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

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

Volume 1

Changes to the tax treatment of petroleum mining

Changes to the tax pooling rules

Tax treatment of emissions trading units

Other policy matters

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Changes to the tax treatment of petroleum mining

OVERVIEW

The bill contains provisions that amend the tax treatment of petroleum mining.

Provisions relating to deductions for expenditure on petroleum mining undertaken via a branch in another country look to ensure 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.

Other provisions look to remove disincentives that may affect investment in oil and gas exploration and development in New Zealand.

Ten submissions were received on the amendments. Most supported the modernisation of the petroleum mining tax rules, but raised some concerns around the practical application of the new rules. Generally, submissions did not support the proposed ring-fencing amendment.

FOREIGN BRANCH RING-FENCING

Clause 71

Submissions

(5 – Lindsay McKay for Greymouth Petroleum, 16 – Petroleum Exploration and Production Association of NZ, 21 – New Zealand Oil and Gas, 32 – KPMG, 68A – Corporate Taxpayers Group)

The proposed rule ring-fencing deductions for petroleum mining expenditure incurred through a foreign branch should apply only to foreign branches of New Zealand-incorporated petroleum miners controlled by non-residents, or to those where the majority of their petroleum mining operations are done outside New Zealand.

The provisions that ring-fence foreign branch losses discriminate against the petroleum industry because all other industries can offset foreign branch losses against New Zealand-sourced income.

Comment

The current petroleum mining rules allow an up-front deduction for exploration expenditure that is of a capital nature to encourage petroleum exploration and development in New Zealand.

The primary reason why we do not support limiting the scope of the proposed amendment is to ensure that New Zealand receives its proper share of benefit from New Zealand petroleum resources. Given the substantial increase in oil production in recent times, the government considers it is critical to protect the New Zealand petroleum mining tax base.

Petroleum mining generally involves large amounts of expenditure incurred by companies that operate in a number of countries. The reality is that these companies, by their very nature, have considerable flexibility over what jurisdiction they structure expenditure through. The costs of a significant foreign exploration or development project could eliminate a New Zealand petroleum miner's tax liability on its New Zealand operations. This concern applies whether the company is owned by residents or non-residents.

The submission that the scope of the current provision in the bill be limited to off-shore branches of New Zealand incorporated petroleum explorers controlled by non-residents is also problematic because it may run foul of the non-discrimination clauses in New Zealand's double tax agreements. These generally prevent New Zealand applying more restrictive tax treatments to non-residents than to New Zealand residents.

The current provision in the bill is in line with the practice in a number of other countries, such as the United Kingdom, which do not allow foreign petroleum mining expenditure to be offset against domestic petroleum mining income.

The current tax treatment of petroleum mining expenditure is arguably concessionary. The concern is that the concession is not working as intended because some New Zealand-resident companies are, in effect, gaining a significant subsidy from the New Zealand tax base for overseas petroleum exploration. Officials were alerted to taxpayers using foreign branches to shelter significant amounts of New Zealand petroleum mining income in late 2007. The proposed legislation merely ensures that the concession is available only for the exploration and development of New Zealand's petroleum resources. Should similar concerns arise in other areas of offshore activity, officials would provide advice on ways of addressing these concerns.

Recommendation

That the submissions be declined.

Submission
(5 – Lindsay McKay for Greymouth Petroleum)

There should be no change to the law for off-shore branch operations of petroleum mining companies, especially when such a change compromises existing petroleum mining off-shore branch operations.

Comment

Legislative changes often preserve the existing tax treatment for expenditure already incurred. The proposal to ring-fence foreign branch expenditure applies only to expenditure incurred on or after 4 March 2008, therefore preserving the tax treatment for expenditure incurred before that date.

However, while the law changes are technically prospective, they do affect the future tax position of petroleum miners who have entered into arrangements involving future expenditure. In this case, the changes defer deductions for the costs of future foreign petroleum mining exploration and development until foreign petroleum income is returned. This treatment may be mitigated by grandparenting provisions, so the law does not apply to transactions already entered into before the proposed change to the law was announced/enacted.

Businesses constantly have to deal with change, such as new competitors, products and services.

Similarly, changes in tax law occur for many reasons, reflecting society's changing view of equity, to counter the erosion of the tax base by aggressive tax behaviour, or to correct mistakes that are harmful to taxpayers. Officials recognise that changing the tax law is not a costless exercise and that costs must be justified.

For this reason, "grandparenting" is sometimes used to introduce changes to the tax system. Grandparenting is generally limited to transactions of a specific nature that are expected to be completed in a relatively short time after enactment. This is because there is a close similarity between the transaction completed just before enactment and one entered into but not completed until just after enactment. Giving the contracting parties certainty in allowing arrangements to be completed as contemplated by the parties helps to outweigh the costs (mainly fiscal) of not allowing these arrangements to be completed as contemplated.

However, longer term arrangements, like obligations given under an exploration permit, tend to involve less certainty across a whole range of factors, including tax rules, than short-term transactions. For example, petroleum exploration tends to involve open-ended arrangements, where decisions about incurring exploration costs can occur many years after the date the arrangement was first entered and these costs may be very large. In such instances grandparenting is not appropriate because the costs (mainly fiscal) outweigh the objective of providing certainty.

For these reasons we do not support grandparenting arrangements beyond expenditure incurred before 4 March 2008.

Recommendation

That the submission be declined.

Submissions
(16 – Petroleum Exploration and Production Association of NZ, 32 – KPMG, 67 – New Zealand Institute of Chartered Accountants)

The submissions suggest a number of alternative proposals to address the government's base maintenance concerns while being less problematic for taxpayers. They include:

- denying deductions for foreign branch losses and expenditure with no tax on foreign branch income; or
- limiting the application of the foreign branch ring-fencing rule to those companies where the majority of their petroleum mining operations (say 75 percent) are done outside of New Zealand, or limiting the rules to companies that are controlled by foreigners.

Comment

Given the immediacy of the risk to the petroleum mining revenue base and the expected timeframe for the review of the tax treatment of foreign branch active income, we consider that ring-fencing petroleum mining expenditure incurred outside New Zealand's territorial waters is a discrete approach that targets the concern.

Provisions within the bill introduce changes to the tax treatment of controlled foreign companies. Under the current proposal, active foreign income will be exempt, and deductions will be excluded from the New Zealand base. Consideration is being given to apply a similar treatment to foreign branch active income. While this reform would in theory protect the New Zealand petroleum mining income base, it is not scheduled to apply until the 2010–11 income year at the earliest. A key concern to be resolved in the review of foreign branch active income relates to the allocation of income and expenditure to branches.

We have previously discussed the problems with applying more restrictive tax rules on non-residents.

Recommendation

That the submissions be declined.

Submission

(16 – Petroleum Exploration and Production Association of NZ, 21 – New Zealand Oil and Gas, 32 – KPMG)

Allow an automatic entitlement to carry forward and reinstate any unallocated foreign branch deductions regardless of the normal shareholder continuity rules. One way to achieve this result would be to apply the amortisation rules that apply to research and development expenditure.

Comment

The government is concerned to ensure that tax losses of one person cannot be acquired by another person who happens to have taxable income. To prevent taxpayers trading losses, the current tax rules only allow deductions for expenditure and losses that are incurred by the taxpayer. The shareholder continuity rules set the bounds for determining changes in shareholder interests.

An exception to the general loss trading policy was implemented for research and development expenditure, because the policy was problematic for the growth cycle of high technology companies. These companies typically have a long lead-in period where significant expenditure is incurred before any income is realised. It is part of the normal financing process for such companies for additional equity investors to come in after the initial development work has been successful. If tax deductions for this development work cannot be used because of shareholding changes, this can effectively result in technology companies being taxed on their gross income.

The government previously decided to defer extending the current tax treatment of research and development expenditure to petroleum mining. As such, any project on this matter needs to be considered in the context of the government's tax policy work programme.

Recommendation

That the submission be declined.

Submission
(68A – Corporate Taxpayers Group)

Under the foreign branch ring-fence proposal, there is a risk that the investment will not produce sufficient petroleum mining income and give rise to a loss which will never be tax deductible.

Comment

The concern the submission raises can occur with rules designed to prevent the trading of losses. For example, a taxpayer goes out of business and has significant tax losses.

While we share the concern that some losses may be stranded, the provisions in the bill try to minimise the risk of this occurring. Allowing foreign branch petroleum mining expenditure to be offset against any foreign petroleum mining income reduces the risk of stranded losses.

Recommendation

That the submission be noted.

