.

This test is intended to complement the trustee-settlor associated persons test. In many cases, a settlor of a trust, as the author of the instrument creating and governing the administration of the trust, retains the power to appoint or remove trustees. However, this power could be reposed in a separate person. It is considered that there is sufficient connection between a trustee of a trust and the person who has the power to appoint or remove the trustee to justify treating them as associated persons.

Partnership and partner test (new section YB 12)

A partnership and a partner in the partnership will be associated persons under new section YB 12.

A separate associated persons rule applies in the case of a limited partnership (as defined in section YA 1 of the Income Tax Act 2007). A limited partnership and a limited partner are associated only if the limited partner has a partnership share of 25 percent or more in the limited partnership.

Partnership and associate of partner test (new section YB 13)

A partnership and a person associated with the partner (other than under this section) will be associated persons under new section YB 13.

A common example of the application of this test would involve the spouse of a partner in a partnership. The spouse would be associated with the partner under the relatives test in new section YB 4, and the partner is associated with the partnership under the partnership and partner test in new section YB 12. Therefore the partnership and the spouse would be associated under the partnership and associate of partner test in new section YB 13.

It is necessary for the new provision to state that the person is associated with the partner in the partnership other than under new section YB 13 itself in order to prevent this test operating in a reiterative manner.

The partnership and the associate of partner test described above does not apply in the case of a limited partnership (as defined in section YA 1 of the Income Tax Act 2007). A limited partnership and a person associated with a limited partner (other than under new section YB 13) are associated persons only if the limited partner has a partnership share of 25 percent or more in the limited partnership.

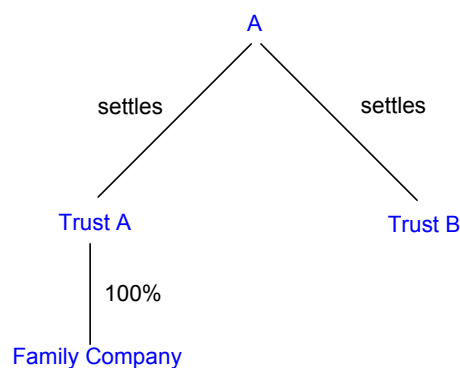
Tripartite test (new section YB 14)

The tripartite test in new section YB 14 will associate two persons if they are each associated with the same third person.

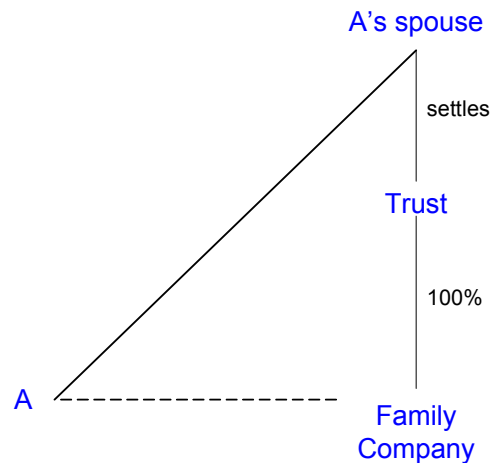
The tripartite test acts as an important buttress to the other associated persons tests and makes the associated persons definition as a whole more difficult to circumvent.

For the tripartite test to associate two persons, each of these persons must be associated, other than under the tripartite test itself, with the same third person. The requirement that the two persons cannot be associated with the same third person under the tripartite test itself is necessary to prevent the tripartite test operating in a reiterative manner.

Set out below are two examples which illustrate the important role of the tripartite test in preventing the other associated persons tests being circumvented by arrangements involving the interposition of relatives, companies and trusts which are under the influence or control of the main protagonists.



A settles two family trusts: Trust A and Trust B. Trust A in turn owns all the shares in Family Company. The issue is whether Family Company is associated with Trust B. Without the tripartite test in new section YB 14, Family Company and Trust B would not be associated, despite the close community of interests between them. However, Family Company and Trust B would be associated under the tripartite test, in conjunction with the test in new section YB 3 associating a company and a person other than a company (company-individual test) and the two trustees-common settlor test in new section YB 7. In particular, Family Company is associated with Trust A under the company-individual test, and Trust A is associated with Trust B under the two trustees-common settlor test. Therefore Family Company and Trust B would be associated under the tripartite test.



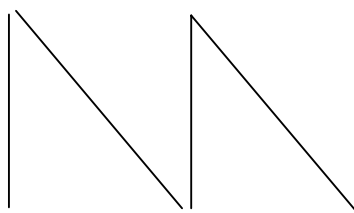
A's spouse settles Trust, which in turn owns all the shares in Family Company. The issue is whether A is associated with Family Company under the test associating a company and a person other than a company in new section YB 3 (company-individual test). Without the tripartite test in new section YB 14 and the rule in the company-individual test aggregating interests held by associated persons, A would not be associated with Family Company even though there is a large community of interest between them. However, A would be associated with Family Company under the company-individual test if that test was buttressed by the tripartite test, in conjunction with the aggregation rule and trustee-settlor tests. In particular, A would be treated for the purposes of the company-individual test as holding all the shares held by Trust in Family Company. This is because Trust is associated with A under the tripartite test: A is associated with her spouse under the relatives test and A's spouse is associated with Trust under the settlor-trustee test, which means that A is associated with Trust under the tripartite test.

The tripartite test in new section YB 14 contains a number of exceptions to ensure that the test does not apply more widely than is necessary to protect the tax base. In particular, the tripartite test will not apply to associate two persons if they are both associated with the same third person under the:

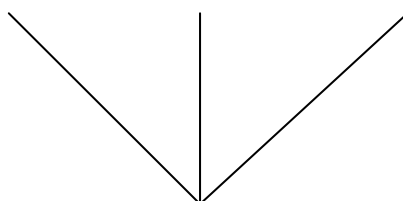
- two companies test (new section YB 2);
- company-individual test (new section YB 3);
- relatives test (new section YB 4);
- partnership-partner test (new section YB 12); or
- partnership-associate of partner test (new section YB 13).

It should be noted that it is necessary for the two persons to be associated with a third person under the same associated persons test (for example, the two companies test) before these exceptions apply.

Set out below are two examples of how these exceptions apply.



In this example individuals X, Y and Z, who are not associated with each other, own all the shares in Company A, Company B and Company C. Without any modifications to the tripartite test, Company A and Company C would be associated, despite not having any common shareholders. However, because Company A and Company C are each associated with Company B under the two companies test, they are not associated under the tripartite test.



A, B and C are individuals who are partners in a partnership. Without any modification to the tripartite test, A, B and C would be associated with each other under the tripartite test because they are each associated with the partnership under the partner-partnership test in new section YB 12. An exception to the tripartite test, however, means that these individuals are not associated with each other under the tripartite test through their association with the partnership. The individuals may still be associated with each other under a different associated persons test. For example, if individuals B and C were married they would be associated with each other under the relatives test in new section YB 4.

Dividend rules

The bill amends the dividend rules in subpart CD by replacing their current associated persons provisions with a rule providing that if a company transfers value to a person and the transfer is caused by a shareholding in the company, the company has paid a dividend regardless of whether the recipient of the benefit is a shareholder in the company. It is considered that the conceptually better approach for dividend taxation is whether a benefit has been provided because of a shareholding relationship rather than whether a company is associated with any person. It is already a requirement in the current dividend rules that the cause of a transfer of value from a company to a person is a shareholding in the company.

This change will be effected by replacing section CD 4(1)(a) so that the primary meaning of a dividend will be a transfer of value from a company to a person if the cause of the transfer is a shareholding in the company, whether or not the person holds shares in the company. This change means that section CD 6(1), which provides that a transfer of value is caused by a shareholding in the company in certain circumstances such as when the recipient is a shareholder or associated with a shareholder, can be omitted. Other references to section CD 6 in section CD 27 (providing that downward transfers of value within a group of companies are not dividends) and section FC 1(1)(d) (dealing with distributions in kind by a company) are consequentially amended.

Fringe benefit tax rules

Currently, fringe benefit tax applies to fringe benefits provided to associated persons of employees: section GB 32 of the Income Tax Act 2007. This associated persons provision will be replaced by rules providing that if an employer provides a benefit because of an employment relationship, the employer has provided a fringe benefit subject to fringe benefit tax, regardless of whether the recipient of the benefit is an employee. This is regarded as a conceptually more coherent approach to the taxation of fringe benefits and is similar to the approach described above in relation to dividends. The main difference between the approach for dividends and that for fringe benefits is that it is necessary to relate the benefit to a particular employee for fringe benefit tax rate purposes, whereas a connection to a specific shareholder is not necessary in the case of dividends because it is the recipient of the benefit that is treated as deriving a dividend and not the shareholder.

This new approach in the fringe benefit tax rules will be effected mainly by amendments to sections GB 32 and CX 18 of the Income Tax Act 2007. Section GB 32 will apply to benefits provided because of an employment relationship to persons other than employees. The focus of the amended section GB 32 will therefore be on whether the benefit is provided because of an employment relationship rather than whether the recipient of the benefit is associated with an employee.

Current section CX 18 covers the situation when benefits are provided to associates of both employees and shareholders. It provides that in such cases the benefit is subject to the fringe benefit tax rules and is treated as not being a dividend. Section CX 18 will be amended to cover the situation when a benefit is provided because of both an employment relationship and a shareholding relationship; such a benefit will be treated as a fringe benefit subject to the fringe benefit tax rules and not a dividend.

Rationalising associated persons references in operative provisions

A number of operative provisions in the Income Tax Act 2007 contain modifications or additional wording in their associated persons references. These modifications are a result of different combinations of the associated persons tests in current subpart YB applying, in particular, the parts of subpart YB that apply for the purposes of the whole Act (excluding the 1973, 1988 and 1990 version provisions) or the 1988 version provisions (corresponding to the associated persons definitions in section OD 7 and OD 8(3) of the Income Tax Act 1994). An example of such a provision is section EX 21(15) (after a remedial amendment in the bill that is effective from 1 April 2008).

These modifications to the associated person references in the operative provisions in the Income Tax Act 2007 will be generally omitted because they are effectively subsumed by the various reforms to the associated persons tests in subpart YB. The wording of these operative provisions can therefore be significantly simplified because they will simply refer to persons being associated without more (for example, without various references to the 1973, 1988 or 1990 version provisions). As a result, the wording of the associated person references in the operative provisions in the Income Tax Act 2007 will be streamlined and easier to understand.

For example, the wording of section GB 28(2) (after a remedial amendment in the bill that is effective from 1 April 2008) is:

“A person is treated as being associated with another person if a person would be treated as being associated under the parts of subpart YB (associated persons and nominees) that apply for the purposes of the whole Act (excluding the 1973, 1988, and 1990 version provisions), or the 1988 version provisions, at the time the services are personally performed by the working person.”

This wording will be replaced simply by:

“A person is treated as being associated with another person if they are associated at the time the services are personally performed by the working person.”

The definitions of the 1973, 1988 and 1990 version provisions and current section YB 20 will be repealed because they are largely subsumed by the various reforms to the associated persons tests in subpart YB. These definitions equate to the lists of operative provisions to which the former specific associated persons definitions in sections OD 8(4), OD 8(3) and OD 8(1) of the Income Tax Act 2004 applied. However, because of the various modifications that apply in the associated persons tests in relation to the land transaction provisions, currently referred to as the “1973 version provisions”, this definition will be re-enacted in section YA 1 and called “land provisions”.

The new associated persons definition in the Income Tax Act 2007 will apply also in the Tax Administration Act 1994 because of section 3(2) of the Tax Administration Act 1994.

A number of the current specific modifications or additional wording in the associated persons references in the operative provisions in the Income Tax Act 2007 are currently incorrect. The bill corrects these references from the commencement of the Income Tax Act 2007 on 1 April 2008, even though these references are themselves being omitted as part of the reform of the associated persons definitions in the Income Tax Act 2007. It is necessary to correct these references from the commencement of the Income Tax Act 2007 on 1 April 2008 because the associated person reforms do not apply until the 2009–10 income year.

Omitted tests

Several associated persons tests contained in the current subpart YB of the Income Tax Act 2007 are being omitted for simplification and rationalisation purposes. These omitted tests are:

- The test associating two persons if they habitually act together (current section YB 18).

- The test associating a person and a charity, friendly society, or non-profit body controlled by that person or a relative of that person (current section YB 19).
- The tests associating two companies and a company and a non company, which are based on income interests (current sections YB 3 and YB 7). These tests are redundant given the equivalent comprehensive tests based on voting interests. The existence of these tests can be explained historically by the fact that they were originally enacted in 1988 before the voting interest concept was enacted in 1992.

Rationalisation of other provisions

A number of provisions in the Income Tax Act 2007 embodying a related person concept, similar to that in the associated persons definitions, will be rationalised. It is desirable, from a simplification perspective, for similar concepts in the Act to be addressed similarly.

Replacing company control definition with associated persons definition

Section YC 1, which defines when a company is treated as being under the control of any persons, will be repealed, and its function performed by the new associated persons definition.

The definition of company control in section YC 1 and the definitions of associated persons in subpart YB are conceptually similar in that they define related parties for the purposes of operative provisions in the Income Tax Act 2007. The separate use of the section YC 1 company control definition rather than the associated persons definitions is probably a legacy of the company control definition being developed in the Income Tax Act before the associated persons definitions. The company control definition in the Act was first implemented in 1939, whereas the first associated persons definition in the Act was not enacted until 1968.

Allowing section YC 1 to be subsumed by the new associated persons definition is a desirable simplification measure.

The provisions in the Income Tax Act 2007 which currently employ the section YC 1 definition of company control and which will be amended to use the new associated persons definition are section GC 5 (leases for inadequate rent), section RF 11 (dividends paid to companies under control of non-residents), and paragraph (a) of the definition of “holding company” in section YA 1 of the Income Tax Act 2007.

There are also a number of provisions in other Acts which utilise current section YC 1 of the Income Tax Act 2007. These section YC 1 references will be replaced with references to the new associated persons definition in the Income Tax Act 2007. The provisions in these other Acts are:

- Insolvency Act 2006, section 182(1);
- Public Service Investment Society Management Act (No.2) 1979, section 2(2);
- Trustee Companies Management Act 1975, section 2(2); and
- Unit Trusts Act 1960, section 3(4).

Replacing related person definition with associated person definition

Section CD 44(15) to (17) of the Income Tax Act 2007 contains a definition of “related person” which is used for determining the amount of the capital gain exclusion from a dividend arising from the realisation of a capital asset in the course of a company’s liquidation. As part of the amendments to rationalise the Income Tax Act provisions which embody an associated persons concept, the function of the related person definition in section CD 44 will be performed by the new associated person definition. The two definitions are conceptually very similar, and replacing the related person definition with the new associated persons definition is a worthwhile simplification measure.