Submission
(67 – New Zealand Institute of Chartered Accountants)

The reference to section IF 1 in new section DT 1A(4) is a 2004 Act reference and should be in the 2007 Act.

Comment

The reference to section IF 1 is correct. There are two versions of section DT 1A(4), one for the Income Tax Act 2004 and one for the Income Tax Act 2007. Both versions have the correct references.

Recommendation

That the submission be declined.

Submission
(16 – Petroleum Exploration and Production Association of NZ, 35B – PricewaterhouseCoopers, 62 – Minter Ellison Rudd Watts)

Section DT 1A(2) should be amended by replacing "those operations" with the phrase "petroleum mining operation undertaken outside New Zealand". This would clarify the basis of deductibility for petroleum mining expenditure incurred through a foreign branch.

Comment

The policy is to allow foreign branch petroleum mining losses to be offset against petroleum mining income from any country other than New Zealand. The provisions in the bill ring-fence foreign branch petroleum mining losses on this basis. The reference to "on a country by country basis" in the commentary does not reflect the government's final policy.

There is a discrepancy between section DT 1A(2) and the commentary on that section. Section DT 1A(2) would be clearer if the words "those operations" were replaced with the words "petroleum mining operation undertaken outside New Zealand".

Recommendation

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

Submission
(16 – Petroleum Exploration and Production Association of NZ)

It is not appropriate to ring-fence deductions for development expenditure and residual expenditure.

Comment

The government is keen to ensure that New Zealand receives its fair share of the benefits from petroleum mining operations in New Zealand. This is fully achieved under the current amendments. Excluding other types of petroleum mining expenditure makes no sense given the policy objective.

Once the petroleum miner returns foreign petroleum mining income, the foreign petroleum mining deductions can be used.

Recommendation

That the submission be declined.

Issue: Allow another method for amortising development expenditure

Submission
(16 – Petroleum Exploration and Production Association of NZ)

The bill should allow petroleum miners to adopt a diminishing value/double declining balance approach as a way of amortising development expenditure. This approach would be in addition to the current straight-line basis and the unit of production basis as contained in the bill.

Comment

Currently, development expenditure is amortised on a straight-line basis over seven years. The bill contains provisions that will allow petroleum miners to choose to amortise development expenditure on plant and equipment designed and constructed to operate for the life of the permit (called "petroleum mining assets") on a unit of production basis or on the current straight-line basis.

The diminishing value method is generally accepted as being the method that more accurately reflects, when compared with straight-line amortisation, the actual decline in value of an asset over its useful life. Therefore, it is an appropriate method of calculating depreciation deductions for capital expenditure that has a finite useful life. The unit of production method provides an even more accurate method.

The unit of production method is a way of calculating depreciation deductions that uses a fixed cost per unit of production, based on an estimate of the total number of units the property will produce during its service life and the total cost of the asset. As each unit is produced, a deduction is allowed for the cost of that unit. Economically, the unit of production method is likely to be the most accurate way of amortising petroleum mining assets. In theory it would therefore be preferable to replace the straight-line method with the unit of production approach.

Economically, we see no reason to allow petroleum miners to amortise the cost of petroleum mining assets on a diminishing value basis. The diminishing value basis is a proxy for the decline in value for a given useful life. Amortising development expenditure over seven years is a concession where the capital spent to develop the field lasts for 20 years. Allowing a greater proportion of the capital expenditure to be taken earlier on in the asset's life is more concessionary.

Given there is no strong economic case for allowing a double declining balance approach, we are of the view that allowing petroleum miners to amortise petroleum mining assets on this basis only increases tax compliance costs, as taxpayers will assess the tax results of each method and select the one that produces the most favourable result.

Recommendation

That the submission be declined.

Issue: Unit of production – formula

Clause 93

Submission
(16 – Petroleum Exploration and Production Association of NZ)

Probable reserves should be replaced with proved reserves in the unit of production formula that allocates expenditure on petroleum mining assets.

Comment

The basic difference between "proved" and "probable" reserves lies in the level of certainty about the quantities of commercially recoverable oil and gas. Reserve estimates are based on information at a given date looking forward, from known reservoirs and under current economic conditions, operating methods and government regulations. Proved reserves have more than a 90 percent probability of recovery, while probable reserves have a greater than 50 percent probability of recovery. Because proved reserves estimates are lower than estimates of probable reserves, the amount of development expenditure deductible per unit of production will be greatest using proved reserves.

So that tax does not interfere with investment decisions, it is important that amortisation rates accurately reflect an asset's decline in value at the point at which the investment occurs. Overly generous rates encourage investment in what becomes a tax-preferred investment at the expense of other investment. Conversely, amortisation rates that are lower than the assets decline in value will discourage investment in what becomes a tax-disadvantaged investment. The question is whether oil companies' investments are based upon proven or probable reserves estimates.

We consider that investment decisions are most likely based on estimates of probable reserves for the following reasons. First, probable reserve estimates are regularly reviewed for both accounting and regulatory purposes, and are frequently used in petroleum mining company annual reports. In addition, the International Accounting Standards Board, the standard-setting body responsible for the development of International Financial Reporting Standards, considered in September 2008 the categories of reserves to be disclosed. While a final decision is still pending, the Board's current view seems to support the categories of reserves to be disclosed for accounting purposes ought to be "proven and probable", as this is the best estimate of the economically recoverable resources. This supports the use of probable reserves as the basis for the unit of production method.

Recommendation

That the submission be declined.

Issue: Unit of production method – previous deductions

Submission
(16 – Petroleum Exploration and Production Association of NZ)

The definition of "previous deduction" should be amended as follows:

> "The total amount of petroleum development expenditure to which this section applies that has been allocated in an earlier income year."

Comment

The submission is concerned that deductions for pre-1 April 2008 reserves expenditure will be counted twice. If this is not corrected, the amount of reserve expenditure to be allocated under the units of production method would be incorrect.

Recommendation

That the submission be accepted.

Issue: Unit of production method – application date

Submission
(16 – Petroleum Exploration and Production Association of NZ, 21 – New Zealand Oil and Gas, 28 – Australian Worldwide Limited, 32 – KPMG, 35B – PricewaterhouseCoopers)

The unit of production method should apply to all expenditure and not just expenditure incurred on or after 1 April 2008.

A number of submissions are also concerned that the unit of production method is not available for development expenditure incurred on or after 1 April 2008 in relation to a permit area where there has been commercial petroleum production.

Comment

While we agree to some extent with the points made in these submissions, officials have at least two concerns.

First, officials are concerned that there are fiscal risks associated with the proposal. It is possible for a number of oil or gas reservoirs to co-exist within a single petroleum mining permit. Commercial practice suggests that where possible, development infrastructure will be used across a number of reservoirs to reduce production costs. By allowing different amortisation rules for development expenditure within the same permit area, petroleum miners would have incentives to elect the seven-year amortisation for some development expenditure – that is, when the seven-year period is concessionary, and to apply the unit of production method to shorter-lived development expenditure. Under this arrangement, a petroleum miner would have the

flexibility and the incentives to undertake arrangements that produce the greatest tax benefits. Allowing taxpayers the flexibility to undertake such arrangements would increase fiscal costs. Allowing a one-off election that applies to the whole permit area, in the year of first production, addresses this concern.

The second concern relates to the compliance and administration costs associated with allowing petroleum miners to mix and match amortisation methods for development expenditure within the same permit area. Complex apportionment rules would be necessary to address concerns of accelerated deductions for longer-lived production assets, when these assets are used for both short-lived and longer-lived reserves. In addition, different calculations would need to be applied to development expenditure for the same petroleum mining development, depending on the amortisation method used.

For these reasons, officials prefer to have development expenditure within a permit area amortised on either the seven-year method or the unit of production method. However, we are still working on these matters.

Recommendation

That the submission be noted.

Issue: Aligning date of application with balance date

Submission
(16 – Petroleum Exploration and Production Association of NZ)

The rules should apply to expenditure, incurred on or after 1 April 2008, from the start of the petroleum miner's income year (2009) to minimise compliance costs.

Comment

The application date is drafted to apply to expenditure incurred on or after 1 April 2008. This submission would, if accepted, defer the ability of taxpayers to apply the unit of production amortisation until the start of a later tax year. The problem is that some taxpayers are less sensitive to compliance costs than others. For those taxpayers that are less sensitive to compliance costs, they may prefer an earlier application date and bear the additional compliance costs. On balance, we think that compliance costs arising from the application date are unlikely to be large and that most taxpayers would prefer the current application date.

Recommendation

That the submission be declined.

Issue: Date of application

Submission
(35B – PricewaterhouseCoopers)

The words "on or" should be added before "after 1 April 2008". As currently drafted, the proposed sections do not apply to expenditure incurred on 1 April 2008.