The amendments involve repealing sections CD 44(15) to (17) and replacing the related person references in sections CD 44(11) and (12) with references to associated persons. The references to related person in the dividend definition in section YA 1 will also be replaced with references to associated persons.

Section CD 22(9) amendment

The definition of “fifteen percent interest reduction” in section CD 22(9), which relates to the share buy-back exclusion from the dividend definition, refers to “counted associate”, which is defined inter alia as “a trustee of a trust under which a spouse, civil union partner or de facto partner, or minor child of the shareholder is a beneficiary”. This wording is being amended to be made consistent with other references in the associated persons definitions which describe discretionary beneficiaries; the provision will therefore refer to a person who has benefited or is eligible to benefit under a trust.

Section DB 42(2) amendment

Section DB 42(1) allows a taxpayer a deduction for any loss arising through misappropriation by an employee. Section DB 42(2) states that this deduction is not available if the taxpayer and the defalcating employee are associated in certain ways.

The new associated persons definition is comprehensive enough to cover all the relationships described in current section DB 42(2). Therefore the specific associated persons tests in this provision will be replaced by a standard associated persons reference. Section DB 42(2) will provide that the section does not apply when a person who misappropriates property is associated with the person who carries on the business.

Other policy matters

TAX TREATMENT OF EMISSIONS TRADING UNITS

(Clauses 9, 31, 48, 61, 81, 84, 85, 98, 187, 408 and 524)

Summary of proposed amendments

New provisions inserted into the Income Tax Act 2007 provide for the tax treatment of emissions trading units. Most costs of emissions trading will be tax-deductible, and the government subsidy (the award of “free” emission units by government) of emissions costs will generally be assessable. The specific taxation treatment varies depending on the emissions type, of which there are four:

- non-forestry – generally dealt with on an accruals basis;
- post-1989 forestry – dealt with on a cash basis;
- pre-1990 forestry where the land is held on capital account – outside the tax system; and
- pre-1990 forestry where the land is held on revenue account – special rules apply.

There are special rules for the surrender of emission units to government and for the timing of the recognition of income arising from the government subsidy.

Emissions units will be treated as excepted financial arrangements that are revenue account property. Thus emissions units will generally be deductible upon acquisition, but added back at cost at year end to the extent they are still on hand.

The changes proposed in the present bill are interdependent with tax amendments contained in the Climate Change (Emissions Trading and Renewable Preference) Bill, which was introduced in December 2007 and is still before Parliament. For that reason, the relevant amendments in the earlier bill are repeated in this bill. This commentary covers both sets of proposed tax amendments.

This bill amends the Income Tax Act 2007. The only businesses that will deal with emissions units under the Income Tax Act 2004 are forestry businesses, and their position is addressed by amendments to the Income Tax Act 2004 introduced in the Climate Change Bill.

Amendments are also made to the Goods and Services Tax Act 1985 to deal with emissions units. Both the supply of emissions units and the actual or deemed supply of any services in exchange for emission units are zero-rated.

Application date

The amendments take effect from 1 January 2009.

Key features

New section CB 36 provides that the disposal of emission units is taxable, other than when the disposal is of a unit allocated in relation to pre-1990 forestry land which is held on capital account – disposal of such a unit is on capital account. The net income to be returned will depend on the tax cost of the units disposed of – this is either actual cost, or tax value determined by subpart ED.

When the disposal is by way of surrender to meet an emissions obligation, special rules apply (generally within section CB 36) to ensure that, generally, the act of surrender does not itself create a deduction. The exceptions are in relation to forestry in some circumstances.

New section CX 51B provides that the receipt of “free” emission units awarded by government does not by itself cause income to be received.

Section DB 60 provides that “free” emission units awarded by government are acquired at a nil cost.

Emission units are added to the list of excepted financial arrangements in section EW 5(3) and excluded from the part E trading stock treatment by new section EB 2(3)(i).

The standard excepted financial arrangement valuation methods of first-in first-out or weighted average cost set out in section ED 1 will generally apply. Separate pools of emissions units are specified to ensure that they can be correctly tracked and that the intended treatment of “free” emission units awarded by the government is not frustrated.

Section ED 1 is also amended to provide that “replacement units” are effectively valued at nil, thus ensuring a deduction in the year of their acquisition. (If such units are surrendered in the year of acquisition the surrender process detailed in section CB 36 will provide the deduction.)

Section ED 1B provides that income from non-forestry “free” emission units awarded by the government is recognised on an emerging basis over the period to which the award relates (usually an emissions year). The exception to this is that if the emerging income has not yet been recognised, a disposal of units will itself result in net income because the units will have a nil cost base at this stage.

Amendments to the Goods and Services Tax Act 1984 are also made. Section 11A(1), which generally lists zero-rated services, is amended with the addition of two new paragraphs, (s) and (t).

Paragraph (s) adds the supply of emissions units to the list of zero-rated services, provided those emissions units are supplied under an arrangement entered into on or after 1 January 2009. This preserves the existing GST treatment of arrangements entered into outside the emissions trading scheme between the government and industry. Paragraph (t) adds the supply of services made in exchange for the supply of a zero-rated emissions unit to the list of zero-rated services.

Example 1, below, shows the tax consequences of some of the transactions in emissions units a forestry business might undertake. Example 2 shows the tax consequences of some of the transactions in emissions units which a non-forestry business might undertake.

Background

Emissions trading rules are contained in the Climate Change (Emissions Trading and Renewable Preference) Bill, which is before Parliament. That bill proposes the insertion of provisions into the Climate Change Response Act 2002, under which:

- businesses in certain sectors will be required to surrender emission units based on their emissions; and
- the government may allocate “free” emission units to businesses in certain sectors.

Amendments to income tax legislation are required to ensure that the tax treatment of emission units is clear, income and expenditure are recognised appropriately, and no unintended distortions arise, such as a mismatch of recognition or timing of income and expenditure. Amendments to GST legislation are proposed to ensure that acquisitions and disposals of GST units can take place across international markets, where buyers and sellers will not be known to each other and where transactions may have multiple counterparties.

Example 1: Post-1989 forest business

DE Forestry has an exotic forest plantation planted in 1991 and has elected into the emissions trading scheme. For the 2009 emissions year, DE Forestry received an allocation of 100 emissions units. It sold 30 units immediately, for \$10 each, and retained 70.

The election and the receipt of units have no taxation consequences.

The sale proceeds of $30 \times \$10 = \300 derived in 2009 are taxable, and there is a nil cost base.

In 2011 DE Forestry bought 30 units on the market for \$15 each.

The purchase cost of $30 \times \$15 = \450 is deductible in 2011, and, as the units are “replacement” units (units purchased to replace post-1989 units previously sold), the year end valuation rule provides that they can be valued at nil, rather than cost. This gives a net deduction in 2011 for these units.

In 2012, DE Forestry harvested its forest and was required to surrender 100 units. The harvest and the subsequent settling of the emissions obligation have no taxation consequences.

Example 2: Non-forestry business

AB Co manufactures product Z for export. Carbon dioxide is emitted as part of manufacturing product Z, and the provisions of the Climate Change Bill will require AB Co to surrender the commensurate number of emission units following the end of each emissions year.

The government will issue an allocation plan under the provisions of the Climate Change Bill under which businesses which make product Z for export are entitled to receive “free” emission units.

AB Co is issued 100 free units for the emissions year which runs from 1 January to 31 December 2015. AB Co’s expected emissions liability for the emissions year is 800 units. AB Co has a 30 June balance date. On 30 April 2015, AB Co buys a further 150 emissions units for \$8 each. On 30 June 2015, emission units are trading at \$10 each.

The following calculations are required for AB Co’s 2014-15 tax return.

Under existing law, AB Co will be entitled to a deduction on an emerging basis for its emissions obligations. Assuming emissions are exactly the same level every month, at the end of the 2014-15 income year, the proportion of the emissions liability to be recognised is $6/12 \times 800$ units = 400 units. The fraction 6/12 is simply the number of months in the 2015 emissions year which have elapsed at the end of the 2014–15 income year.

The 2014–15 income year deduction for the accrued liability to surrender 400 units will be calculated as follows:

- 150 units \times \$8 = \$1,200. This is the portion of the liability matched to the 150 units which have been purchased, valued at the cost price of those units.
- 250 units \times \$10 = \$2,500, which is the remaining portion of the liability, valued at the market value of those units at balance date. Any variance between the year end market value and the eventual actual cost of the 250 units required will be brought to account in the following income year.

The 100 free units are not relevant to calculation of the deduction.

The total deduction for the liability accrued in 2014–15 to surrender 400 units is therefore $\$1,200 + \$2,500 = \$3,700$.

The approach taken to recognition of the income from the 100 free units is similar. Income from the 100 allocated units will be recognised over the period to which the allocation applies, on a basis which matches the allocated units to the costs that they are intended to compensate for.

AB Co will therefore recognise as income the value of $400/800 \times 100$ units = 50 units at the end of its 2014–15 income year. The fraction 400/800 is the number of units of emissions actually emitted in the 2015 emissions year at the end of the 2014–15 income year, divided by the number of units of emissions expected for the entire 2015 emissions year.

The balance date market value of the units is used to calculate the income, so this is 50 units \times \$10 = \$500.

However, if the 100 units were sold immediately upon receipt for \$8 each (and this might occur if the business does not have a direct emissions obligation, but rather is downstream from a business with emission obligations), then the sale proceeds of \$800 would be income. The units sold would have no cost base.

TAX TREATMENT OF REIMBURSEMENTS AND HONORARIA PAID TO VOLUNTEERS

(Clauses 23 and 39)

Summary of proposed amendments

The bill introduces specific tax rules for the treatment of payments that reimburse expenditure incurred in undertaking voluntary activities. Reimbursement payments received by people who meet the qualifying criteria for being considered a volunteer will be treated as exempt income under the new provisions. The rules also make it clear that a payment characterised as an honorarium, even if it includes an element of reimbursement for expenditure incurred, is treated as a schedular payment and the PAYE rules apply to the whole payment.

Application date

The new rules for the treatment of reimbursements paid to volunteers will apply from 1 April 2009.

Key features

New section CO 1 of the Income Tax Act 2007 provides a general rule treating reimbursement payments for expenditure incurred in undertaking voluntary activities as income.

New section CW 62B provides that:

- Reimbursement payments that are based on actual expenses incurred by volunteers in undertaking voluntary activities will be treated as exempt income.
- If a paying organisation puts in place a process for making a reasonable estimate of the amount of expenditure likely to be incurred by a volunteer for which reimbursement is payable, then payments based on that estimate will also be treated as exempt income. This will provide flexibility, such as when it is not practical for organisations to reimburse their volunteers on the basis of actual costs incurred. It is intended that this will include reimbursements in non-cash form such as petrol vouchers.

The proposed treatment will extend to reimbursement of transport costs incurred in getting to and from the place of volunteering, as well as costs incurred in the course of volunteering.

Volunteers are defined as people who:

- are resident in New Zealand under subpart YD (Residence and source in New Zealand); and

- freely undertake an activity in New Zealand:
 - chosen either by themselves or a group of which they are a member; and
 - that provides a benefit to another person; and
 - for which there is no purpose or intention of private pecuniary gain.

The new section also clarifies the treatment of a payment that is partly honorarium and partly reimbursement. In that case, the whole payment is to be treated as a schedular payment, and the PAYE rules apply. This does not alter the provision that allows an organisation making mixed schedular payments to apply for a determination under section RD 8(3) (Schedular payments). Under section RD 8(3) the Commissioner may determine how much expenditure the recipient of the payment has incurred in deriving that payment and the amount of the determination is not subject to withholding tax.

For clarity, the term “honorarium” is defined for the purposes of both new section CW 62B and schedule 4, part B (Rates of tax for schedular payments).

The new section makes it clear that the proposed tax treatment will apply regardless of whether reimbursements are paid progressively through the year or in a lump sum.

Background

In November 2007 Inland Revenue released the issues paper *The tax treatment of honoraria and reimbursements paid to volunteers*. It outlined options for clarifying the tax treatment of volunteer reimbursements and honoraria, to make it easier for volunteers and community organisations to comply with their tax obligations.

One of the long-standing problems for volunteers and the organisations who use their services is that our tax laws are unclear about how reimbursement payments made to volunteers should be taxed. Under a strict interpretation, such payments are considered income and the relevant expenses are deductible. That means the income should be stated and expenses claimed in the volunteer’s income tax return. Because volunteers and community organisations have often been uncertain about their tax obligations relating to reimbursements, an inconsistent range of administrative practices has developed, resulting in high compliance costs for many of them.

Similar problems relating to tax obligations have arisen over payments of honoraria. Honoraria are schedular payments from which the payer, under current law, must deduct tax at the rate of 33 cents in the dollar. However, payments that are characterised as honoraria sometimes include reimbursements along with a fee for service, or may even be wholly reimbursement payments. Recipients of such payments must file a tax return before their tax position can be finalised.

FILM AND GOVERNMENT FUNDING

(Clauses 36, 45, 46, 62, 63, 65, 69, 70, 89-92, 408, 470, 471 and 473)

Summary of proposed amendments

Amendments are being made to tax law following the Budget 2008 announcement that, from 1 July, a new film grant, the New Zealand Screen Production Incentive Fund (SPIF) grant, will be available for “New Zealand” film and other screen formats. The tax amendments are being made to turn off the immediate deduction incentive provided in current law for films that attract SPIF grants. The bill also makes consequential amendments in relation to SPIF grant co-funding by government agencies. Amendments will also give Large Budget Screen Production Grants (LBSPG) standard grant treatment, which prevents the creation of artificial losses.

Application date

The principal amendments will apply from 1 July 2008. Changes to the LBSPG will apply from 1 April 2009.

Key features

SPIF grants will receive the standard grant treatment – meaning that deductible expenditure will be reduced by the amount of the grant. No law change is necessary to achieve this.

The Income Tax Act 2007 is being amended as follows:

- The definition of “Government Screen Production Payment” will be used to describe both LBSPG and SPIF grants.
- Film that receives a SPIF grant will be deductible over the more usual two-year period, rather than qualify for the immediate deduction incentive.
- The standard grant treatment will also explicitly apply to any funding from government funding organisations that is in addition to funding received via SPIF grants. This further reduces the allowable deductible expenditure of the production by the value of the additional funding from government funding organisations. Any payments to these funding bodies will, however, be deductible.
- From 1 April 2009 the LBSPG will also being given the standard grant treatment.

The Tax Administration Act 1994 will be amended so that tax auditing and secrecy obligations for the LBSPG also apply to SPIF grants.

Background

As part of Budget 2008, the government announced a new film grant – the SPIF grant. Under the terms of the grant, “New Zealand” feature films will be eligible for a 40 percent grant and other “New Zealand” screen formats will be eligible for a 20 percent grant. The Film Commission will have overall responsibility for administration and will pay the grant, but Inland Revenue will be responsible for verifying the cost of the production to enable the grant to be quantified.

Detailed analysis

Standard grant treatment

Under current legislation, the LBSPG does not receive standard grant treatment. This means that expenditure arising from funds given through this scheme to a production is treated as deductible for the production. This has resulted in the creation of artificial tax losses, and some film companies can use these losses, while others cannot.

Under the new rules, the LBSPG and the SPIF grants are both afforded standard grant treatment, which, in this case, reduces the deductible expenditure by the amount of the grant. The LBSPG changes are achieved through the repeal of section CW 37 and the removal of the reference to the LBSPG in sections CX 47(3) and DF 1(6) of the Income Tax Act 2007.

These changes are to apply from 1 April 2009, which should give any productions already planning to deduct expenditure derived in relation to a LBSPG payment sufficient warning to allow for the change.

Introduction of SPIF grants

References to “LBSPG” will be replaced by the generic, defined term “Government Screen Production Payment”, which covers both the LBSPG and SPIF grants. The repeal of the definition of the term “Large Budget Screen Production Grant” will occur from 1 April 2009 to coincide with the time LBSPG payments are given standard grant treatment.

Removal of early deduction incentive

As was done for LBSPG films, films that receive a SPIF grant will not also be entitled to the immediate deduction tax incentive. Rather, amendments made to subpart EJ (which, among other things, governs the timing of the deduction for film) will provide that the deduction is available over a two-year period.

Co-funding

Government agencies such as the New Zealand Film Commission, NZ On Air, the New Zealand Film Production Fund Trust and Te Māngai Pāho are unable to provide additional funding (co-funding) to a production if that production has already received a LBSPG payment. However, these agencies can provide co-funding to productions that receive the SPIF grant. In these circumstances, the value of the additional government funding received by these agencies will also be unavailable as deductible expenditure. This will be done in a similar fashion to how government grants are treated and will formalise a practice already used by the Film Commission.

The result is that, for tax purposes, the cost of the film or other screen format will be actual cost reduced by all government funding.

When the funding from these government agencies comes with repayment obligations they will now explicitly be deductible. This is necessary to properly balance the changed treatment of the receipt of the co-funding from government agencies.

These amendments are being made through the insertion of new sections CX 48B and DF 5.

Tax Administration Act amendments

Inland Revenue will have responsibility for verifying expenditure for the grant, which will be administered and paid out by the Film Commission. Sections 81(4)(p), 85F and 87(5)(d) of the Tax Administration Act 1994 are being amended so that those responsible for the administration of the SPIF grants are subject to the same secrecy requirements as those responsible for the administration of the LBSPG.

CLARIFYING THE TAX STATUS OF GENERAL INSURANCE RISK MARGINS

(Clauses 29, 79, 408, 546 and 555)

Summary of proposed amendments

Amendments to the Income Tax Act 2007 clarify that movements in a general insurer's outstanding claims reserve (OCR) determined under the requirements of International Financial Reporting Standard (IFRS) 4 will be deductible, provided certain requirements are met: the amount of the movement and how it is determined are well documented, reflect the company's business experience, and are made for sound commercial or business reasons and not for income tax purposes.

Application date

The amendments apply from the first income year that the insurer adopts IFRS 4.

Key features

An insurer who uses IFRS 4 for accounting for its general insurance contracts may claim as a tax deduction (section DW 4) or return as income (section CR 3) the movement between the opening and closing OCR for the income year, provided the amount is "actuarially determined".

The OCR means the amount of a person's outstanding claims liability for general insurance contracts, excluding contracts for which section FC 14 applies, determined under Appendix D paragraphs 5.1 to 5.2.12 of IFRS 4.

The amount is "actuarially determined" when its calculation and methodology are certified by an actuary, but does not include an amount:

- that does not accurately reflect the insurer's business experience;
- is not made according to usual business practice; and
- is, or is part of, a tax avoidance arrangement.

The amendment will not cover deductions for pre-IFRS 4 OCR movements, which will still need to be considered according to ordinary tax principles.

Background

Under IFRS 4, the OCR of a general insurance company has two components. The first, the "central estimate", is the average present value of expected future payments. The second is a risk margin, which is a prudential addition to reflect the inherent uncertainty of the central estimate. IFRS 4 does not say how either of the components should be calculated, so reliance is placed on actuarial standards and practice.

Many general insurers already claim a tax deduction for the entire annual movement in the OCR. While it is clear that the movement in the central estimate is tax deductible under general tax principles, the law is unclear on the deductibility of the movement in the risk margin, though it is likely to be determined on the facts of each insurer. The amendments remove the uncertainty and confirm deductibility for financial accounts prepared under IFRS 4 provided certain other requirements are met.

CHANGES TO THE TAX TREATMENT OF PETROLEUM MINING

(Clauses 71, 73, 74, 93-97, 551, 553, 554, 558, 559, 560, 561 and 562)

Summary of proposed amendments

As part of the government's tax policy work programme a number of proposed amendments have been included in this taxation bill. The bill contains following proposals for the petroleum mining rules:

- Deductions for expenditure on petroleum mining undertaken via a branch in another country will be allowed to be allocated only against petroleum mining income from foreign branch operations. The amendment ensures that New Zealand receives its proper share of benefit from New Zealand petroleum resources by preventing foreign branch petroleum mining expenditure being offset against income in New Zealand.
- Further amendments remove disincentives that may affect investment in oil and gas exploration and development in New Zealand. For example, modern drilling techniques have made the current onshore offshore boundary unsustainable.
- A remedial amendment ensures that a petroleum mining anti-avoidance provision does not inappropriately reduce a taxpayer's deductions.

Application date

- The amendment relating to petroleum mining expenditure incurred by a branch in another country, will apply to expenditure incurred on or after 4 March 2008.
- The amendment that removes disincentives that may affect investment will apply to expenditure incurred on or after 1 April 2008.
- The remedial amendment to the petroleum mining anti-avoidance provision will apply from 1 December 2007.

Key features

Expenditure on petroleum mining operations undertaken through a branch in another country

Expenditure incurred on petroleum mining operations undertaken through a branch in another country will be allowed to be deducted only from income from foreign petroleum mining operations. The effect is to prevent foreign branch petroleum mining expenditure being offset against income from petroleum mining in New Zealand, so that tax is paid on it. This change will also prevent this expenditure from being used to offset non-petroleum mining income.

Petroleum mining expenditure not allocated in a current year is carried forward and is available for allocation in the next income years. The amount that can be allocated in future years is capped to the amount of income that a petroleum miner earns from those petroleum mining operations in that country.

Removing existing impediments to investment

The amendments are intended to remove disincentives that may affect investment in oil and gas exploration and development in New Zealand.

Removing the onshore offshore boundary

The bill repeals the current distinction between onshore and offshore petroleum mining development and allows deductions for petroleum development expenditure to be allocated from the date that expenditure is incurred. Section EJ 12 of the Income Tax Act 2007 currently allows different starting points for the allocation of deductions for onshore and offshore petroleum development expenditure. Modern drilling and oil and gas extraction techniques have made the current onshore offshore boundary unsustainable. The amendment replaces the two starting points with a single starting point and allows deductions for petroleum development expenditure to start to be allocated in the year that development expenditure is incurred.

Consequential amendments will also be made to the Income Tax Act 2004.

Units of production amortisation

Under the proposed changes, petroleum miners will be able to elect to amortise development expenditure under either the current straight-line method or on the proposed units of production basis. The changes deal with a concern that petroleum miners may be discouraged under the current rules from investing in projects that have a shorter life span. Allowing development costs to be amortised over the life of the project more appropriately reflects the allocation of development costs over the life of the field. Petroleum miners will be able to choose to allocate development expenditure under the units of production method in the year that commercial production begins. The bill also proposes that a 50 percent reserves estimate be used for the unit of production amortisation. It also allows a deduction for any unallocated expenditure when a production well stops producing, when a taxpayer is amortising development expenditure under the units of production method.

Consequential amendments will also be made to the Income Tax Act 2004.

Deduction for expenditure on a dry well

Petroleum miners will be allowed a deduction for the cost of a dry production well. A dry production well is one that is completed but will never produce petroleum in commercial quantities. A deduction for such expenditure will be allowed if the well is abandoned.

Consequential amendments will also be made to the Income Tax Act 2004.

Remedial amendment to petroleum mining anti-avoidance provision

A remedial change is being made to a petroleum mining anti-avoidance provision in the Income Tax Act 2004 and Income Tax Act 2007 – section DT 2 – to ensure that it does not apply more broadly than intended. Section DT 2 is aimed at preventing double deductions for the same amount of expenditure. However, in some cases it could give the inappropriate result of reducing a taxpayer's deductions from a single deduction to no deduction at all.

The amendment to section DT 2 will prevent this inappropriate result by excluding from the provision transactions involving the disposal of foreign petroleum mining assets. The proposed amendment will apply from 1 December 2007.

Background

On 4 March 2008, the Minister of Finance and the Minister of Revenue announced changes to the tax treatment of foreign branches of petroleum miners. The changes will safeguard tax revenue from New Zealand's growing petroleum production. The concern was that New Zealand may not receive its proper share of benefit from New Zealand petroleum resources as a result of arrangements involving expenditure on petroleum mining operations undertaken through a foreign branch being offset against New Zealand income.

On 26 November 2007, tax policy officials released a consultative paper on possible changes to the tax treatment of petroleum mining expenditure. The proposed legislative changes are primarily designed to remove the uncertainty and disincentives to petroleum exploration and development in the current tax rules.

NIUE DEVELOPMENT

(Clause 219)

Summary of proposed amendment

This amendment allows the 66 percent common ownership requirement for loss grouping to be varied by Order in Council in relation to Niue development projects. The purpose of the concession is to assist in the development of the Niuean economy.

Application date

The amendment comes into force on 1 April 2008 and has effect for the 2008–09 and subsequent income years.

Key features

The proposed amendment allows the percentage thresholds in sections IC 2(2), IC 3 and IC 5(1)(a) of the Income Tax Act 2007 to be varied by Order in Council in relation to Niue development companies.

An order may be made if the Governor General is satisfied that the company is carrying on a business that has been or is carried on wholly or mainly for the development of Niue or has been or is important to the development of Niue. Alternatively, an order may be made if the Governor General is satisfied that the company has incurred expenditure wholly or mainly in deriving income from Niue or in the course of carrying on a business in Niue for the purpose of deriving income.

The order must name the company or companies with a tax loss to which the varied threshold should apply (referred to as company A in subpart IC). The relaxation of the common ownership requirement would be effected by replacing the percentage figure specified in section IC 3(1)(a) and (b) with a lower figure.

Section IC 6(1) provides that the common ownership requirement applies for the commonality period. This is the period beginning from the start of the income year in which company A incurs the loss and ending at the end of the income year in which company B (the company to which the loss is made available) uses that loss. The order may specify a period or periods for which it applies. If no period is specified, the order applies for the whole of the commonality period.

Background

Currently, under section IC 3, losses incurred by one company can be offset against the profits of another company only if there is at least 66 percent common ownership of the two companies. This is intended to allow the ultimate shareholders of a group of companies to obtain immediate relief for a loss, while ensuring that the people who enjoy that relief are those who actually bore the economic loss in the first place.

The immediate intention is to use this order-making power to vary the common ownership threshold of two joint ventures which the New Zealand-based Reef Group is engaged in with the Government of Niue, in Niue. This will enable Reef to set losses incurred by the joint ventures against its other group profits. This is a concessionary measure intended to assist in the development of Niue's economy.

RAISING CERTAIN TAX THRESHOLDS

(Clauses 83, 105, 106, 109-114, 387(5) & (8), 389, 390, 494, 526 and 527)

Summary of proposed amendments

The amendments will raise certain tax thresholds, as outlined in the government discussion document, *Reducing tax compliance costs for small and medium-sized enterprises*, released in December 2007.

The amendments are largely aimed at helping to reduce tax compliance costs for small and medium-sized enterprises (SMEs), although some will also apply to other individuals and businesses generally.

Application date

The amendments will apply from 1 April 2009.

Key features

The following changes to tax thresholds are being introduced:

- Section RD 22 of the Income Tax Act 2007 is being amended to raise the threshold for filing and paying Pay As You Earn (PAYE) once a month from \$100,000 to \$250,000 (based on annual PAYE and SSCWT deductions). This will allow more employers to file and pay PAYE deductions once a month instead of twice a month.
- Sections RD 60 and 61 of the Income Tax Act 2007 are being amended to raise the number of employers that can file and pay fringe benefit tax (FBT) returns on an annual basis rather than quarterly. The threshold for filing FBT on an annual basis is being raised from \$100,000 to \$250,000 (based on annual PAYE and SSCWT deductions). In addition, closely held businesses will be allowed to file FBT returns annually, regardless of their annual PAYE and SSCWT deductions, when their FBT liability arises solely from the provision of up to two vehicles for shareholder-employees.
- Section 120KE of the Tax Administration Act 1994 is being amended to raise the safe harbour threshold for provisional tax use-of-money interest (UOMI) from \$35,000 to \$50,000 (based on annual residual income tax). This will allow more taxpayers to use the standard uplift method of calculating provisional tax rather than estimating their liability.
- Section EB 23 of the Income Tax Act 2007 is being amended to raise the exemption threshold for low-value trading stock from \$5,000 to \$10,000 (based on the value of trading stock). This will allow more businesses for which stock on hand is an incidental part of their business to use a simplified valuation rule for tax purposes.

- Sections EW 54 to 60 of the Income Tax Act 2007 are being amended to allow non-individuals (such as companies and trusts) to return income tax for financial arrangements on a cash accounting basis. Currently, only individuals may account for financial arrangements using the cash basis.
- Section EW 17 of the Income Tax Act 2007 is being amended to raise the threshold for allowing financial arrangements to be accounted for on a straight-line basis from \$1.5 million to \$1.85 million (based on the total level of financial arrangements). This means fewer taxpayers will have to make complex calculations when calculating their tax liabilities on financial arrangements.
- Section 51 of the Goods and Services Tax Act 1985 is being amended to raise the threshold above which GST registration is required, from \$40,000 to \$50,000 (based on annual GST turnover). This will allow more taxpayers to exit the GST base if they wish to do so, thus enjoying the associated compliance savings that this entails.
- Section 15 of the Goods and Services Tax Act 1985 is being amended to raise the threshold for filing GST on a six-monthly basis from \$250,000 to \$500,000 (based on annual turnover). This will allow more taxpayers to file GST returns on that basis if they wish to do so.

Background

Compliance with tax laws can entail significant time and costs for many businesses. Compliance costs can arise because of the variety of tax compliance activities involved (for example, performing tax calculations, seeking advice, record-keeping, filing returns and making tax payments), and the complexity of tax law and administrative procedures. These costs often have a disproportionate effect on SMEs, which make up approximately 96 percent of businesses in New Zealand.