Comment

Officials agree with this submission.

Recommendation

That the submission be accepted.

Issue: Cap amortisation period

Submission
(16 – Petroleum Exploration and Production Association of NZ)

Irrespective of the choice of amortisation method, petroleum miners should be able to write off any remaining reserve value in the seventh year.

Comment

There is no basis for this approach as the seven-year period is arbitrary. In addition, capping the amortisation period for development expenditure would become a concession, under the unit of production method, and would have an additional fiscal cost. Consequently, officials do not support this submission.

Recommendation

That the submission be declined.

Issue: Transitional sections

Submission
(16 – Petroleum Exploration and Production Association of NZ)

A transition section is required for expenditure incurred before 1 April 2008 that has not yet been amortised.

Comment

The new sections apply to expenditure incurred on or after 1 April 2008. Officials will ensure that deductions can be taken for pre-1 April 2008 expenditure.

Recommendation

That the submission be noted.

Issue: Dry well and depleted production wells

Clause 95

Submission
(16 – Petroleum Exploration and Production Association of NZ)

The expenditure write-off provisions for dry and exhausted wells should apply from 1 April 2008, irrespective of the date when the expenditure was incurred.

Comment

The bill introduces a deduction for expenditure incurred on dry wells and the remaining book value of wells that stop producing, if the unit of production method is used. The provisions apply to expenditure incurred on or after 1 April 2008.

Allowing these provisions to apply to expenditure incurred before 1 April 2008 would produce a windfall gain for petroleum miners that incurred development expenditure earlier than 1 April 2008. It would also add fiscal costs. Petroleum miners undertake investment on the basis of the relevant economic and regulatory environment. For the investment to have occurred, they would have considered that the risks and returns made commercial sense.

Retrospectively altering the regulatory treatment of these sunken costs does nothing to alter investor behaviour. Instead, it produces windfall gains only for those who had investment before 1 April 2008.

Recommendation

That the submission be declined.

Submission
(35B – PricewaterhouseCoopers)

We support the proposal to allow a deduction for the cost of drilling a dry completed production well at the time the well is abandoned. However, this provision should be extended to apply also to wells which are only partly completed before being abandoned.

Comment

Officials agree with this submission.

Recommendation

That the submission be accepted.

Issue: Removing the onshore/offshore boundary

Submission
(68A – Corporate Taxpayers Group)

Taxpayers have had to historically determine whether or not any horizontal drilling operations were onshore or offshore, to determine when they could start amortising any petroleum development expenditure. Where such filing positions have been undertaken previously, these taxpayers should be grandparented and not subject to Inland Revenue audit, as there seems little point in seeking to clarify whether a boundary exists, when it is proposed to be removed.

Comment

Taxpayers are often required to make judgements that can have an effect on the tax treatment of certain transactions. Normally, previous decisions are safe-harboured if there is ambiguity about what the law means. This is not the case here.

The main concern that led to this provision was that horizontal drilling techniques meant that the current onshore/offshore boundary no longer served a policy purpose. For this reason we do not support the proposal.

Recommendation

That the submission be declined.

Issue: GST input deductions for restoration costs

Submission
(67 – New Zealand Institute of Chartered Accountants)

An amendment to the Goods and Services Act 1985 should be made that allows input tax credits to be claimed on the costs of restoration associated with past taxable activities.

Comment

The Commissioner's view of the law that raised the concerns that input deductions might not be allowed for restoration costs associated with past taxable activity is currently being reviewed. Officials are waiting for the outcome of this review before recommending possible changes to the Goods and Services Act 1985.

Recommendation

That the submission be noted.

Issue: Extending section CW 57

Submission
(27 – Origin Energy, 68A – Corporate Taxpayers Group)

The current exemption for income earned by a non-resident company for certain exploration and development activities in an off-shore permit area should be extended beyond 31 December 2009, as part of this bill.

Comment

The current exemption ends on 31 December 2009. The exemption was introduced as part of a package of measures designed to enhance security of gas supply in 2005. This issue is currently under active consideration by the government.

Recommendation

That the submission be noted.

Issue: Claw-back provisions for exploration well expenditure

Submission
(16 – Petroleum Exploration and Production Association of NZ)

The current rules that recover deductions previously allowed for exploration well expenditure should be removed, because this treatment does not occur anywhere else in the tax legislation.

Comment

There is a distinction made between the treatment of exploration and development expenditures, where the former is treated as a revenue expense and the latter is treated as a capital expense. The current rules use a final purpose test to determine what type of expenditure has been incurred. This is to ensure that the boundary between exploration and production expenditure can be effectively policed.

While it is very unlikely that an exploration well will be re-entered after it is sealed and abandoned, it is technically possible to re-enter a well. Without the claw-back provision, however, there would be an opportunity for petroleum miners to seal and abandon an exploration well, claim the expenditure as a deduction, and then reopen the well some time later.

Recommendation

That the submission be declined.

Changes to the tax pooling rules

OVERVIEW

Provisional taxpayers don't always know how much their tax liability will be for the year and therefore how much provisional tax to pay. If they get the calculation wrong, they are subject to two-way use-of-money interest on the under-payment or over-payment of their tax liability.

Provisional tax pooling was introduced in April 2003 and allows compliant taxpayers to reduce their exposure to use-of-money interest on under-payments as a result of uncertainty about their provisional tax payments by purchasing funds from, or depositing funds with, a tax pooling intermediary.

Tax pooling generally involves a taxpayer depositing money with a tax pooling intermediary. The deposit earns interest. The intermediary deposits that money in their pooling account with Inland Revenue. The taxpayer may use the funds (deposit) in the future to pay outstanding tax liabilities or sell the funds to the tax pooling intermediary. If the taxpayer sells the funds to the intermediary, the intermediary can sell the funds to another taxpayer for a fee. On payment of the fee, the intermediary transfers the funds to the other taxpayer's income tax account as at the date that the money was deposited with the intermediary (usually this will coincide with the provisional tax due dates). Tax pooling enables provisional taxpayers to access money at lower interest rates than if they failed to pay provisional tax on the due date and were subject to use-of-money interest. It also enables taxpayers who have overpaid their tax to get a higher return, from selling the funds, than they would receive from Inland Revenue.

The fundamental principle on which tax pooling is based is the reduction of interest in situations where the taxpayer is uncertain of the amount they are required to pay on the due date. If there is certainty of liability on the due date, the taxpayer is required to pay that amount and tax pooling is not available.

There are other instances, apart from provisional tax, where a taxpayer is uncertain of their tax liability, namely additional tax payable as a result of a reassessment or a dispute with Inland Revenue. The bill introduces changes which extend the tax pooling regime to additional tax payable as a result of a reassessment (including voluntary disclosures and the resolution of a dispute) for all tax types.

Seven submissions were received on the proposed amendments. Most submissions were generally supportive of the changes, with some concerns raised over the resolution of tax disputes.

PROVISIONAL TAX POOLING

Clauses 405 and 406

Submissions

(44 – Provisional Tax Finance, 45 – Tax Management New Zealand, 50 – Electronic Tax Exchange, 67 – New Zealand Institute of Chartered Accountants, 68A – Corporate Taxpayers Group)

Provisional Tax Finance, Tax Management New Zealand, Electronic Tax Exchange, New Zealand Institute of Chartered Accountants, and the Corporate Taxpayers Group support the proposed changes in the bill to enable taxpayers to transfer their funds from one tax pooling intermediary to another while retaining the original deposit date of the funds. This provision is pivotal in creating competition in the tax pooling market and will clearly deliver benefits to taxpayers.

Tax Management New Zealand has received strong support from their clients for the proposals in the bill to extend tax pooling to reassessments of all taxes. Provisional Tax Finance also supports the extension of the regime to reassessments of other tax types.

Recommendation

That the submissions be noted.

Issue: Time period to access tax pooling funds following a reassessment

Clauses 405 and 407

Submission

(12 – Chapman Tripp, 35 – PricewaterhouseCoopers, 45 – Tax Management New Zealand, 67 – New Zealand Institute of Chartered Accountants)

The bill extends the tax pooling rules to include the financing of additional tax payable as a result of a reassessment of tax (including voluntary disclosures) and the resolution of a dispute. The bill allows taxpayers 60 days from the date the Commissioner issued an amended assessment to access funds from a pooling intermediary. The 60-day period is adequate for reassessments of income tax but the submitters consider that the 60-day period does not adequately cater for situations when the taxpayer initiates dispute proceedings.

The submitters recommend that for disputes, the 60-day period should begin from the date the dispute between the Commissioner and the taxpayer is resolved.

Comment

Officials agree that the legislation as drafted does not provide the right policy outcome in cases of dispute between the Commissioner and the taxpayer. In these situations there may be a significant amount of time (maybe even years) between when the Commissioner issues an amended assessment, which is then disputed by the taxpayer, and resolution of the dispute.

Officials recommend that sections RP 17B(3)(v) and (5), be amended and a new provision inserted (section RP 17B(6)) to enable taxpayers who have resolved a dispute and owe additional tax to access funds from a tax pooling intermediary within 60 days from the date the dispute is resolved.

Recommendation

That the submission be accepted.

Issue: Resolution of a tax dispute

Clause 405

Submission
(68A – Corporate Taxpayers Group)

The tax pooling rules should be available for the settlement of any dispute, without restrictions. There can be instances when a dispute arises, but ultimately does not change an assessment. The benefit of tax pooling should be available in this instance.

Currently taxpayers in this situation would have to pay the whole amount of the assessment up-front if they wanted to access tax pooling funds.

Comment

Tax pooling is only available to reduce exposure to use-of-money interest if there is uncertainty over the correct tax liability at the due date.

Taxpayers can access tax pooling funds to pay the original income tax assessed if the funds are accessed within 60 days of the terminal tax due date. If the amount is subsequently disputed, there is no uncertainty over the original amount assessed. Uncertainty only arises over the amount of the altered assessment. Tax pooling will be available for an increased amount over and above the original assessment.

Extending tax pooling to include the original assessed amount could have two results: taxpayers could dispute their assessment before the due date to defer the payment of tax to subsequently reduce their interest exposure by using pooling funds, or extend the tax pooling rules to cover regular payments of other taxes. Both of these results open the scheme up to non-compliance and are contrary to the original intent of the tax pooling rules.

Recommendation

That the submission be declined.

Issue: Extending the 60-day period

Clause 405

Submission
(35 – PricewaterhouseCoopers, 67 – New Zealand Institute of Chartered Accountants)

The bill provides for a 60-day period within which a taxpayer can access funds from a tax pooling intermediary to pay additional tax resulting from a reassessment. The 60-day period is not an appropriate timeframe and should be extended in situations when the taxpayer does not have the immediate financial resources to settle the debt.

Comment

On the resolution of a dispute or issuing of a reassessment, the Commissioner allows a minimum of 30 days (usually 60 days) to make payment before imposing penalties.

The taxpayer will usually know early on in the dispute what their maximum level of exposure is if they lose and have time to obtain finance. Also, disputes can take some time to resolve and therefore tax can be deferred for a significant length of time.

An extension to the 60-day period simply postpones the payment of government revenue. Although allowing further time to arrange finance seems reasonable, it is difficult to distinguish between someone arranging finance and someone who is not complying and is waiting until the last moment to make payment.

Also, the 60-day period for obtaining finance is consistent with the maximum time allowed by the Commissioner for payment following a reassessment.

Officials recommend that the 60-day period not be extended.

Recommendation

That the submission be declined.

Issue: Widening the tax pooling rules to taxpayers other than provisional taxpayers

Clause 405

Submissions
(35 – PricewaterhouseCoopers, 45 – Tax Management New Zealand, 67 – New Zealand Institute of Chartered Accountants)

The proposed section RP 17B(1) currently limits access to the tax pooling rules to provisional taxpayers. With the extension of the tax pooling rules to reassessments of all taxes, references in legislation to the scheme being available only to provisional taxpayers should be removed.

This will also enable any person to deposit money into a tax pooling account, not just provisional taxpayers, and provide a source of funds for tax pooling intermediaries.

Also, the wording of the proposed section RP 17B(2) should be amended to clarify that amounts held in a tax pooling account on behalf of a person may be refunded to the person or sold, or used to satisfy a person's terminal tax or provisional tax liability or an increased amount resulting from a reassessment, voluntary disclosure, or resolution of a dispute.

The current wording in the bill does not reflect the taxpayer's right to have the funds refunded or transferred.

Comment

Officials agree with the suggested changes to sections RP 17B(1) and (2), which are consistent with the other changes in the bill.

Recommendation

That the submissions be accepted

Issue: Extending tax pooling to GST and other tax payments

Clause 405

Submission
(44 – Provisional Tax Finance)

The tax pooling rules should be amended to allow taxpayers to access tax pooling funds to pay other tax obligations such as GST.

Provisional Tax Finance has been overwhelmed with enquiries from taxpayers asking if tax pooling can be used for GST payments. They consider they can provide financing to businesses to fund GST payments for up to 60 days for around 12% to 13%.

Extending the tax pooling rules to regular GST payments would help smaller businesses with their cash flow and therefore should be considered on economic stimulus grounds.

The submitter also recommends that the tax pooling rules should be extended to regular GST payments. Provisional Tax Finance considers that access to pooling funds should only be available for up to 60 days after the GST due date.

Comment

The tax pooling rules were introduced to deal with taxpayers' exposure to use-of-money interest if they are uncertain of their tax liability when they have to make a payment, such as provisional tax. The amendments in this bill extend the tax pooling rules to include other tax payments where uncertainty arises, such as a reassessment of tax or a dispute.

The tax pooling rules were not intended to be used for payments when the quantum of a tax liability is known with certainty at the due date, such as regular GST payments. Extending the tax pooling rules to include regular payments of GST would open the rules up to abuse by non-compliant taxpayers. For example, taxpayers could deliberately not pay GST, knowing that if they are caught they could access tax pooling funds with a backdated effective date, at a significantly lower cost than paying the outstanding GST, penalties and interest cost to Inland Revenue. This would undermine both the penalties rules and voluntary compliance.

Also, once the due date passes, it is difficult to distinguish between compliant taxpayers who are having financial difficulties and non-compliant taxpayers that are trying to reduce their exposure to penalties and interest.

The proposal raised by Provisional Tax Finance is for tax pooling to be extended to regular GST payments. A taxpayer would apply to the pooling intermediary for pooling funds before the GST due date. The intermediary deposits the funds in the tax pool with Inland Revenue at the GST due date. If within the 60-day period the taxpayer pays the intermediary, the pooling intermediary transfers the funds from the tax pool to the taxpayer's GST account with Inland Revenue at a backdated effective date – the GST due date.

If the taxpayer does not pay the pooling intermediary within the 60-day period, the intermediary withdraws the money from the tax pool. Inland Revenue would then have to begin recovery action for the overdue amount. This is a risk-free transaction for the tax pooling intermediary. If a bank were to lend money to this taxpayer, the bank would bear the risk of non-payment. Under the proposal, the risk from non-payment is carried by the government. Also, Inland Revenue will be 60 days late in beginning recovery action and therefore have a lower chance of collection.

There are other options available to businesses that are having financial difficulties. They could approach a financier before the due date and obtain finance. Alternatively, businesses can enter into instalment arrangements with Inland Revenue before the due date and will only be subject to a 1% penalty plus use-of-money interest.

Further, officials consider that Inland Revenue would not be in a position to implement the amendment proposed by Provisional Tax Finance this year in any event because of resourcing constraints and related systems pressures.

Recommendation

That the submission be declined

Issue: Application date of tax pooling amendments

Clause 406

Submission
(50 – Electronic Tax Exchange, 67 – New Zealand Institute of Chartered Accountants)

To enable the changes to the tax pooling rules to apply as soon as possible, the provisions should be separated from the rest of the bill and enacted separately.

The changes in the bill provide for the transferring of tax pooling deposits between intermediaries. One of the main payments which taxpayers use tax pooling funds to finance is their terminal tax payment. Taxpayers have until the middle of June 2009 to access this finance through their intermediary. If the bill is enacted after mid-June, funds will not be available from some intermediaries to meet 2009 terminal tax payments. The main benefits from the provisions enabling transfer of money between intermediaries will be delayed until 2010.

As the amendments to the tax pooling provisions are not contentious, they should be split out from the bill and enacted separately.

Also, clause 406 of the bill provides for the transfer of pooling funds between tax pooling intermediaries, either at the taxpayers request or by mutual agreement between intermediaries. This clause comes into force on the date of assent of the Act. However, all the other clauses introducing changes to the tax pooling rules apply from 1 April 2009.

The bill should be amended to enable the transfer of tax pooling funds to apply from 1 April 2009. *(Electronic Tax Exchange)*

The application date should be backdated, but to the date the bill was introduced. This would allow taxpayers to benefit from reduced use-of-money interest. *(New Zealand Institute of Chartered Accountants)*

Comment

The original expectation was that the bill would be enacted before 1 April 2009, and therefore the provision enabling the transfer of pooling funds between intermediaries would apply from date of assent, being before 1 April 2009. With the delay in enacting the bill, the date of assent will now be after 1 April 2009.