Reducing the complexity of the tax rules means that taxpayers are less likely to require expert assistance, and are less likely to make errors. As well as reducing tangible costs, such as hours spent and expenditure on accounting fees, reducing the complexity of the tax rules allows business operators to spend more time on their businesses.

Tax thresholds can be changed by increasing the level at which they are set, and by extending the types of taxpayers that may elect to use them. Changing a tax threshold can reduce compliance costs in several ways. It can reduce the number of tax returns that must be completed, the amount of information or the number of calculations required to complete each return, and the number of payments the taxpayer must make to Inland Revenue. In turn, this reduces the number of interactions taxpayers have with Inland Revenue, and the amount of time taxpayers spend complying with tax rules.

CHANGES TO THE TAX POOLING RULES

(Clauses 280, 282, 404, 405, 406, 407, 408(141), 492 and 510)

Summary of proposed amendments

A number of amendments are being made to the provisional tax pooling rules to ensure the legislation reflects the original policy intent and to extend tax pooling to include reassessments of all taxes (such as voluntary disclosure and resolution of disputes).

Application date

The amendments will apply from 1 April 2009, apart from the amendment to allow transfers of money between tax pooling intermediaries, which applies from the date of enactment.

Key features

The provisional tax pooling rules have been amended to ensure that the only regular tax payments that pooling funds can be used for is provisional tax and terminal tax. Pooling funds are not available to meet regular payments such as GST and PAYE because the amount due is known by the due date, unlike provisional tax. This change reflects the original policy intent.

The policy intent of the tax pooling rules was that provisional taxpayers who meet their provisional tax liabilities during the year but who end up with tax to pay at the end of the year should, within 60 days of their terminal tax date, be able to purchase funds from a tax pooling intermediary to settle their provisional tax and terminal tax liabilities. The legislative amendment allows this.

An amendment is being made to section RP 19(1) to clarify that transfers to provisional or terminal tax with an effective date after the terminal tax date are applied first to the interest outstanding. Any remainder is then applied to the core tax.

The transfer rules in section 173M of the Tax Administration Act 1994 have been amended to clarify that transfers can be made from any tax type to a tax pooling account. The effective date of the transfer will be the date of the request (not a backdated date). This reflects current administrative practice.

The tax pooling rules are to be extended. New section RP 17B is inserted in the Income Tax Act 2007 to provide for the extension of tax pooling to include reassessments of all taxes, including voluntary disclosures and resolution of disputes. The request for pooling funds must be made within 60 days of being notified of the reassessed amount by the Commissioner.

Pooling funds will be available only for the difference between the previously assessed amount and the new reassessed amount.

If tax pooling funds are used to pay a reassessed amount of tax other than income tax, the taxpayer's imputation credit account is debited for the amount transferred to another tax type.

Taxpayers who change tax pooling intermediaries will be able to transfer their funds from one intermediary to another while retaining the original effective (deposit) date, which will foster competition between tax pooling intermediaries. The change will apply to both new and existing deposits.

There has been some uncertainty over how the term "tax paid" should be interpreted. Section 120C(1) of the Tax Administration Act is also being amended to clarify that tax paid means the amount transferred to a taxpayer's account or a tax pooling account by the due date for the tax.

Background

A review of the legislation applying to tax pooling intermediaries has been undertaken to ensure the rules are working as intended. The changes proposed in this bill have resulted from that review.

MIGRANT WORKERS EMPLOYED UNDER THE RECOGNISED SEASONAL EMPLOYER POLICY

(Clauses 383, 408 (91) and (116), 417, 422, 444, 445 and 454)

Summary of proposed amendments

Several remedial amendments are being made to reduce the compliance costs incurred by migrant workers who come to New Zealand to work under the recognised seasonal employer policy. The compliance costs will be reduced by correctly deducting tax from migrant workers during the year and removing the requirement for these workers to file end of year tax returns.

Application date

The amendments will apply from 1 April 2009.

Key features

Changes are being made to reduce the tax compliance costs faced by migrant workers and deduct the correct tax from them during the year. They include a definition of non-resident seasonal worker which is being inserted in the definitions section, section YA 1, of the Income Tax Act 2007 and changes to the rules that deal with the residency of natural persons (section YD 1(10)), to treat these migrant workers, who would otherwise be treated as residents, as non-residents. This imposes significant compliance costs especially if the worker does not speak English.

A new tax deduction code, "NSW", is being introduced for these non-resident seasonal workers. The tax code requires tax to be deducted at a full and final flat tax rate of 19 cents in the dollar. Amendments are being made to Schedule 2 of the Income Tax Act 2007 and to sections 24B(3) and 24F(5) of the Tax Administration Act 1994 to give effect to the new tax deduction code and rate.

The return filing requirements of section 33A of the Tax Administration Act 1994 are being amended to remove the requirement for these migrant workers to file an income tax return or personal tax summary.

Background

Migrant workers who come to New Zealand under the Recognised Seasonal Employer policy can work here for seven to nine months before going home. As they are here more than 183 days, they are treated as resident for tax purposes. Because they work for only part of the year, the PAYE tax deduction system over-taxes these workers, requiring them to file an end-of-year return to receive their refund.

BANKING CONTINUITY ISSUES

(Clauses 408(98) and 416)

Summary of proposed amendments

The bill introduces changes to ensure shareholder continuity is preserved for certain restructuring arrangements that result in no change of economic ownership of a group of companies. The preservation of shareholder continuity will ensure that no unintended consequences of the continuity rules as they apply to imputation credits and losses will arise as a result of the restructuring. In the absence of the amendments the concessionary continuity rules would not provide continuity, and the core continuity rule could not be readily applied.

Application date

The amendments will apply from 1 April 2008.

Key features

New section YC 18B ensures that shareholder continuity is preserved for restructuring that result in no significant change of ownership within a group of companies. Shareholder continuity is preserved for the initial parent, new parent and any interests considered to be held by the initial parent before the restructuring.

The main criteria for the concession will be that the restructuring will result in no significant change to the ultimate economic ownership of the initial parent company and its subsidiaries.

The criteria for the concession are as follows:

- Except for a nominal amount of shares issued to facilitate the reorganisation, shareholders of the initial parent company will have the same interests in the same proportions in the new parent as they did at the start of the restructuring and at its conclusion.
- The market value of any nominal amount of shares issued to facilitate the restructuring expressed as a percentage of the market value of all the shares in the new parent company is such that it is reasonable to treat the exchanging shareholders as owning all the shares.
- The restructuring does not result in any return to the shareholders (ignoring any nominal amount of shares issued to facilitate the transaction), apart from the exchange of shares in the initial parent company for shares in the new parent company.

- The initial parent company at the start of the restructuring and new parent company immediately at the completion of the restructuring are limited attribution companies. If the initial parent ceases to be a limited attribution company before the new parent company becomes a limited attribution company this will be ignored.

If the criteria are met, the new parent company is regarded as holding all the interests and limited attribution status that the initial parent company held. This results in no breach of the concessionary continuity rules.

Background

Some Australian banking groups with significant New Zealand operations are considering restructuring to separate their banking from their other businesses. The restructuring results in the Australian bank replacing its initial parent company with a new company as the listed banking group parent company.

This restructuring is a direct response to Australian regulatory standards and has the full support of the regulators and the Australian government. From a New Zealand tax policy perspective, the restructuring should not have any effect for New Zealand tax purposes, whether for New Zealand holders of the initial parent company's shares or for the New Zealand banking group.

The Income Tax Act 2007 provides general rules to determine the shareholder interests in a company. There are a number of concessionary rules that deal with situations where it is impractical to apply the more detailed general rules. However, this particular type of restructuring falls outside of the requirements of the concessions. This means that the initial parent company and its subsidiaries will not be able to carry forward any tax losses and imputation credits they had before restructuring under the concessionary rules.

From a policy perspective, the initial parent company and its subsidiaries should be able to preserve their continuity, as the replacement parent company does not result in any substantive change to the ultimate ownership of the initial parent company and its subsidiaries.

CHARITABLE DONEE STATUS

(Clause 427)

Summary of proposed amendments

The Educational Aid for International Development Trust Board, the Ingwavuma Orphan Trust Fund of New Zealand, the Kyrgyzstan New Zealand Rural Trust, the L Women of Africa Fund, Partners Relief and Development NZ, the Tender Trust, The Band Aid Box, The Destitute Children's Home, Pokhara, Charitable Trust, The Palestine Children's Relief Fund Charitable Trust, the Triyog Himalaya Trust and the UNHCR (United Nations High Commissioner for Refugees) are to be given charitable donee status. This will enable donors to obtain tax relief on their donations.

Application date

The amendments will apply from the 2008–09 tax year.

Key features

The following organisations are being added to Schedule 32 of the Income Tax Act 2007, which lists the organisations that qualify for charitable donee status:

- Educational Aid for International Development Trust Board;
- Ingwavuma Orphan Trust Fund of New Zealand;
- Kyrgyzstan New Zealand Rural Trust;
- L Women of Africa Fund;
- Partners Relief and Development NZ;
- Tender Trust;
- The Band Aid Box;
- The Destitute Children's Home, Pokhara, Charitable Trust;
- The Palestine Children's Relief Fund Charitable Trust;
- Triyog Himalaya Trust; and
- UNHCR (United Nations High Commissioner for Refugees).

A change is also being made to reflect that the Bright Hope International Trust, which already has donee status, has changed its name to Global Hope.

Background

Donations to qualifying organisations entitle individual taxpayers to a rebate of 33 $\frac{1}{3}$ percent of the amount donated.

Donations by companies qualify for a deduction. A Māori authority may also claim a deduction from its net income for donations to charitable organisations and/or a body that has been defined as a “Māori association” under the Māori Community Development Act 1962.

Educational Aid for International Development Trust Board

This organisation is involved in the establishment of a secondary school in the Kagera region of Tanzania. It is currently considering other projects in this region, including secondary teacher and nursing training.

Ingwavuma Orphan Trust Fund of New Zealand

This Trust provides care and education for children in the Ingwavuma area of Natal in South Africa who have been orphaned or who are in need.

Kyrgyzstan New Zealand Rural Trust

This Trust is engaged in agricultural aid programmes in Kyrgyzstan.

L Women of Africa Fund

This organisation funds surgery for women in Africa who are suffering from vesico vaginal fistula (caused by complications in childbirth).

Partners Relief and Development NZ

Partners Relief and Development is part of a global organisation that is providing humanitarian aid in Burma.

Tender Trust

The Tender Trust has established and runs an orphanage in Uganda.

The Band Aid Box

This organisation is providing medical assistance to the people of the Khari Khola area in Nepal.

The Destitute Children’s Home, Pokhara, Charitable Trust

This Trust has been established to support a small home for needy children in Pokhara, Nepal.

The Palestine Children's Relief Fund Charitable Trust

The Trust raises funds for medical services, particularly paediatric cardiac services for needy Palestine children, training medical staff in Palestine, and to bring Palestinian medical staff to New Zealand for advanced training.

Triyog Himalaya Trust

The Trust has been established for aid activities in Nepal. It is currently raising funds to sponsor a secondary school teacher.

UNHCR (United Nations High Commissioner for Refugees)

The United Nations General Assembly established a High Commissioner's Office for Refugees in 1951. UNHCR provides humanitarian aid in numerous countries.

APPLICATION OF THE NON-DISCLOSURE RIGHT

(Clauses 433(2) & (5) and 437-441)

Summary of proposed amendment

An amendment is being made to the Tax Administration Act 1994 to allow the right of non-disclosure to apply to discovery and similar processes that occur during litigation.

Application date

The amendment will apply to challenge proceedings filed on or after the date of enactment.

Key features

The right of non-disclosure in sections 20B to 20G of the Tax Administration Act is being amended to allow the right to apply to documents that the Commissioner has sought to be disclosed during litigation. The amendment will allow the Courts to have access to the facts (the tax contextual information), but not to the tax advisor's view of the facts.

Currently, the ability of the Commissioner or taxpayer to challenge the claim that a book or document is a "tax advice document" subject to the non-disclosure right is determined by a District Court Judge. This can create difficulties if the matter is being heard in another court. A further amendment is being made to allow the determination to be made by the court hearing the matter.

Background

In 2005, the government introduced a right of non-disclosure relating to certain tax advice documents provided between tax advisors and their clients so there is greater parity between lawyers (who are able to claim legal professional privilege) and other tax advisors. The ability to not disclose such documents applies at the investigation and disputes phases entered into by, or with, Inland Revenue. However, the right does not extend to preventing disclosure of these documents by the Commissioner of Inland Revenue during litigation. In contrast, legal privilege extends throughout both court proceedings and Inland Revenue administrative proceedings.

TAX RECOVERY ARRANGEMENTS

(Clause 508)

Summary of the proposed amendments

An amendment is being made to the Tax Administration Act 1994 to clarify that bilateral tax recovery arrangements entered into in double tax agreements (DTAs) may provide for charges associated with a collectible foreign tax debt also to be collected. The change is aimed at resolving uncertainty over what charges such as penalties, interest and costs of collection New Zealand can collect on behalf of other countries under a DTA arrangement.

Application date

The amendment will apply from 1 April 2008.

Key features

A clarification is being inserted into section 173D of the Tax Administration Act 1994 to ensure that charges such as interest, administrative penalties and costs may be collected under New Zealand's tax recovery arrangements.

Background

New Zealand has recently begun entering into bilateral tax recovery arrangements in its DTAs. Part XA of the Tax Administration Act 1994 imposes some limitations on the tax recovery assistance that New Zealand can provide to other countries. DTAs generally override domestic law, but Part XA has been deliberately framed so that it cannot be overridden by a DTA.

Part XA is silent on the matter of charges associated with the foreign unpaid tax that New Zealand may be asked to collect for other countries under such arrangements (such as penalties, interest and costs). However, concerns have arisen that an argument could be constructed that the way "tax" is defined for the purposes of the Act results in Part XA, preventing New Zealand from collecting such charges. This would run counter to the original intention that associated charges would be collected. It would also conflict with our tax recovery arrangements, all of which are explicit that such charges are to be collected.

To date, New Zealand has entered into tax recovery arrangements only with Australia, the Netherlands, Poland and the United Kingdom. The administrative details for these arrangements have now been finalised, and New Zealand has potentially been able to receive requests for assistance from 1 April 2008. The clarifying amendment will therefore apply from that date.

PUBLIC AUTHORITIES AND GST

(Clauses 2(2) and 519(4))

Summary of proposed amendments

An amendment to the GST Act 1985 will confirm that the Office of the Clerk of the House of Representatives and the Parliamentary Service have an obligation to charge GST on the activities they undertake. The change reflects the activities of these offices in making supplies of goods and services which should be subject to GST.

Application dates

In relation to the Parliamentary Service, the amendment will apply from 1 October 1986, the date GST started. The amendment will apply to the Office of Clerk of the House of Representatives from 1 August 1988, the date the Office of the Clerk of the House of Representatives was established.