There is no ability for the legislative provision which enables tax pooling funds to be transferred between intermediaries to be backdated to apply from 1 April 2008. To be effective, a transfer would need to occur under the existing legislation, which does not allow such transfers.

As a result of the delays in enacting the bill, officials recommend that the application date for the tax pooling provisions be the date of assent of the legislation.

The delays in enactment will reduce the time available for tax pooling intermediaries to attract new deposits for the 2009–10 tax year.

Recommendation

That the Committee agree to the tax pooling provision applying from the date of assent of the legislation as a result of the delays in enactment of the bill.

Issue: Transfer of pooling funds by an intermediary to another intermediary

Clauses 406 and 510

Submission
(Matter raised by officials)

Clause 406 allows a taxpayer to transfer funds from one tax pooling intermediary to another intermediary, while retaining the original effective date of the deposit. However, the provision does not provide for an intermediary to instigate the transfer of pooling funds between intermediaries. The transfer between intermediaries could apply when one of the intermediaries is beginning or ceasing business.

This provision would foster competition among intermediaries and enable intermediaries to transfer their business to another intermediary if they wanted to cease business.

The new provision should apply to all deposits held by an intermediary.

Also, where amounts are transferred between intermediaries, the amounts retain their original effective date, being the deposit date with the original intermediary. The effective date provision is currently contained in clause 510 of the bill. To make the pooling rules easier to understand, officials recommend that the effective date provision be included in clause 406 of the bill, which provides for transfers between intermediaries.

Recommendation

That the submission be accepted.

Issue: Ordering rule for the allocation of tax pooling funds

Clause 407

Submission
(35 – PricewaterhouseCoopers)

The bill provides that where an amount is transferred from a tax pooling account and credited to a taxpayer's account after the terminal tax date, the amount is applied first to any interest outstanding and the remainder applied to the principal. This provision should be omitted.

Comment

Where a taxpayer applies, within 60 days of the terminal tax date, to use tax pooling funds to pay their terminal tax liability, the funds are credited to the taxpayers account as at the terminal tax date and applied to the principal amount. Where the taxpayer applies to use tax pooling funds to satisfy a terminal tax liability outside the 60-day period, the taxpayer has not complied with the tax legislation and the funds are transferred at the date of payment. The taxpayer will therefore be liable for interest from the due date to the date of payment.

When the penalties and interest legislation was introduced, consideration was given to how payments were to be applied to outstanding tax liabilities. The government of the day decided to apply payments to penalties and interest first, with any remainder applying to the principal tax amount. If payments were instead applied to the principal amount first, there would be an incentive not to pay the penalties and interest amounts, thereby reducing the cost to taxpayers of not complying with their obligations.

The ordering rules relating to tax payments from a tax pooling account reflect the ordering rules for other tax payments.

Recommendation

That the submission be declined.

Issue: Commissioner's notification

Submission
(Matter raised by officials)

The current legislation requires the tax pooling intermediary to provide the Commissioner with details relating to deposits made with the intermediary. On receipt of this information, the Commissioner provides this information back to the intermediary. In practice, the Commissioner does not currently provide the details back to the intermediary. To do so would increase both compliance and administration costs, with no real gain.

Officials propose to amend section RP 18(4) of the Income Tax Act 2007 to require simply that the Commissioner confirms receipt of details provided by the pooling intermediary, rather than provide the details back to the intermediary.

Recommendation

That the submission be accepted

Issue: Transferring of funds between tax pooling intermediaries

Clause 510

Submission
(Matter raised by officials)

The ability to transfer money between tax pooling intermediaries is currently contained in two Acts. The ability to transfer funds between tax pooling intermediaries is in the Income Tax Act and the effective date of the transfer is contained in the Tax Administration Act.

Officials consider the provisions that apply to the transfer of funds between tax pooling intermediaries should be contained in one Act, the Income Tax Act and therefore recommend that clause 510 of the bill be amalgamated with clause 406.

Recommendation

That the submission be accepted

Issue: Interest paid on deposits in tax pooling accounts

Submission

(Matter raised by officials)

An amendment is proposed to section 120OE(1) of the Tax Administration Act 1994 to specify that interest is payable on deposits in a tax pooling intermediary's account from the date of the deposit and ends on the date the amount is refunded or transferred. The current wording does not specify the end date for the calculation of the interest.

Recommendation

That the submission be accepted.

Tax treatment of emissions trading units

OVERVIEW

The changes provide for the income tax treatment of transactions under the Emissions Trading Scheme (ETS). The ETS was enacted by the Climate Change Response (Emissions Trading) Amendment Act 2008 (Emissions Trading Act).

The purpose of the changes is to provide income tax rules which cover recognition of income and deductions, and timing and valuation rules for both forestry and non-forestry businesses.

The income tax amendments made by the Emissions Trading Act to the Income Tax Act 2007 are replaced by these provisions.

Submissions were received from four tax professional organisations. At a general level, one supported the approach being taken while another thought legislation should wait until the outcome of the review of the Emissions Trading Scheme is known. A number of submissions were made on technical issues around the application and operation of the provisions and officials have recommended that a number of these submissions be accepted.

GENERAL MATTERS

Clauses 9, 45B, 48, 61, 81, 84, 85, 98, 186B, 187, 519 and 524

Issue: Support for amendments

Submission
(68 – Corporate Taxpayers Group)

Corporate Taxpayers Group is generally supportive of the proposed legislative changes.

Recommendation

That the submission be noted.

Issue: The ETS tax provisions should be put on hold

Submission
(62 – Minter Ellison Rudd Watts)

Given the review of the ETS by the Emissions Trading Scheme Review Select Committee, it may be preferable for the ETS tax provisions to be put on hold until the outcome of that review is known.

Comment

There are arguments both in favour of and against this submission. The principal supporting argument is that if an ETS is not proceeded with, this legislation will be unnecessary, and that if a substantially amended ETS is proceeded with, the legislation may require further amendment.

The main argument against the submission is that there is a likelihood that an ETS will be proceeded with. If it is, much of what is in the legislation is general in nature, and will continue to apply to whatever form the ETS takes. Accordingly, proceeding with the legislation in its current form gives taxpayers some degree of certainty, which is especially important in light of the next sector entry date under the current ETS of 1 January 2010. Any amendments which become necessary at a later stage can be made by subsequent legislation.

Also, it should be noted that the forestry part of the ETS already applies.

Recommendation

That the submission be declined.

Issue: Sale of free units which relate to a future year

Submission
(68A – Corporate Taxpayers Group)

If a non-forestry taxpayer sells free units in the current income year but those units relate to an emissions liability in a future year, the tax liability should be recognised in that future year, not the current year as the bill now provides.

Comment

The general objective in the tax treatment of emissions unit transactions is to have standard principles apply wherever possible, and provide specific rules only when the application of standard principles is unclear or gives an inappropriate result.

The application of standard accrual accounting principles to the receipt of free units would, in all probability, require the income to be recognised either on an accruals basis when the entitlement to receive those units is known, or possibly at a later date when those units are actually received. The tax rules proposed in this bill recognise that the concept underlying the receipt of those units is to compensate for increased costs or emissions liabilities in the future, and so defer the recognition of income until those costs accrue.

There is an exception to this rule when units are sold and the value of the units has not yet been recognised as described above – then, the income from their sale is recognised. As noted above, officials expect that for financial reporting purposes all of the income would be recognised at the point of sale. If, as accounting standards are developed, this turns out not to be the case, officials will revisit this issue.

We do not agree with the submission that the recognition of this income should be deferred to a later year. Following sale of the units, the taxpayer has converted a near-cash asset into a cash asset, and it is entirely appropriate to recognise that income in the year in which it arises.

Recommendation

That the submission be declined.

Issue: Reference to issue of free units

Submission
(Matter raised by officials)

The tax provisions should be amended to be consistent with the process set out in the Climate Change Response Act 2002.

Comment

A number of provisions use the expression "issue" to refer to the process by which a business receives a free allocation of units from government. However, the Climate Change Response Act 2002 describes the process as a "transfer" of emissions units. To avoid any confusion, the terminology used in tax provisions should be consistent with the Climate Change Response Act 2002.

Recommendation

That the submission be accepted.

Issue: Relationship between sections CX 51B and ED 1B is unclear

Submission
(62 – Minter Ellison Rudd Watts)

Section CX 51B should be amended to make it clear that income which arises under the valuation rules in section ED 1B is not excluded income.