Key features

Section 2, the interpretation section of the GST Act, will be amended to include the Office of the Clerk of the House of Representatives and the Parliamentary Service in the definition of “public authority”.

Background

The GST Act currently treats public authorities as carrying on a taxable activity and requires GST to be charged on appropriations received from Parliament. This outcome is achieved by deeming public authorities, including instruments of government and certain offices of Parliament, to be carrying on a taxable activity and making supplies of goods and services in return for appropriations from Parliament. This is consistent with the comprehensiveness of the GST base.

GST ON CERTAIN LOYALTY TRANSACTIONS

(Clauses 519(3), 520, 521 and 525)

Summary of proposed amendments

An amendment to the GST Act 1985 is being introduced to allow certain loyalty programme operators to defer the imposition of GST until the redemption of loyalty points to ensure that GST is being paid at the correct rate. The new rules will ensure that the correct GST rate is imposed on loyalty points, depending on whether the points are ultimately redeemed for supplies that would normally be zero-rated or for supplies that are normally subject to a standard rate of GST.

Application dates

The amendment will apply from the date of enactment.

Key features

New section 9(9) will allow certain loyalty programme operators to defer the imposition of GST on a sale of loyalty points to another person until such time that the loyalty points are redeemed.

New section 11C specifies the requirements that must be satisfied before a loyalty programme operator can defer the imposition of GST under the proposed section 9(9). A loyalty programme operator will be able to use the proposed rules if it makes supplies for consideration under an arrangement with another person to provide loyalty points to a third person and the following conditions are satisfied:

- Twenty-five percent or more of the loyalty programme operator's business, or an associated person's business involves providing zero-rated goods or services.
- The operator or its associated person has a business activity outside the activity of operating a loyalty programme (the main business activity) and the loyalty points can be redeemed for rewards supplied by the operator or its associated person as part of the main business activity.
- The loyalty programme operator can identify, at the time of the redemption of loyalty points, whether GST has already been imposed on the points in question when they were issued or whether the GST liability was deferred until the redemption of points under proposed section 9(9).

New section 11C(6) states that the second requirement will still be satisfied if, in addition to being redeemable for rewards supplied by the operator's or associated person's main business activity, the loyalty points can be redeemed for a reward supplied by an operator's partner under an associated loyalty programme.

The legislation also defines the term “loyalty programme” in section 2, and makes a consequential amendment to the meaning of the term “supply” in section 5(14).

The new rules will ensure that the correct GST rate is imposed on loyalty points, depending on whether the points are ultimately redeemed for normally zero-rated supplies or for supplies that are normally subject to a standard rate of GST.

Background

GST is charged on goods and services consumed in New Zealand. Since exported goods and services are generally consumed outside of New Zealand, exports of goods and services are zero-rated. Zero-rating allows a supplier of goods and services not to charge GST, but to still be able to claim input tax deductions.

There may be situations where, because of the involvement of an intermediary, supplies of what are normally considered zero-rated goods or services are subject to GST at the standard rate. For example, a loyalty programme operator (such as an airline) may enter into a transaction with a purchaser whereby the purchaser pays the loyalty programme operator for crediting loyalty points to a customer. The customer may later redeem the loyalty points for a zero-rated reward supplied by the loyalty programme operator. By imposing GST on the loyalty points at the time they were issued, GST is in effect imposed on what would normally be a zero-rated supply. This anomaly would not exist if the supply were acquired directly from the operator for a monetary consideration instead of through the use of loyalty points.

Therefore an amendment to the GST Act is required to allow certain loyalty programme operators to defer the imposition of GST until the nature, and normal GST rate, of a reward is known.

GST AND EXPORTED SECOND-HAND GOODS

(Clauses 522 and 523)

Summary of proposed amendments

Changes are being made to the Goods and Services Tax Act 1985 to allow, in certain circumstances, exported second-hand goods to be zero-rated when the exporter has claimed a second-hand goods input tax deduction. The changes ensure that exported second-hand goods that are not brought back into New Zealand are treated in the same way as exported new goods.

Application date

The amendments will apply from the date of enactment.

Key features

The zero-rating rules that apply to exported goods are being amended by inserting three new subsections in section 11 of the GST Act.

New section 11(3B) permits certain exported second-hand goods for which a second-hand goods input tax deduction has been claimed to be zero-rated, if:

- the goods are entered for export under the Customs and Excise Act 1996; and
- the goods leave New Zealand within 28 days of the goods being supplied (as determined by the earlier event of the recipient paying for the goods or the supplier issuing an invoice).

New section 11(3B) will apply if the recipient provides the supplier, at or before the time of supply, a written undertaking that the goods will not be brought back to New Zealand by the recipient, or a person associated with the recipient, in a condition that is substantially the same as the condition in which they were exported.

New section 11(3C) is an anti-avoidance provision that requires GST to be charged if all of the following events have taken place:

- the exported goods were previously zero-rated;
- the goods are subsequently imported into New Zealand;
- the goods are reacquired by the exporter in a condition that is substantially the same as when the goods were zero-rated; and
- the exporter had claimed a second-hand goods input tax deduction in connection with the original export of the goods.

New section 11(3D) provides that section 11(3C) applies at the time the goods are reacquired unless GST is imposed under section 12 of the GST Act when the goods are subsequently imported into New Zealand.

A consequential change is being made to section 10(4), which determines the taxable value of the exported goods if section 11(3C) applies.

Background

Exports of second-hand goods are currently subject to GST at the standard rate of 12.5% if the exporter, or an associate of the exporter, has claimed a second-hand goods input tax deduction. The imposition of GST in these circumstances is designed to prevent revenue losses from exporting second-hand goods that have never been subject to GST but gave rise to an input tax deduction when acquired. A further tax base risk arises if the goods are subsequently brought back to New Zealand without GST applying on importation and again sold to the exporter or an associate of the exporter to create another second-hand goods deduction. These risks are dealt with by section 11(3)(a), which, by reference to section 10(4), requires GST to be charged on exported second-hand goods.

Example 1: Exported scrap metal under the current rules

Company A Ltd pays \$630 for scrap metal (2,000 kg of light gauge grade steel and 1,500 kg of oversized grade steel) acquired from the demolition of a haybarn on private property. The owner of the haybarn is not registered for GST, and Company A claims a second-hand goods deduction of \$70 ($\$630 \div 9$) on the purchase of the scrap metal. Company A cleans and sorts the steel and cuts any oversized components to light gauge specification. The steel is baled and stored with similar gauged steel which is held as trading stock.

Company A receives an order for 6,000 kg of steel from an Indonesian firm.

Supplying the order involves Company A using a mixture of scrap metal that has been acquired from unregistered and registered persons (including all of the steel that was formerly part of the haybarn). Company A needs to calculate and charge GST on the quantity (3,500 kg) of scrap metal from the haybarn. GST of \$70 is therefore payable on the export. The remaining quantity (2,500 kg) is zero-rated.

The problem with charging GST on exported second-hand goods is, however, that it treats these goods differently from exported new goods and is inconsistent with the broad objective that goods consumed by businesses outside New Zealand should be zero-rated. For these reasons, the GST Act is being amended so that it allows exported second-hand goods to be zero-rated if:

- the goods are entered for export;
- the goods leave New Zealand within 28 days of the time of supply; and
- the recipient provides a declaration (for example, in the sale and purchase agreement or other sales document) at or before the time of supply that neither they nor an associated person will cause the goods to be reimported to New Zealand in the same condition in which they were exported.

To reduce the tax base risks identified with zero-rating exported second-hand goods, an anti-avoidance measure is being added and will apply at the time of reacquisition if the exported goods are sold back to the exporter or an associate of the exporter in substantially the same condition in which they were originally supplied. The anti-avoidance provision would not apply if, in bringing the goods back to New Zealand, GST was imposed on importation as in this situation the GST treatment of the second-hand goods is considered to be tax-neutral.

Example 2: Exported scrap metal under the proposed rules

In the situation set out in Example 1, the entire export can be zero-rated under the proposed amendments if the Indonesian firm provides a declaration – for example, a clause in the sale and purchase agreement, that it or a person associated with the firm will not cause the goods to be brought back into New Zealand in substantially the same condition in which they were exported.

Remedial amendments

TECHNICAL AMENDMENTS TO THE PORTFOLIO INVESTMENT ENTITY RULES

(Clauses 49, 56, 76-78, 206-211, 213, 223, 237, 275, 286, 408, 449, 460, 463, 581-587 and 613)

Summary of proposed amendments

A number of remedial amendments are being made to the new tax rules for portfolio investment entities (PIEs). These proposed amendments ensure that the rules achieve their intended policy effect.

Application date

The amendments to the PIE rules in the Income Tax Act 2007 are effective from 1 April 2008. The amendments to the PIE rules in the Income Tax Act 2004 are effective from 1 October 2007. The relevant amendments to the Tax Administration Act 1994 are effective from 1 October 2007.

Key features

The main areas covered by the amendments are the eligibility criteria for becoming a portfolio investment entity, the calculation of tax liability, filing and information provision requirements, and investors' tax rates that are used by portfolio investment entities.

Background

New tax rules for collective investment vehicles that meet the definition of a "portfolio investment entity" (PIE) were enacted by the Taxation (Savings Investment and Miscellaneous Provisions) Act in December 2006.

The PIE rules were designed to alleviate a number of long-standing problems with the taxation of collective investment vehicles. The rules treat investment through PIEs largely in the same way as direct investment by individuals, thus removing long-standing disadvantages of saving through collective investment vehicles, such as superannuation funds being taxed at a rate higher than investors in those funds with a lower marginal tax rate. These reforms were particularly important given the implementation of KiwiSaver in 2007.

PIEs are not taxable on realised share gains made on investments in New Zealand and certain Australian companies. They pay tax on investment income for their individual investors at a rate of 19.5% or 30%, depending on the investor's income in the previous two years. Income earned through a PIE generally does not affect investors' entitlements to family assistance, their student loan repayments or child support obligations.

The amendments in the bill are of a remedial nature and address technical problems that have been identified with the new rules or amend the rules to cater for different circumstances. The amendments are consistent with the policy intent of the new tax rules for portfolio investment entities.

Detailed analysis

Land-owning companies

As well as holding shares and debt investments, PIEs can also directly own land because passive investments in land can be a major element of a diversified investment portfolio. However, weaknesses in the current law allow land-rich active businesses (for example, rest homes and airports) to use the ability of portfolio investment entities to own land directly to their advantage and restructure themselves as PIEs. This is contrary to the policy intent of the portfolio investment entity rules, which were designed to be used by widely held passive savings vehicles.

In particular, the weakness in the current law allow a land-rich active business to be effectively split up into a land-owning company (the PIE), and an operating company, using a structure that ensures the operating company does not “taint” the land-owning company and prevent it from being a PIE. This can be done by:

- stapling shares in the land-owning company to shares in the operating company; or
- leasing the PIE’s land and buildings to an associated operating company and ensuring the operating company does not represent a significant portion of the PIE’s total investments.

The Minister of Finance and the Minister of Revenue announced in September 2007 that amendments would be introduced to address these weaknesses, with application from 1 October 2007.

The weaknesses in the current law that allow a land-owning active business to access the PIE rules in a way that is contrary to policy intent will be addressed by amending the income type requirement in section HL 10(2)(b)(iii) of the Income Tax Act 2004 and the Income Tax Act 2007, which currently provides that income under a lease of land meets the income type requirement. The amendment will provide that income under a lease of land derived by a PIE from an associated person (which would include a company whose shares are stapled to the shares in the PIE) does not count as qualifying income for the purposes of the income type eligibility requirement in section HL 10(2)(b)(iii).

Transfer of expenditure to portfolio investment entities

The PIE tax rules allow a superannuation fund or a unit trust (a member fund) that has not elected to be a PIE but has invested in a portfolio investment entity to transfer deductible expenditure to the PIE. A member fund may want to transfer expenditure to a PIE in this way as it may not have sufficient income against which to offset the expenditure. The member fund gains the tax benefit of the expenditure it transfers because the PIE offsets the transferred expenditure against the income that it earns for the member fund.

A number of remedial amendments to the expenditure transfer rules in subpart DV of the Income Tax Act 2007 are required so that they apply appropriately for portfolio tax rate entities.

Section DV 2 will be amended to ensure that the transferred expenditure is deductible to the portfolio tax rate entity in the income year the expenditure is transferred by the member fund.

Sections DV 2 and DV 5 of the Income Tax Act 2007 are being amended to provide that a portfolio tax rate entity's deduction is limited to:

- expenditure that the member fund has incurred since it started investing in the portfolio tax rate entity; and
- expenditure that the member fund has incurred in relation to its investment in the portfolio tax rate entity.

Section DV 4, which allows surplus expenditure to be carried forward by member funds, will be amended so that it does not apply to transfers of expenditure to portfolio tax rate entities.

Australasian share gains exclusion

Section CX 55 of the Income Tax Act 2007, which provides that proceeds from disposals of certain Australasian shares by PIEs are excluded income, will be amended to reinstate the previous Australian Stock Exchange listing and franking account requirements. These requirements were contained in the former section CX 55(1)(a)(ii) and (iii) and were inadvertently omitted when an amendment was made to this provision by the Taxation (Business Taxation and Remedial Matters) Act 2007.

Entity type eligibility requirement

Section HL 4(1)(a) of the Income Tax Act 2007 and Income Tax Act 2004 is being amended to provide that an entity ceases to be a PIE if the entity fails to meet the entity type requirements in section HL 2(2) – for example, the requirement that a portfolio tax rate entity must be a company, superannuation fund or a group investment fund.

Effect of failure to meet eligibility requirements

Section HL 4(2)(a) of the Income Tax Act 2007 and the Income Tax Act 2004, concerning breaches of certain eligibility requirements, is being amended to apply fully on a portfolio investor class basis in relation to a failure to meet a requirement of section HL 6 (investor membership requirement) or section HL 9 (investor interest size requirement). New section HL 4(2)(ab), concerning breaches of the investment requirements in section HL 10, will be structured on an entity rather a portfolio investor class basis.

Becoming a portfolio investment entity

Section HL 13 of the Income Tax Act 2007 and section HL 12 of the Income Tax Act 2004 contain rules dealing with consequences of an entity becoming a portfolio investment entity. Section HL 13(1)(b) of the Income Tax Act 2007 and section HL 12(1)(b) of the Income Tax Act 2004 provide that an entity is deemed never to have been a PIE if within 12 months of the date of election to become a PIE it fails to meet one or more of the eligibility criteria referred to in section HL 4. These deeming provisions are being amended so that they apply only if an entity fails to meet one or more of the eligibility requirements in section HL 6 (investor membership requirement), HL 9 (investor interest size requirement), or section HL 10 (investment requirements) in each quarter of the 12-month period.

Credits received by portfolio tax rate entities

The credit allocation rules for PIEs in section HL 29(7) of the Income Tax Act 2007 and section HL 27(7) of the Income Tax Act 2004 are being amended to ensure that an investor with a portfolio investor exit period (exiting investor) is not allocated an excessive amount of credits.