Comment

Section CX 51B provides that any income which arises from the receipt of free emissions units is excluded income. Section ED 1B establishes rules for the timing of recognition of income in relation to these free units (essentially, as the costs for which that free allocation is intended to compensate arises). The intention is that these two provisions work together to ensure that no income arises when the units are first issued, but income is recognised later, on an appropriate accrual basis.

Following consideration, we recommend this issue be addressed by deleting section CX 51B and achieving the desired effect of no income arising on the issue of units by inserting a valuation rule which will initially value free units at nil.

Recommendation

That the submission be accepted, as described above.

Issue: Revenue account treatment of free units

Submission
(68A – Corporate Taxpayers Group)

If, in the future, units are allocated on the basis of the diminution of the value of the taxpayer's assets, those emissions units should be treated as being received on capital account.

Comment

The bill treats all allocations of emissions units as being on revenue account except for allocations made to pre-1990 foresters. This is on the basis that allocations other than those made to pre-1990 foresters are made to compensate businesses for either their emissions liabilities, or the cost increases they face as a result of the introduction of the ETS (such as increased power prices).

As noted, there is an exception for pre-1990 foresters. The allocation of units to foresters is to compensate for the fall in value of their land, rather than their potential emissions unit liability. Pre-1990 forestry is unusual in that allocations of units are made to businesses which only suffer an impact on the asset value, and cost increases only in relation to a capital transaction (deforestation is a fundamental change in the nature of the business and so would be on capital account under ordinary principles). Accordingly, this allocation of units is appropriately treated as being on capital account. This capital treatment extends to the purchase of further emissions units to satisfy a liability to surrender.

If emission units are in the future allocated by reference to the impact of the ETS on asset values, then capital treatment should be considered. However, in most instances, allocation of units will be to businesses which suffer cost increases – for example, a business which owns an industrial plant which emits CO_2 and so gives rise to an emissions liability when surrendered. Cost increases will be on revenue account, and so treating the allocation of units as being on revenue account is appropriate.

Recommendation

That the submission be noted for future consideration if the government does issue units for dimunition of asset values.

Issue: Cost of emissions units valued under section ED 1B(3)(a)

Submission
(35 – PricewaterhouseCoopers)

The definition of "cost" should be modified to include the cost of emissions units valued under section ED 1B(3)(a).

Comment

Section ED 1B(3)(a) states that the cost of emissions units which are recognised as having accrued to the business is their market value at the end of the year. This feeds into section CB 36 correctly. However, "cost" is defined in section YA 1 without any cross-reference to the cost concepts in section ED 1B.

We agree this is potentially confusing. We propose that section ED 1B should instead define "value" for certain emissions units, and that section CB 36 and other sections where this issue arises refer to cost or value, for those emissions units for which a value is prescribed.

Recommendation

That the submission be accepted, with the issue being addressed as described above.

Issue: Surrender of emissions units valued under section ED 1B(3)(b)

Submission
(35 – PricewaterhouseCoopers)

The surrender of a unit which is given a zero cost by section ED 1B(3)(b) will not give rise to any income. An amendment should be made to ensure that income does arise.

Comment

Section ED 1B(3)(b) provides that a unit which has been transferred by government to compensate for an emissions liability or increased cost which has not yet arisen has a market value of nil. As the submission points out, the current drafting of section CB 36 means that if such a unit was surrendered, its receipt would never be taxable.

We agree that such a unit should be deemed to be disposed of for its market value when surrendered, and recommend that proposed section CB 36 be amended. We note that the same problem arises with section ED 1B(2)(a), which also values emissions units at zero.

Recommendation

That the submission be accepted.

Issue: Year-end valuation for free units

Submission
(68A – Corporate Taxpayers Group)

Free units should be brought into account at an average value, rather than the emissions year-end value, to avoid any price spikes.

Comment

Free units received by non-forestry taxpayers are brought into account at the end of the year at which the relevant increased costs or emissions liability accrues. The value brought into account is the market value at the end of the relevant income year.

Because the market value used is the market value at the end of the income year, which will vary amongst different taxpayers, we do not think price spikes are as likely as the submission suggests. If any price spikes do occur, they are likely to be around the time emitters are required to surrender units to the government, which is not aligned to any income year (or the emissions year). The ability of New Zealand businesses to surrender emissions units purchased on the international markets, as well as New Zealand units should mean that price spikes do not arise – it is unlikely that the New Zealand surrender timetable will have any effect on international markets.

Accordingly, we think the methodology currently proposed is robust.

Recommendation

That the submission be declined.

Issue: Operation of section ED 1B

Submission
(62 – Minter Ellison Rudd Watts)

Section ED 1B is complex and there are a number of concerns with it. These include:

- confusion between the valuation of a single emissions unit and the valuation of a pool of emissions units;
- the definitions in the formula are circular and contain reference to some terms which are not defined; and
- the formula gives a negative result if some emissions have already been sold, which should not be the case.

Comment

Officials agree that this provision is complex. In relation to the specific matters raised:

- We agree that there is one instance in which a singular concept is used rather than a plural one, and agree that this should be amended.
- We agree that one expression is not defined, and this should be corrected.
- We agree that the formula can produce a negative result when more units have been sold than need to be recognised as income, but disagree that this is the wrong outcome. The words preceding the formula state that any negative number is to be treated as zero. A zero result simply means that a sufficient number of units have already been brought into the income calculation by virtue of being sold, and no further units are required to be recognised at that time.

Recommendation

That the submission be accepted in part.

Issue: Valuation of excess units held

Submission
(68A – Corporate Taxpayers Group)

Taxpayers who hold units at year-end which have fallen in value since acquisition, should be able to value those units at the lower of cost or market value.

Comment

The valuation methodology currently provided for emission units which have been purchased is the cost basis.

An alternative approach would have been to value these units at market value, which would allow taxpayers to take losses when values fall, but recognise increases when values rise (financial arrangements model). Because the majority of taxpayers will hold units for compliance purposes rather than speculative purposes, the decision was taken following consultation that for simplicity and compliance-cost purposes, a cost basis method of valuation should be used.

We note that the submission requests that cost be written down to a lower market value, but there is no suggestion that if market value increases above cost, the increase be recognised as income.

Recommendation

That the submission be declined.

Issue: Surrender of a post-1989 forest land unit to meet a pre-1990 forest liability

Submission
(35 – PricewaterhouseCoopers)

Income ought to arise when a post-1989 forest land unit is surrendered to meet a pre-1990 forest liability.

Comment

Post-1989 forestry is generally on revenue account, and pre-1990 forestry is generally on capital account. Forestry is also taxed on a cash basis. Units received in relation to post-1989 forestry give rise to a tax liability when they are sold.

The current provisions would result in no income arising if post-1989 units were surrendered to meet a pre-1990 forestry liability. The same issue will arise if post-1989 units are surrendered for any other liability.

This is inconsistent with the treatment of their sale, and we agree that amendment is required.

Recommendation

That the submission be accepted, and the amendment apply to the surrender of a post-1989 forest land unit in relation to any emissions liability which is not a post-1989 forest liability.

Issue: Incorrect reference to "deforestation" in section CB 36(4)

Submission
(Matter raised by officials)

This subsection refers to the liability to surrender emissions units on the "deforestation" of post-1989 forest land, but in fact the liability arises on harvest, fire, wind-throw or other carbon loss. A more general expression should be substituted.

Recommendation

That the submission be accepted.

Issue: Interest deductibility should be available for companies that derive exempt ETS income

Submission
(35 – PricewaterhouseCoopers)

The general provisions dealing with interest deductibility should be amended to include companies that derive exempt income from the disposal of pre-1990 forest land units.

Comment

This issue arises because the sale of pre-1990 forestry units is treated by the proposed legislation as giving rise to exempt income – consistent with the general treatment of post-1990 forestry as being on capital account. Under existing general provisions, most companies are entitled to a deduction for interest paid regardless of the nature of their business or the underlying purpose of the borrowing. However, when a company derives exempt income, the interest deduction is available only when the exempt income falls into one of three specified categories. The disposal of pre-1990 forest land units is not one of those specified categories.

However, adding pre-1990 forestry to the specified categories for exempt income would not deal with the position of sole traders, who would still be denied a deduction for interest.

We think the best way to resolve this issue is to instead treat the sale of emission units awarded in relation to pre-1990 forestry as giving rise to excluded, rather than exempt, income. There is no restriction on the deduction of interest expenditure by taxpayers that earn excluded income.

Recommendation

That the submission be accepted.

Issue: Deduction in relation to forest emissions liabilities

Submission
(35 – PricewaterhouseCoopers)

The legislation should be amended to make it clear that taxpayers cannot claim a deduction for accrued emissions liabilities related to forests.

Comment

The intention of the legislation is that emissions transactions for foresters are dealt with on a cash basis, consistent with other forestry income and expenditure. Deductions should accrue to post-1989 foresters and pre-1990 foresters who hold the land on revenue account when they acquire replacement units or surrender units (or are implicitly given by the non-recognition of income from the award of free units).

Deductions should not be recognised on an accrual basis in the way they are in the non-forestry sector, and we agree that there is value in making this clear in the legislation.

Recommendation

That the submission be accepted.

Issue: Use of expression "paragraphs" may be confusing

Submission
(Matter raised by officials)

The expression "paragraphs" in section ED 1(5B) should be clarified.

Comment

Section ED 1(5B) divides emissions units into different pools for valuation purposes. It states that emissions units may not be pooled with emissions units described in another paragraph. These paragraphs contain sub-paragraphs. There is a risk that some readers will not appreciate the difference between paragraphs and sub-paragraphs, and find the section confusing.

Recommendation

That the submission be accepted.

Issue: Eligibility for a deduction for emissions liability accruals should be set out in statute

Submission
(62 – Minter Ellison Rudd Watts)

Officials have stated that a deduction for accruing liabilities will be available under existing law. However, it is not clear that this is the case, and the legislation should be amended to expressly provide for this deduction.

Comment

The submission correctly states that a deduction cannot be claimed for a provision, only for a liability which has economically accrued at balance date.

In our view it is clear that a properly calculated amount for an emissions liability at the end of an income year is deductible, even when the requirement to surrender the relevant emissions units arises in a subsequent year. The liability arises under statute, and it is certain that it will arise. In *CIR* v *Mitsubishi Motors Limited*, the Privy Council upheld the taxpayer's claim to deduct a provision for warranty defects, on the basis that the cars had already been sold with the latent warranty defects in them, and noted that at balance date those defects were an existing fact and not a future contingency.

Recommendation

That the submission be declined.

Issue: Method for calculating emissions liability accruals should be set out in legislation

Submission
(35 – PricewaterhouseCoopers)

Officials have explained that the accrual calculation for an emissions liability for a non-forestry user will be calculated by reference to the cost of units on hand, the market value of units which have been awarded by government, and a reasonable estimate of the cost of units to be acquired post-balance date. This approach is a reasonable one but it is not set out anywhere in legislation, as it should be.

Comment

The method for valuing the accrued liabilities is in accordance with our understanding of standard accounting and tax practice. Our view is that further explicit guidance is unnecessary.

Recommendation

That the submission be declined.

Issue: Identifying the cost of units held in excess of accrued liabilities

Submission
(35 – PricewaterhouseCoopers)

The legislation should prescribe the valuation method to be applied when units are acquired in excess of those required to satisfy accrued liabilities.

Comment

The legislation provides that emissions units are to be valued using either first-in first-out or the weighted average cost method. Provided one of these methods is used in a consistent way across the taxpayer's entire stock of emissions units, we do not see that any problem should arise.

Recommendation

That the submission be declined.

Issue: Application of anti-avoidance provisions

Submission
(62 – Minter Ellison Rudd Watts)

Section GC 4B should be clarified to ensure that it is not applied when a market value is difficult to ascertain, or when fixed-price forward contracts are entered into by unrelated parties.

Comment

The proposed legislation defines emissions units as trading stock. This means that section GC 4B is no longer required, and the standard trading stock rule, section GC 1, can apply.

Officials do not have any concerns around units having a value which is difficult to ascertain. It is likely that the New Zealand market will develop sufficiently for prices to be readily ascertainable. If it does not, then units which are internationally recognised will have readily ascertainable prices on world markets. New Zealand units can be valued by reference to equivalent Kyoto units. In any event, a price which is reached between unrelated parties and in the absence of any other circumstances influencing price will, by definition, be a market value.

We also do not have any concerns around the use of forward contracts. If this was an issue, it would already be a known concern for forward contracts for shares, which are also trading stock for some taxpayers.

Recommendation

That the submission be declined.

Issue: "Replacement forest land emissions unit" definition – application to surrender

Submission
(Matter raised by officials)

The definition should be amended to make it clear that it does not apply when post-1989 forest land emissions units are disposed of by surrender.

Comment

The purpose of the definition of replacement forest land emissions is to allow an immediate deduction where emissions units are purchased to replace post-1989 forestry units previously sold. The definition should not apply where units are purchased following the surrender of post-1989 forestry units, as it presently does.

Recommendation

That the submission be accepted.

Issue: "Replacement forest land emissions unit" definition – application to certain pre-1990 forest land transactions

Submission
(35 – PricewaterhouseCoopers)

The "replacement forest land emissions unit" definition should be extended to apply when pre-1990 forest land is held on revenue account.

Comment

The definition of "replacement forest land emissions unit" is part of the mechanism which ensures that a person who sells a post-1989 forest land unit (which will be taxable) and then purchases a replacement unit is entitled to a deduction for that subsequent purchase. This is consistent with the cash-basis treatment of forestry.

While pre-1990 forestry land is generally considered to be on capital account, the legislation acknowledges that some pre-1990 forestry land could be on revenue account (such as when it is held by a land developer).

The drafting in the bill presently ensures that a deduction will be available when the deforestation liability for pre-1990 land held on revenue account is met. No deduction is available when units which replace those previously sold are acquired.

While this treatment differs from the cash basis treatment provided to post-1989 foresters, we think that this difference is appropriate as someone who holds pre-1990 forest land on revenue account is holding it for a non-forestry purpose, and so ought not to be entitled to use the cash basis.

Recommendation

That the submission be declined.

Issue: Operation of "replacement forest land emissions unit" definition

Submission
(62 – Minter Ellison Rudd Watts)

The definition appears to allow a deduction to be available for a replacement forest land emissions unit only once all other units disposed of by the taxpayer have been replaced. It should be amended.

Comment

The definition is certainly not intended to have the meaning suggested by this submission. However, it does include some wording which may cause confusion and is probably unnecessary, so we agree that it should be amended.

Recommendation

That the submission be accepted.

Issue: Certain definitions should be simplified

Submission
(62 – Minter Ellison Rudd Watts, matter raised by officials)

Certain definitions are complex in their construction and should be replaced with simpler cross-references to the Climate Change Response Act 2002.

Comment

The bill was introduced in July 2008 before enactment of the recent amendments to the Climate Change Response Act 2002 in September 2008. Because a bill cannot refer to another bill (as its enactment is uncertain), certain definitions had to be constructed in a way which did not refer to the proposed amendments to the Climate Change Response Act 2002, so are more complicated than now required.

Recommendation

That the submission be accepted.

Issue: Forestry income tax provisions introduced by the Emissions Trading Act

Submission
(Matter raised by officials)

The amendments made by the Emissions Trading Act to the Income Tax Act 2007 are superseded by the amendments in the current bill, and should be repealed.

Comment

The Emissions Trading Act made amendments to the Income Tax Act 2004 and the Income Tax Act 2007 dealing with the application of the ETS to the forestry sector.

The provisions in the 2007 Act will be superseded by the provisions in the current bill, so those existing 2007 Act provisions should be repealed. This bill does not amend the 2004 Act, so those provisions ought to remain.

Recommendation

That the submission be accepted.

Issue: GST provisions contained in current bill

Submission
(53 – Ernst & Young)

The provisions in the bill which address the GST treatment of transactions relating to emissions units should be deleted, as they appear to have been superseded by more comprehensive amendments enacted in the Climate Change Response (Emissions Trading) Amendment Act 2008.

Comment

The original intention was to enact the necessary amendments to the GST legislation in the current bill. However, a subsequent decision was made to enact the necessary GST amendments in the Climate Change Response (Emissions Trading) Amendment Act 2008, which was enacted in September 2008, to give taxpayers greater certainty.

Officials agree that the GST provisions in the current bill are no longer required.

Recommendation

That the submission be accepted.

Issue: Application of reverse charge provisions

Submission
(35 – PricewaterhouseCoopers)

Either:

- the legislation should make it clear that, if the reverse charge applies to a supply of emissions units, GST is charged at zero %; or
- the reverse charge rules should not apply to a supply of emissions units.

Comment

The reverse charge rules apply to a small number of transactions involving imported services. If a non-New Zealand resident makes supplies to a New Zealand-resident, and the resident does not make at least 95 percent taxable supplies, the New Zealand resident is required to account for GST on the imported services as if they had made the supply, as well as receiving it.