An exiting investor in a quarterly portfolio tax rate entity should be treated as receiving a credit which has been allocated to the investor in the quarter in which the exit occurs. Under the current wording of these provisions the exiting investor may get the benefit of credits that are allocated in previous quarters twice – first by the portfolio tax rate entity reducing its portfolio entity tax liability, and second by the investor being able to use the allocated credit against other tax liabilities. Therefore a clarifying amendment is being made to section HL 29(7) of the Income Tax Act 2007 and section HL 27(7) of the Income Tax Act 2004 to ensure that the proper amount of credit is allocated to an exiting investor.

Recording allocated credits in company investor's imputation credit account

A new provision, section OB 9B, is being inserted in the Income Tax Act 2007 to ensure that a company investor in a portfolio tax rate entity can include imputation credits allocated to it under section HL 29(7)(b) in its imputation credit account. The imputation credit will be recorded in the company investor's imputation credit account on the date the credit is allocated by the portfolio tax rate entity to the investor.

Current section OB 9 allows a company to include in its imputation credit account an imputation credit attached to a dividend derived by the company. This does not cater for a company investor in a portfolio tax rate entity which is allocated imputation credits under section HL 29(7)(b) separately from any distribution from the portfolio tax rate entity.

Use of allocated imputation credits

A clarifying amendment is being made to section LE 1 of the Income Tax Act 2007 to ensure that persons are allowed a tax credit if imputation credits are allocated to them under section HL 29(7)(b). The relevant persons are zero-rated portfolio investors such as companies and trustees and investors with portfolio investor exit periods. New section LE (1B) will provide that an investor in a portfolio tax rate entity who is

allocated an imputation credit under section HL 29(7)(b) has a tax credit for the tax year of an amount equal to the imputation credit.

The main imputation crediting provision in section LE 1(1) refers to a person whose assessable income for an income year includes an imputation credit. This inclusion is achieved by section CD 15, which provides that an amount of a dividend is increased by an imputation credit attached to the dividend. This provision, however, is not applicable to investors in portfolio tax rate entities who are allocated imputation credits under section HL 29(7)(b) separately from any dividend.

Current section LE 1(4) will be consequently repealed.

Confirming refundability of certain tax credits for portfolio tax rate entities

A clarifying amendment is being made to ensure that tax credits under section LS 1 of the Income Tax Act 2007 are refundable to a portfolio tax rate entity (other than an entity that chooses to pay provisional tax). The relevant credits are credits (not being foreign tax credits) allocated to individual investors (other than investors with portfolio investor exit periods) under section HL 29 and credits arising under section HL 21(2) from portfolio investor allocated losses of such investors.

The amendment confirming refundability of credits arising under section LS 1 involves including section LS 1 credits in the list of refundable credits in section LA 6(1). The section YA 1 definition of “refundable tax credit” is also being amended to include credits arising under section LS 1.

Prescribed investor rates and trustees of charitable trusts

The definition of “prescribed investor rate” in section YA 1 of the Income Tax Act 2007 and section OB 1 of the Income Tax Act 2004 is being amended to prevent trustees of charitable trusts electing a 30% rate instead of being zero-rated portfolio investors. If charitable investors could elect a 30% rate this could mean they could get the benefit of refundable credits for portfolio investor allocated losses and excess imputation or other credits, something they could not get as zero-rated portfolio investors. This would be contrary to the policy intent of the portfolio investment entity rules.

Selection of incorrect portfolio investor rate

An amendment is being made to the definition of “portfolio investor rate” in section YA 1 of the Income Tax Act 2007 to allow the Commissioner to override a rate incorrectly selected by an investor; the exercise of this discretion would result in the default portfolio investor rate of 30% applying.

Normally, the portfolio investor rate is the rate that an investor notifies to the portfolio tax rate entity as the investor’s prescribed investor rate. The portfolio tax rate entity is entitled to rely on the rate notified to it by the investor. Under the proposed amendment, the rate notified by the investor to the portfolio tax rate entity will continue to apply as the portfolio investor rate unless the Commissioner has notified the entity that the rate notified by the investor is to be disregarded, in which case the default rate of 30% under paragraph (a) of the portfolio investor rate definition applies.

Information provided by portfolio tax rate entities to investors

Section 31B(1) of the Tax Administration Act 1994, which contains the requirement for portfolio tax rate entities to provide information statements to zero-rated portfolio investors, is being repealed. This means that such investors will be covered by the information statement rules in section 31B(3), which require portfolio tax rate entities to provide information statements to their investors by 30 June after the end of the tax year (or a later date if the entity has a late balance date).

Currently, portfolio tax rate entities are required under section 31B(2B) to provide information statements to their zero-rated portfolio investors within one month of the end of the relevant period, which in practice is an insufficient period to comply with. Also, for zero-rated portfolio investors in quarterly portfolio tax rate entities it is important only that they receive information on an annual basis rather than after the end of each quarter, as is currently required.

Returns by portfolio tax rate entities

Section 57B(6)(c) is being amended to provide an additional month for portfolio tax rate entities that are ceasing to file their final return. This means that such entities will have three months rather than the current two months to provide their final return.

A cross-referencing correction to section 57B of the Tax Administration Act 1994 is being made in section 61(1C). The amended section 61(1C) will require a portfolio tax rate entity (not being an entity that chooses under section HL 23 to pay provisional tax) to disclose its interests in foreign companies or foreign investment funds by the due date for the entity's return under section 57B(5).

The provision in section 57B, containing the deadlines by when portfolio tax rate entities must perform their responsibilities for investors with portfolio investor exit periods, is being re-enacted as subsection (3B); the provision is currently incorrectly located within section 57B.

Minor drafting corrections

A number of amendments have been made to correct minor drafting and cross-referencing errors. These are:

- Section HL 6(4)(a) and (b) of the Income Tax Act 2007 and the Income Tax Act 2004, relating to the investor membership requirement, are being amended to include a cross-reference to the paragraph that lists Auckland Regional Holdings.
- Section HL 9(6)(a) and (b) of the Income Tax Act 2007 and the Income Tax Act 2004, relating to the investor interest size requirement, are being amended to include a cross-reference to the paragraph that lists Auckland Regional Holdings.
- Section HL 12(1)(a) of the Income Tax Act 2007 and section HL 11B(1)(a) of the Income Tax Act 2004, relating to unlisted companies choosing to become portfolio listed companies, are being amended so that the reference to an unlisted company needing to have 100 shareholders is changed to an unlisted company needing to have at least 100 shareholders.

TECHNICAL AMENDMENTS TO THE OFFSHORE PORTFOLIO SHARE INVESTMENT RULES

(Clauses 15, 128, 130, 132-137, 139, 463, 513, 543 and 569-575)

Summary of proposed amendments

A number of remedial amendments are being made to the new tax rules for offshore portfolio investment in shares. These proposed amendments ensure that the new rules achieve their intended policy effect.

Application date

The amendments contained in the Income Tax Act 2007 are effective from 1 April 2008. The smaller number of amendments to the Income Tax Act 2004 are effective from 1 April 2007.

Background

New tax rules for offshore portfolio investment in shares were enacted by the Taxation (Savings, Investment, and Miscellaneous Provisions) Act 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 relate to the foreign investment fund rules. The main changes were that the “grey list” exemption in the foreign investment fund rules has been removed and the 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 amendments in the bill are of a remedial nature and address technical problems that have been identified with the new rules or amend the rules to cater for different circumstances; all the amendments are consistent with the policy intent of the new tax rules for offshore portfolio investment in shares.

Detailed analysis

Venture capital exemption

Several aspects of the exemption in the foreign investment fund rules for interests in grey list companies which own New Zealand venture capital companies – section EX 37 of the Income Tax Act 2007 and section EX 33(4) of the Income Tax Act 2004 – will be clarified. First, ownership of the New Zealand company should be defined as holding more than 50 percent of the voting interests in the company. This amendment will make it clear when the 10-year limitation for the exemption ends. Secondly, it will be clarified that the company that carries on business in New Zealand is a New Zealand-resident company.

Australian-resident listed company exemption

The exemption from the foreign investment fund rules for shares in Australian-resident companies listed on the Australian Stock Exchange is being amended to cater for companies which are the subject of court-approved reorganisations. In particular, the requirement that shares in the company be included in an approved Australian Stock Exchange index will be expanded to include the situation where the shares are included in an approved index at the beginning of the final month of the preceding income year, if the shares are cancelled in the first month of an income year under a court-approved arrangement.

Excluding managed funds from grey list exception in fair dividend rate method

The fair dividend rate rules were amended by the Taxation (Business Taxation and Remedial Matters) Act 2007 to provide that there is no foreign investment fund income in the situation where a 10 percent or more holding is held in a grey list company at the start of an income year. This ensures there is no foreign investment fund income if that holding falls below 10 percent during the year. This treatment is consistent with the general fair dividend rate treatment, which ignores purchases of shares during a year (other than quick sales).

However, this 2007 amendment should not generally apply to managed funds that hold shares in a foreign investment vehicle because the remaining grey list exemption for 10 percent or more interests does not apply to managed funds such as portfolio investment entities; instead the fair dividend rate method applies to such investments. Accordingly, an exclusion will be made to this amendment for managed funds (portfolio investment entities, entities eligible to be portfolio investment entities, or life insurance companies) that hold interests in foreign investment vehicles (as defined in section YA 1 of the Income Tax Act 2007 and section OB 1 of the Income Tax Act 2004).

A managed fund will therefore be able to use the fair dividend rate method for a 10 percent or more interest in a foreign investment vehicle that is resident in a grey list country (as it can currently for an interest in a foreign investment vehicle resident in a non-grey list country). This exclusion will be achieved by amendments to the fair dividend rate method provisions in the Income Tax Act 2007 (sections EX 52 and EX 53) and the Income Tax Act 2004 (sections EX 44C and EX 44D).

Related amendments are being made to sections EX 59 and CD 36 of the Income Tax Act 2007 and sections EX 47 and CD 26 of the Income Tax Act 2004 to ensure that the dividend exclusion continues to apply for a managed fund holding an interest in a foreign investment vehicle.

Comparative value method and currency conversion rules

A clarifying amendment is being made to the opening value definition in the comparative value method in the foreign investment fund rules (section EX 51 of the Income Tax Act 2007 and section EX 44 of the Income Tax Act 2004) to ensure that the correct exchange rate is used.

The opening value definition in the comparative value method refers to the market value of the person's interest at the end of the previous income year. If a person has chosen to use the average exchange rate (the average of the close of trading spot exchange rates for the 15th day of each month that falls in the year), it is the average exchange rate applying for that previous year which should be used to calculate the opening value for the current year. This approach is necessary to ensure that exchange rate gains and losses are reflected in foreign investment fund income or loss under the comparative value method over different income years.

Therefore the comparative value method provisions are being amended to ensure that it is the relevant exchange rate applying in the previous income year that is used to calculate the opening value for the current year.

Cost method

The cost method in the foreign investment fund rules was amended by the Taxation (Business Taxation and Remedial Matters) Act 2007 to allow investors to use their actual cost for their opening value under that method, instead of having to obtain an independent valuation, for interests acquired in the 2005–06 or 2006–07 income year. This amendment was designed to reduce compliance costs for a person using the cost method for the 2007–08 income year, the first income year that the cost method is used for.

An amendment is being made to the cost method in section EX 56 of the Income Tax Act 2007 and section EX 45B of the Income Tax Act 2004 to ensure that this opening value option is available only for the 2007–08 income year and not future income years as this opening value does not include an uplift factor for the previous year's foreign investment fund income to act as a proxy for an increase in the value of the investment.

Drafting consistency amendment

To achieve consistency with other references to the comparative value method in sections EX 46(4)(a)(i) and EX 62(2)(c), section EX 47 of the Income Tax Act 2007 will be amended by replacing the reference to “start of the income year” with “end of the income year”. Therefore a person who is not allowed to use the fair dividend rate method for an attributing interest is required to use the comparative value method for that interest or the deemed rate of return method if the comparative value method is not practical because the person cannot obtain the market value of the interest at the end of the income year. The same change is also being made to the corresponding provision in section EX 40B of the Income Tax Act 2004.

Income Tax Act rewrite-related amendments

A number of remedial amendments are being made to the foreign investment fund rules in the Income Tax Act 2007 to ensure that there has been no change to the rules as part of the Income Tax Act rewrite process. The significant rewrite-related amendments are:

- The fair dividend rate rules in sections EX 52 and EX 53 of the Income Tax Act 2007 are being amended to allow an investor to offset a net loss from one foreign investment fund interest against the net gain from another foreign investment fund interest. This reinstates the position that under the Income Tax Act 2004. The fair dividend rate rules in the Income Tax Act 2004 pooled the results for all attributing interests for which an investor used the fair dividend rate method. In contrast, the fair dividend rate rules in the Income Tax Act 2007 deal separately with each foreign investment fund in which an investor holds attributing interests. This approach prevents an investor offsetting, under the quick sale gains part of the fair dividend rate formula, a net loss from one foreign investment fund interest against a net gain from another foreign investment fund interest.
- The references to treating certain shares as debt will be removed from sections EX 46 and EX 47. That will prevent the wording of a number of provisions in sections EX 46 and EX 47 of the Income Tax Act 2007 giving the incorrect impression that certain types of shares for which the fair dividend rate method may not be used are instead treated as debt for the purposes of the Income Tax Act 2007 (and therefore subject to the financial arrangement rules rather than the foreign investment fund rules). It is intended that such shares are taxed under the comparative value method in the foreign investment fund rules.
- For the purposes of applying the fair dividend rate method, an original share in a foreign company that is subject to a returning share transfer should be treated as being held by the share supplier and not the share user. This amendment was made by the Taxation (Business Taxation and Remedial Matters) Act 2007 to the fair dividend rate method provisions in the Income Tax Act 2004 but was inadvertently not made to the corresponding provisions in the Income Tax Act 2007; this omission will be rectified by amendments to sections EX 52 and EX 53 of the Income Tax Act 2007.

Disclosure of foreign interests

Section 61 of the Tax Administration Act 1994, containing the disclosure requirements for interests in foreign companies or foreign investment funds, is being amended to facilitate electronic filing. The part of the current provision that may be problematic for electronic filing is the requirement in the opening wording of section 61(1) that the disclosure must be “with that person’s return of income”. This will be replaced by a requirement that the disclosure be made within the time allowed for providing a person’s return of income for the year.

The first reference to “tax year” in section 61(1) is also being replaced with “income year” to cater for persons with non-standard balance dates. This amendment is a correction since references to years in the international tax rules – which include section 61 of the Tax Administration Act 1994 – have always included non-standard accounting years since their inception in 1988. This amendment is effective from 1 April 2005.

Suspending obligation to pay tax on foreign investment fund income

Section 183 of the Tax Administration Act 1994, which allows the payment of tax on foreign investment fund income to be suspended in very limited circumstances, is being repealed as a tax simplification measure. This complicated provision is not used in practice and has also been superseded by exemptions enacted in 2006 for new migrants.

AMENDMENTS TO R&D TAX CREDIT RULES

(Clauses 47, 243-247, 273, 279, 280, 284, 287, 296, 307, 325-329, 331, 336, 337, 339, 343, 424, 433, 466, 467, 474-476, 490, 491, 509 and 511)

The bill contains several remedial amendments to the R&D tax credit rules in the Income Tax Act 2007 and related administrative provisions in the Tax Administration Act 2004. They are required to fine-tune the provisions to ensure that they give full effect to the policy intent of the R&D tax credits.

Summary of proposed changes

The proposed amendments:

- align the expenditure rules for testing a process with other expenditure rules;
- amend the timing rules so that deferred salary expenditure will be eligible for the tax credit in the year in which the salary is actually paid and overseas expenditure that has been carried forward will be eligible for a tax credit at the time there is sufficient local expenditure to make a claim;
- remove the option for partnerships to file R&D detailed statements on behalf of partners;
- create a requirement that a detailed statement supporting an R&D tax credit claim or a proposed amendment leading to a tax credit must be received before the claim can be processed;
- align the final dates for filing a tax credit claim, providing supporting information, and amending a tax credit claim by making them relative to the due date for the initial claim;
- allow more time for Inland Revenue to revise up claims in some cases when a request for amendment arrives close to the final date; and
- confirm current policy in relation to imputation rules, refunds, effective dates of transfer and the tax status of the credit.

Application date

The amendments will apply from the 2008–09 income year, the application date for the R&D tax credit.

Process testing expenditure

Two amendments are proposed to the provisions that deal with expenditure incurred in circumstances where, typically, a mass-production process is being tested as part of an R&D activity.

The current schedule 21, part A, clause 8, which is a general provision allowing a credit for this type of expenditure, is to be repealed. This will mean that to qualify for the tax credit, the majority of “process” expenditure needs to meet the general tests in part A in the same way other types of expenditure need to. The exception is materials processed or transformed as part of the R&D activity, which are to be covered by the new clause 8.

The current schedule 21, part B, clause 7 is intended to limit process expenditure eligible for the credit to the excess of that spending over any valuable output of the process. This provision could be interpreted to have a wider application and so is being rewritten to make its application clear.

Deferred salaries and overseas R&D expenditure

Currently, the R&D activity must be performed in the income year for which the claimant has a tax credit. Similarly, the expenditure must be incurred in the income year for which the claim is made. These timing rules prevent tax credits arising for deferred salary expenditure and for overseas expenditure that has been required to be carried forward until there is sufficient local expenditure.

Therefore new sections LH 5B and LH 5C are being inserted to override the two timing rules for these two types of expenditure. The amendments do not change the requirement that the claimant must have satisfied the requirements in section LH 2(1) at the time the R&D activities were undertaken. New section LH 3(6) is a consequential amendment.

Filing on behalf of partners

The amendments to sections 68D and 68E of the Tax Administration Act remove the ability for partnerships to file a single R&D detailed statement on behalf of all partners. The changes are intended to prevent potential disclosure of information about non-partnership R&D activities and to simplify administration.

No credit until detailed statement is filed

A new section LH 2(8) is being added to prevent an R&D tax credit arising before a detailed statement for the relevant year is filed under sections 68D or 68E of the Tax Administration Act 1994. The information contained in the detailed statement is necessary for Inland Revenue to be able to process the claim properly for a credit, and needs to be received before the credit legally arises. Sections 68D and 68E are consequentially modified so that they will not override section LH 2(8).

Change to response periods for notices related to R&D tax credits

The core definition of “response period” is to be moved from section 3(1) to a new section 89AB. Time periods for filing notices of proposed adjustment (NOPAs) that relate solely to an amount of R&D tax credit are to be altered so that they are consistent with other time limits for those credits. Currently claimants have one year from the final date for filing a tax return to file a NOPA that relates solely to an amount of R&D tax credit for that income year. There is a temporary extension from one year to two years for the 2008–09 and 2009–10 income years. There is no intention to change response periods except in the case of NOPAs relating solely to an amount of R&D tax credit.

Requirements for notice of proposed adjustment relating to R&D tax credit

If a taxpayer has claimed a tax credit in an income tax return and/or is going to issue a NOPA that would affect the entitlement to an amount of tax credit, it should not be possible for the claimant to issue a NOPA in relation to that return unless a detailed statement has been filed. Amendments to sections 89D and 89DA ensure that a claimant files a detailed statement under sections 68D or 68E, as applicable, before disputing an assessment of an amount of tax credit. This is to ensure that Inland Revenue has basic information about the R&D activities of the taxpayer before the dispute commences.

Date after which amount of R&D tax credit may not be raised

Section 108(1B) prevents the Commissioner of Inland Revenue from increasing the amount of tax credit after a certain time has passed. The section is being amended so that the date is consistent with other time limits for R&D tax credits. The amount of credit may not be increased if one year has passed since the final date for filing a tax return for the relevant income year. Section 108(1C) provides a temporary extension from one year to two years, in the 2008–09 and 2009–10 income years.

The time limit does not apply if a NOPA relating to the amount of credit has been issued within the relevant time period, or if a request has been made within the relevant time period to adjust the amount under section 113 and appropriate documentation has been provided. This is to allow time for the disputes process to be completed, or for the request to be properly processed.

Section 113D provides that if the time limit in section 108(1B) does not apply, the amount of the tax credit may not be increased to more than the amount specified in the NOPA or request. The intent is that NOPAs or requests received within the relevant time periods can be processed, not that the extension of time will allow further claims.

Effective date of transfer when excess R&D tax credits transferred

When excess tax is transferred under Part 10B of the Tax Administration Act, the taxpayer may choose an effective date for the transfer. Section 173L specifies when the effective date may be. Section 173L is to be amended so that the earliest date for transfers of excess R&D tax credits is the same as the date for refundable credits that are deducted at source, such as resident withholding tax. For most taxpayers this will mean an earlier effective date, which is to their advantage.

Surplus R&D tax credit used to satisfy liabilities treated as excess tax

A new section LH 2(7) is being added to treat surplus R&D tax credits that are used by the Commissioner to satisfy a liability of the taxpayer under an Inland Revenue Act as excess tax for the purposes of Part 10B of the Tax Administration Act 1994. This will ensure that section 173T of the Tax Administration Act applies, and the taxpayer may choose a date for the transfer under that Part. This aligns the treatment of amounts transferred compulsorily by the Commissioner under section LH 2(6) with the treatment of amounts transferred at the request of the taxpayer under section LA 6(2)(d).

Recovery of overpaid R&D tax credits

R&D tax credits are offset against a person's income tax liability under section LA 2 or otherwise used under sections LA 6(2) or LH 2(6). A new section LH 14B ensures that if the Commissioner considers that the amount so offset or used was greater than the proper amount, the difference between that amount and the proper amount may be recovered as if it were tax payable by the person.

This provision will apply if, for example, a taxpayer mistakenly claims too much tax credit and later corrects the mistake, or if the taxpayer is audited and a claim is found to be in excess of the proper amount. The tax or other amounts saved by the person, or the refund received, will become repayable.

Interaction of the imputation rules and R&D tax credits

When a company with an imputation credit account receives an amount of R&D tax credit it receives a corresponding credit to its imputation credit account. An amendment to section OB 4(3) ensures that only a single credit arises in the imputation credit account (ICA) of that company.

An amendment to section OB 37 ensures that if a refund of R&D tax credits is used other than to offset income tax liabilities of the taxpayer (that is, used under sections LA 6(2)(d), (e) and LH 2(6)), the company will have a corresponding debit to its imputation credit account. Amendments to sections OB 32 and OB 33 are intended to ensure that a company does not receive a double debit to its imputation credit account.

Additionally, if a refundable credit is used under sections LA 6(2)(d), LA 6(2)(e) or LH 2(6) by a company with an Foreign Dividend Payment (FDP) account, that company will also receive a debit to its ICA. There is one exception: if the credit is an FDP credit, use of these credits by a company will generate a debit in the FDP account of that company rather than a debit in its ICA. This amendment to section OB 37 corrects an unintended change introduced by the rewrite of the Income Tax Act.

Similar changes apply to Maori authority credit accounts and imputation credit accounts of consolidated imputation groups.

Refunds of R&D tax credit when instalment arrangement in place

Taxpayers with overdue liabilities under an Inland Revenue Act may have established an instalment arrangement to enable them to pay their debts. If such an arrangement is in place and is being complied with, it is desirable that the taxpayer be able to receive tax refunds if it elects to do so. Section 177B is to be amended so that an amount of R&D tax credit may be refunded or transferred in such a case, rather than being applied to outstanding tax liabilities under sections LA 6(2) or LH 2(6) of the Income Tax Act 2007. This also applies to other credits used under section LA 6(2) but does not apply to a current-year income tax liability, which is offset under section LA 2 of the Income Tax Act.

R&D tax credits are excluded income

New sections LH 1(3) and CX 48B are being added to clarify that the R&D tax credit is excluded income of the claimant. It was not intended that a person claiming would be required to pay income tax on those credits when they were received.

Incorrect cross-reference

The cross-reference in section 139BA(3)(b) of the Tax Administration Act 1994 is being corrected to refer to section 177(4).

TAX DEPRECIATION RULES

(Clauses 86, 87, 423, 478-482, 556, 557, 614, 618, 620, 621, 622 and 625)

Summary of proposed amendments

The bill contains a number of minor amendments to the tax depreciation rules, mostly dealing with remedial matters. The other amendments add two categories to the list of depreciable land improvements. The amendments clarify current tax depreciation policy settings.

Application dates

The application dates for the amendments depend on when the remedial matter arose. Many of the amendments have retrospective application dates to provide taxpayer comfort about previous years' tax positions.

Proposal	Application dates
<ul style="list-style-type: none">– Power to withdraw provisional rate determinations– Power to withdraw economic rate determinations– Schedule 13 – purpose-built surfaces for outdoor sports grounds	1 April 2008 and from the 2008–2009 and subsequent income years
<ul style="list-style-type: none">– Scope for retrospective determinations	3 April 2006 and from the 2005–2006 and subsequent income years
<ul style="list-style-type: none">– Calculation of provisional rates– Formula for calculating special rates	1 October 2005 and from the 2005–2006 and subsequent income years
<ul style="list-style-type: none">– Incorrect legislative references in the Income Tax (Depreciation Determination) Regulations 1993– Annual rate for depreciable property– High residual value assets– Obsolescence and special rates	1 April 2005 and from the 2005–2006 and subsequent income years
<ul style="list-style-type: none">– Schedule 13/16 – pipes and conduit– Status of default rates	1 April 1993 and from the 1993–1994 and subsequent income years

Key features

The depreciation proposals in this bill amend the Income Tax Acts 1976, 1994, 2004 and 2007, the Tax Administration Act 1994 and the Income Tax (Depreciation Determination) Regulations 1993.

Power to withdraw provisional and economic rate determinations

The amendment gives the Commissioner of Inland Revenue the power to withdraw both provisional determinations and economic rate determinations. Currently, the Commissioner does not have the power to make these determinations, which are necessary for administrative reasons. For example, a depreciation determination (either a provisional or on economic rate) may become outdated because the item no longer exists in the form set out in the determination, and should be withdrawn. Providing the Commissioner the power to withdraw depreciation determinations deals with this concern.

Annual rate for depreciable property

The lack of a reference to “special rate” or “provisional rate” in section EE 31 of the Income Tax Act 2007 raises two concerns. The first is whether depreciation loading is allowed for assets that are the subject of a special or provisional rate determination. The second is that taxpayers relying on these determinations may not be entitled to depreciation deductions. Neither result is consistent with the original policy. Including “special rate” and “provisional rate” in section EE 31 deals with both concerns. Consequential amendments to section EE 26 of the Income Tax Act 2004 will also be made.

Determining a provisional rate

The amendment deals with two remedial matters by inserting “provisional rate, as applicable” in section 91 AAG(3) of the Tax Administration Act 1994. First, it clarifies that provisional rate determinations are based upon the same methodology as economic rate determinations. Currently, the legislation contains no reference to the formulas the Commissioner of Inland Revenue must use to set the rate under a provisional rate determination.

Secondly, the amendment clarifies that the Commissioner must select the appropriate formula when making a determination that sets a provisional rate or special rate. It is currently unclear whether the Commissioner should consider the other requirements of the sections that contain the formulae when making these types of determinations. For example, the formula in section EE 28 only applies to assets that are buildings.

Default rates

The changes clarify that taxpayers can apply in writing for a provisional rate determination when there is an applicable default rate available. There is some uncertainty whether the law currently allows these applications to be made. The amendment also allows the Commissioner to decline an application for a provisional rate when it is unlikely that the work would result in a change in depreciation rate, as a result of the requirement that the Commissioner rounds the rate to the nearest banded rate in Schedule 11 or 12 of the Income Tax Act 2007.

Comprehensiveness of the pre-2005 rules

The amendment inserts section EZ 23 to the list in section 91AAG(3) of the Tax Administration Act 1994. This addition ensures that special rate determinations for assets acquired before the reform of the depreciation rules in 2005 are determined under the earlier rules. As a matter of principle, special rate applications for assets held before 1 April 2005 should be determined using the earlier rules.

Update of references depreciation regulations

As a result of the Taxation (Venture Capital and Miscellaneous Provisions) Act 2004, certain legislative references in the Income Tax (Depreciation Determination) Regulations 1993 are no longer correct and require updating. Accordingly, the Income Tax (Depreciation Determination) Regulations 1993 are being updated so that the legislative references in the regulations correctly reflect the proper reference in the Tax Administration Act 1994. References to sections 91AE and 91AJ in the regulations are being amended to sections 91AAG and 91AAL respectively.

Missing phrase “of cost” in section EE 30

The amendment inserts the words “of cost” in subsection (1) paragraph (b) of section EE 30 of the Income Tax Act 2007. This clarifies that a high residual value asset is one where the estimated residual value is greater than 13.5 percent of cost. Consequential amendments to the Income tax Act 2004 will also be made.

Removing Commissioner’s ability to make retrospective determinations

The amendments to section 91 AAF(4) prevent the Commissioner from being able to issue a determination that has a retrospective application. Section 91AAF(3) provides taxpayers with certainty that the Commissioner cannot retrospectively change economic depreciation rates for assets already owned or under contract to purchase. However, the current phrasing in section 91AAF(4) overrides section 91AAF(3) with the effect that the Commissioner has the power to make a retrospective determination on economic rate. This result is inconsistent with the policy intent.

Additions to the list of depreciable land improvements

The bill adds two categories of depreciable land improvements to Schedule 13 of the Income Tax Act 2007, with consequential amendments to earlier Income Tax Acts.

Under existing tax law, land is not generally considered to be depreciable property. However, certain improvements to the land, that in a legal sense become part of the land, do depreciate over a reasonably easily determinable period. Not allowing depreciation deductions on these improvements may discourage investment in making improvements to land.

The first category added to the list, “pipes and conduit”, deals with an omission dating back to when the current tax depreciation rules were introduced in 1993. The second category inserted, “purpose-built surfaces for outdoor sports grounds”, is in response to two requests for two types of land improvements to be added to the list of depreciable land improvements. The first request relates to “stabilised turf” (a composite of natural turf and synthetic materials) and the second relates to an equestrian arena.

Both types of land improvement depreciate and should be added to the list. The proposed wording broadly captures these types of surfaces and will allow the Commissioner to make depreciation determinations for these and other types of purpose-built surfaces for outdoor sports grounds (for example, tennis courts and artificial turf).

KIWISAVER AMENDMENTS

(Clauses 258-261, 408(28), 465, 529-541 and 613(4))

The bill makes several remedial amendments to the Tax Administration Act 1994, Income Tax Act 2004, the Income Tax Act 2007 and the KiwiSaver Act 2006. Some are required to fine-tune the provisions to ensure that they give full effect to the policy intent of KiwiSaver, while others correct minor drafting errors.

Calculation of the employer tax credit

(Clauses 258-261)

Summary of proposed changes

The government announced in Budget 2007 that, from 1 April 2008, the employer tax credit would reimburse employers for matching contributions they make into their employees' KiwiSaver (and complying fund) accounts at a rate of 100 percent, up to a maximum of \$20 per week for each employee. The existing formula in the KiwiSaver Act will not provide all eligible employers with the full entitlement to the credit.

New sections MK 2(B) and MK 12B to MK 12D of the Income Tax Act 2007 introduce an annual square-up process to ensure that employers receive their full entitlement to the employer tax credit. The process enables employers who experience a short payment of the tax credit to make an additional claim at the end of the tax year (from 1 April 2009). This means that employers are able to claim up to \$1,042.86 each year for each employee and do not have to keep track of when extra pays and therefore tax credit shortfalls occur during the year.

Application dates

The amendments relating to employer contributions made from 1 April 2008 will apply from 1 April 2009. The application dates for the remaining amendments vary from 1 July 2007 to the date of enactment. (See following text.)

Liability to pay compulsory employer contributions in cases of belated automatic enrolment

(Clauses 536 and 538)

Non-compliance with the automatic enrolment rules has implications for employees in terms of their entitlement to and accumulation of compulsory employer contributions.

From 1 April 2008, compulsory employer contributions are payable if the employer is required to make KiwiSaver deductions from an employee's salary or wages. Employers who fail to comply with the automatic enrolment provisions of the KiwiSaver Act by not making deductions from their employees' salary or wages when they begin new employment must back-pay any unpaid compulsory employer contributions once their non-compliance is detected. The amendments to sections 101A and 101FB of the KiwiSaver Act therefore limit employers' liability to pay compulsory

employer contributions to the lesser of the duration of the current employment relationship or a time period of the first year of current employment (provided the employee becomes a KiwiSaver member during either of those periods).

The amendment strikes a balance between the employer's obligation to automatically enrol new employees (and make employer contributions) and employees' obligations to make contributions from their salary or wages in order to receive employer contributions by becoming a member of KiwiSaver.

Application date

The amendments are to apply from 1 April 2008.

Minor technical and drafting amendments

A number of proposed amendments relating to KiwiSaver correct errors of a minor technical or drafting nature.

Application date – 1 July 2007

The following minor amendments are to apply from 1 July 2007:

Kick-start payment (clause 540)

Section 226(4) of the KiwiSaver Act provides that in all instances when people have ceased to be a member of a KiwiSaver scheme, and then rejoin, they will not be entitled to the kick-start contribution even if they have never previously benefited from the kick-start. The policy intention was, however, that each KiwiSaver member is eligible for one kick-start payment.

The amendments to section 226 of the KiwiSaver Act will ensure that people who have not received a kick-start payment before but subsequently become members, are able to receive a kick-start payment.

Commissioner discretion to back-date member tax credit (clauses 408(28) and 613(4))

Non-compliance by employers with the automatic enrolment rules has implications for employees in terms of their entitlement to and accumulation of the member tax credit.

Membership for employees who join KiwiSaver through their employer begins on the first of the month in which their first contribution is deducted from their salary or wages or the first of the month in which Inland Revenue received the first contribution. If people were not automatically enrolled into KiwiSaver when they should have been, they will have a belated membership start date because their employer failed to begin deductions. This results in these employees missing out on the member tax credit for periods of time against which their annual contributions could be pro-rated.

The amendment to the definition of “creditable membership” in sections OB 1 of the Income Tax Act 2004 and sections YA 1 of the Income Tax Act 2007 provides a Commissioner discretion so that the start date of “creditable membership” can be backdated when, because of circumstances outside the control of the employee, deductions of KiwiSaver contributions from an employee’s salary or wages did not begin at the correct time.

The amendment to the definition of “creditable membership” in section YA 1 of the Income Tax Act 2007 will apply from 1 April 2008.

Application date – 1 April 2008

The following minor amendments are to apply from 1 April 2008:

Refund of employer contributions (clause 535)

Currently, a refund of KiwiSaver employer contributions may be used either to offset tax debt or be forwarded to the employer at the discretion of Inland Revenue. As employer contributions may form part of an employee’s total remuneration package, the amendment to section 100 of the KiwiSaver Act will ensure that employer contributions that are to be refunded to an employer (for example, because an employee has opted out of KiwiSaver) must be refunded to employers and not offset against tax debt.

Employer contributions for employees with two or more funds (clause 538)

Problems arise when an employee is a member of two funds, such as a KiwiSaver scheme and an existing employer fund. That is because of the difference in the base on which contributions are calculated between complying superannuation funds and other existing schemes (calculated on a gross base salary and wage basis) and KiwiSaver funds (calculated on a gross salary or wage basis).

New section 101FC of the KiwiSaver Act ensures that when an employee is a member of two funds the employer is not required to make a “top up” payment of the difference to the employee’s KiwiSaver scheme.

Extending double dipping provisions to existing defined contribution schemes (clause 537)

The proposed amendment extends the legislation for preventing double dipping to existing defined superannuation schemes in which membership rights are portable. This means that members of a multi-employer scheme who change jobs to work for another employer who is part of the same scheme will not be able to continue receiving employer contributions for their existing scheme as well as access compulsory employer contributions for KiwiSaver.

Employer tax credit – “payment period” (clause 530)

The KiwiSaver Act requires the employer tax credit to be based on the PAYE payment period. However, Inland Revenue does not have the information necessary to correctly administer employers’ entitlement to the employer tax credit because large employers pay employer contributions twice monthly but file information relating to the amounts contributed only once a month. Accordingly, the amendment to section 4(1) of the KiwiSaver Act will amend the reference to “payment period” for the employer tax credit, to reflect the payment period covered and align it with the employer monthly schedule that is monthly.

Application date – 1 July 2008

The following minor amendment is to apply from 1 July 2008.

Mortgage diversion facility – fixed dollar amount (clause 541)

The “fixed dollar amount” requirement has been identified by superannuation industry representatives as being administratively costly and complex and likely to result in delays in payments to members’ mortgage lenders.

The amendment to section 229(2)(i) of the KiwiSaver Act therefore removes the requirement that amounts diverted under the mortgage diversion facility be a “fixed dollar amount”. This will mean that the amount diverted from a person’s KiwiSaver scheme and complying funds will be capped at not more than the total of:

- half the total contributions deducted for or contributed by the person and received by the KiwiSaver scheme provider; and
- half the person’s contributions to the complying superannuation funds, but limited to 4% of their annual gross base salary or wages for each complying superannuation fund.

This will ensure that members’ diverted contributions can be applied to their mortgage repayments in a timely manner.

Application date – 1 October 2008

The following minor amendment is to apply from 1 October 2008:

Removal of section 13 (clause 531)

Section 13 of the KiwiSaver Act 2006 provides that employees who begin a new job at a state or integrated school are treated as starting new employment, despite staying on the same payroll. However, to date, automatic enrolment has not occurred because Boards of Trustees³ are exempt from automatically enrolling new employees as they meet the exempt employer requirements in the Act. This exemption will be revoked from 1 October 2008, when the State Sector Retirement Savings Scheme and the Teachers Retirement Savings Scheme, the vehicles which provided the exempt employer status, are closed to new enrolments. The Boards of Trustees’ exemption for automatic enrolment will therefore be revoked, creating compliance problems for

³ The Board of Trustees of a school is treated as the employer for KiwiSaver purposes.

Boards of Trustees and the Education Service Payroll, particularly in respect of transferring employees and employees in multiple employment across the education sector.

The amendment accordingly removes section 13 of the KiwiSaver 2006 so that automatic enrolment will not occur for employees who transfer between schools.

Application date – date of enactment

The following minor amendments are to apply from the date of enactment of the amending legislation:

Member tax credit (clause 465)

The Tax Administration Act 1994 provides that fund providers must furnish the member tax credit claim on a date determined by the Commissioner. The reason for the due date was to ensure that each provider had the same opportunity to claim the credit and for the member tax credit payment to be pro-rated between providers for members who contribute to more than one scheme.

The pro-rating of the credit between providers was removed at the select committee stage of the Taxation (KiwiSaver) Act 2007. Accordingly, the credit is to be paid to providers on a first come, first served basis, removing the need for a due date (other than after the end of the member tax credit year (30 June)). The amendment to section 68C of the Tax Administration Act will remove the requirement that the member tax credit claimed by a fund provider be furnished on a date determined by the Commissioner.

Complying fund providers – eligibility to withdraw funds (clause 539)

Employers are required to make compulsory contributions into their employees' KiwiSaver or complying superannuation fund only for employees who are over 18 and under the age of eligibility to withdraw. Members become eligible to withdraw their KiwiSaver savings when they reach the age of eligibility for New Zealand Superannuation or after having been a member for five years, whichever occurs later.

Section 101G(3) of the KiwiSaver Act requires providers to notify Inland Revenue of the date that members will be entitled to withdraw their accumulated interest in the scheme. This must be done within two months of members becoming entitled to withdraw the accumulated interest. The Commissioner may notify a member's employer of the date so that the employer can cease making compulsory employer contributions.

As complying superannuation fund providers have a direct relationship with employers, the amendment to section 101G (3) of the KiwiSaver Act ensures that complying fund providers inform employers directly (rather than via Inland Revenue) of the date upon which a member will be eligible to withdraw funds.

Exempt employer provisions sunset clause (clause 532)

Sections 24 to 31 of the KiwiSaver Act contain the rules allowing certain employers to be exempt from the requirement to automatically enrol their new employees in KiwiSaver. Namely, employers can apply to the Government Actuary for approval for their employees to be exempt from the automatic enrolment rules if they provide access to an approved registered superannuation scheme which complies with specific criteria.

The government is concerned that a number of employers have been establishing schemes which are not KiwiSaver schemes, for the apparent purpose of avoiding the automatic enrolment rules. This behaviour undermines the policy intent of KiwiSaver and the rationale behind the exemption from the automatic enrolment rules. To overcome this concern, an amendment to section 25(1)(b) of the KiwiSaver Act introduces a sunset clause for the exemption from automatic enrolment. The exemption applies only if the scheme is in existence at the date of enactment of the amending legislation.

Interest paid on refunds (clause 534)

Inland Revenue pays interest on money to be refunded to members and employers – for example, if members opt out. A minimum-value threshold of five dollars currently applies to interest paid on refunded contributions.

The proposed repeal of sections 89(3) and (4) of the KiwiSaver Act will remove the threshold of five dollars for KiwiSaver purposes only so that interest is payable on all KiwiSaver refunds.

MISCELLANEOUS TECHNICAL ISSUES

Amendments to correct drafting and printing errors *(Various clauses)*

An unfortunate but inevitable consequence of the enactment of more than 3000 pages of tax legislation in 2007 is the need for remedial legislation to address drafting and printing issues that occurred in the last three months of the year. This bill contains over 100 amendments of this type. The amendments are to correct wrong cross-references, replace incorrect formulae with correct formulae, replace incorrect terminology with correct terminology, and to correct commencement dates. These amendments affect the Income Tax Act 2007, the Tax Administration Act 1994, and the KiwiSaver Act 2006. Pending enactment of legislation introduced in this bill, the effect of section ZA 3 of the Income Tax Act 2007 (the transitional provision) is generally considered to be that the meanings of the comparable provisions in the Income Tax Act 2004 are preserved.

Recharacterisation of certain debentures *(Clause 151)*

A remedial amendment corrects two unintended changes arising from the recent rewrite of the Income Tax Act which are contained in section FA 2 of the Income Tax Act 2007. The first unintended change is that certain debentures with market-related interest rates appear to be recharacterised as shares, contrary to former section FC 1 of the Income Tax Act 2004.

The second unintended change relates to “substituting debentures”, which correspond to debentures included in former section FC 2 of the Income Tax Act 2004. That section excluded all convertible notes, but it appears that subsection FA 2(6) of the rewritten Act does not do so in the case of convertible notes issued with reference to shares in another company.

The amendment applies from when the Income Tax Act 2007 came into force.

Threshold rise for attribution of personal services income *(Clause 181)*

The \$60,000 income threshold in the personal services attribution rule is being raised to reflect the new personal tax rate structure enacted as part of Budget 2008 legislation.

The personal services attribution rule ensures that income from personal services is attributed to the person who performs the services, rather than an interposed entity, in certain circumstances. Currently, the personal services attribution rule applies if the net income of the person performing the services is more than \$60,000.

The Taxation (Personal Tax Cuts, Annual Rates, and Remedial Matters) Act 2008 increases the threshold for the highest marginal tax rate over a period of four years. Section GB 27(2)(c) is therefore being consequentially amended to raise the personal services attribution threshold to \$70,000 from 1 April 2008, \$75,000 from 1 April 2010, and \$80,000 from 1 April 2011.

Rewriting of the portfolio investment entity rules
(Clause 214)

In the second half of 2007, while the Income Tax Act 2007 was in its final Parliamentary stages, the portfolio investment entity rules (then Subpart HL of the 2004 Act) were in the course of extensive further development.

To assist users of those rules, it was decided not to rewrite the rules for the Income Tax Act 2007. Undertakings were however given to rewrite these rules in “rewrite” style and to consult with representatives of the tax professions to ensure that the rewritten rules correctly reflect the law as it stood at the end of 2007. The rules have now been rewritten and the comments and suggestions of the various reviewers have been taken in to account.

The rewritten portfolio investment entity rules appear in this bill as an amendment to insert the new Subpart HM of the Income Tax Act 2007 and have application from 1 April 2009 for the 2009–10 and later income years.