This provision will clearly apply to the acquisition of emission units from non-residents by New Zealand-resident entities such as financial institutions, which typically do not meet the 95 percent taxable supply threshold.

Officials do not agree with the submission that there is any uncertainty about either this or the application of the zero-rating provisions. It is clear that this transaction is zero-rated under the provisions previously introduced.

This outcome is preferable to that sought under the submission's second alternative, which is not to apply the reverse charge rules to emissions units.

Recommendation

That the submission be declined, noting that the objective sought is already achieved under current legislation.

Issue: Application of section 5(6D)

Submission
(35 – PricewaterhouseCoopers)

That the legislation be amended to make it clear that section 5(6D) does not apply.

Comment

Section 5(6D) provides that when the Crown makes any payment "in the nature of a grant or subsidy", that grant or subsidy is deemed to be consideration for a taxable supply made by the recipient of the grant or subsidy.

This will apply to some situations when the government awards emissions units to businesses – such as the award of units to pre-1990 foresters or businesses in the industrial sector.

These supplies are zero-rated under the amendments introduced in the Emissions Trading Act.

Officials have considered whether the deeming provision ought to be "switched off". This would be done by way of an Order in Council under section 5(6E), rather than by a legislative amendment.

However, our view is that the better outcome is for this provision to continue to apply. This is because, consistent with the general approach to emissions transactions as an ordinary part of business, businesses which receive income in the form of emissions units should recognise that they are making taxable supplies in exchange for that income. Requiring these businesses to recognise that they have made taxable supplies will mean that the various supply-based thresholds, such as liability to register and the return periods, will apply.

A further consideration is that in some instances, it will not be clear whether businesses are making an actual supply, or a deemed supply under section 5(6D). Leaving section 5(6D) to apply means this question need not be addressed, thereby making compliance simpler.

Recommendation

That the submission be declined.

Issue: GST treatment of derivatives

Submission
(35 – PricewaterhouseCoopers)

The zero-rating which is currently applied to emissions units transactions should also apply to derivatives of emissions units.

Comment

This matter was considered when the GST provisions dealing with emissions units were introduced.

The submission makes the point that the EU experience shows that derivatives comprise a very large proportion of the carbon market. In due course, a derivatives market may also develop in New Zealand.

The effect of the current law is that a derivative which could be satisfied by the delivery of an emissions unit would be standard-rated (not zero-rated as the submission suggests), whereas a derivative which could not be satisfied by delivery of an emissions unit would be an exempt financial service.

This is the same as the treatment of any other derivative which relates to an underlying commodity (such as oil or aluminium) and we do not think that an exception is justified for derivatives relating to emissions units. In particular, several of the reasons for zero-rating emissions units do not apply to derivatives.

At this stage, we are not aware of a significant market in derivatives having been established. If this does develop over time, we can consider this matter again.

Recommendation

That the submission be declined.

Issue: Application of GST provisions to legacy schemes

Submission

(Matter raised by officials)

The existing GST zero-rating treatment of government allocation of emissions units under the ETS should be extended to government allocation of units under some of the other earlier schemes.

Comment

In addition to the transfer of emissions units to forestry and other businesses under the ETS, the government also transfers emissions units under three other arrangements – the Permanent Forest Sink Initiative (PFSI), Project to Reduce Emissions (PRE), and Negotiated Greenhouse Agreements (NGA).

Of these three schemes, only the PFSI is still open to new participants (and had its first participant enter the scheme late last year). PRE and NGA have long since closed to new participants, although emissions units continue to be allocated under them.

The current GST provisions do not apply either to the transfer of emissions units under these agreements, or any supplies made in exchange for those emissions units (such as the supply of the services of carbon capture). Accordingly, they are standard-rated, although any subsequent supply of units by the recipient of them will be zero-rated. This last aspect is important, because it means that a subsequent purchaser has no need to enquire into the original source of the units.

Officials recommend that PRE and NGA arrangements remain standard-rated for GST. These arrangements were entered into at a time when it was clear that the supplies were to be standard-rated. Some of the contractual arrangements included specific reference to GST, and a binding ruling has since been issued on the GST treatment of PRE. We see no reason to upset these established arrangements by zero-rating these transactions.

There is ambiguity in the current legislation under which certain transactions in emissions units involving the government are being zero-rated, although this was not the policy intention. Because of the nature of these transactions, there is no revenue loss, but in the interests of consistency this ambiguity should be clarified, with effect from the day on which this bill receives the Royal assent.

However, officials recommend that PFSI transactions are zero-rated. There are two reasons for the distinction between PFSI and the other legacy schemes. First, PFSI covenants have been entered into only very recently, and will continue to be entered into in the future. So, participants' understanding of the GST treatment is being developed now, rather than arising at a time when standard-rating was the only possibility. Secondly, some businesses which enter PFSI will also participate in forestry aspects of the ETS, which are zero-rated. It would be confusing for these forestry businesses to have different GST rules applying to their transactions with the government.

This amendment should also have effect from 1 January 2009.

Recommendation

That the submission be accepted.

NON-KYOTO UNITS

Issue: A deduction should be expressly provided for acquisition of non-Kyoto units

Submission
(35 – PricewaterhouseCoopers)

A deduction should be expressly provided for the acquisition of non-Kyoto units.

Comment

Legislation enacted previously, and contained in the current bill, is restricted to the tax treatment of emissions units which are recognised under the Kyoto Treaty or the New Zealand Emissions Trading Scheme (ETS). Other emissions units exist which have essentially been created by non-government sources, which are not recognised under the Kyoto Treaty, and which are not eligible for surrender under the ETS.

Our view is that because these units are not used in transactions with government, their tax treatment should be determined under ordinary tax rules. The questions raised in the submission (such as whether these units should be capitalised or deducted, depending on the circumstances) are entirely appropriate to be dealt with on a case-by-case basis. It is not clear that deductibility is the right answer in all circumstances.

However, if transactions in non-Kyoto units become significant in the future, consideration could be given to amending the law generally. This is something which should go through a proper consultation process. In the interim, we think that acceptance of the submission below will provide sufficient clarity.

Recommendation

That the submission be declined.

Issue: Basic income tax concepts which apply to emissions units should be extended to non-Kyoto emissions units

Submission
(35 – PricewaterhouseCoopers)

ETS units will be treated for tax purposes as excepted financial arrangements and revenue account property which is not trading stock. These rules should be extended to non-Kyoto units.

Comment

In the interests of certainty, bringing all types of emissions units within the trading stock and excepted financial arrangements rules is desirable.

Recommendation

That the submission be accepted.

Issue: The GST rules which apply to Kyoto units should also apply to non-Kyoto units

Submission
(35 – PricewaterhouseCoopers)

The zero-rating treatment that applies to Kyoto units should also be extended to apply to non-Kyoto units to ensure that the New Zealand market is attractive to foreign participants.

Comment

This matter was considered when the GST provisions dealing with emissions units were introduced.

New Zealand has adopted a broad-based, low-rate approach to GST. This results in New Zealand's GST being one of the most efficient value-added taxes anywhere in the world. Accordingly, the standard-rating model is deviated from only with very good reason.

Zero-rating was justified for Kyoto units for the following reasons:

- Transactions in Kyoto units will almost exclusively be business-to-business, so there is no revenue loss from zero-rating.
- Transactions involving the government, where no consideration is paid, are unusual from a GST perspective and the risks of error are high.
- Under current emissions projections, there will be a shortfall of units on the domestic market, which will require the import of units, some of which are likely to be acquired on international electronic markets.
- It is important for price stability that New Zealand businesses can both buy and sell emissions units on international markets, as the domestic market, in early years in particular, will be thin.
- The ability of New Zealand businesses to buy and sell emissions units simply and efficiently is key to the success of the ETS and New Zealand's response to its Kyoto obligations.

While non-Kyoto units may be traded internationally, it is not clear that some of the other reasons set out above apply to them, and some reasons clearly do not.

Accordingly, we do not consider that zero-rating should be extended to non-Kyoto units at this stage.

Recommendation

That the submission be declined.

TREATMENT OF NON-RESIDENTS

Issue: Application of income tax rules to non-residents

Submission
(35 – PricewaterhouseCoopers)

Specific rules should be included to ensure that a non-resident which does not have a permanent establishment in New Zealand is not subject to income tax on the sale of emissions units in New Zealand.

Comment

The standard treatment of non-residents is that they are taxable on New Zealand-sourced income. It is not clear to us why a special exemption to this rule should be created for non-residents when it applies to, for example, non-residents who trade in New Zealand shares or debt instruments. Variations to the taxation of non-residents should be considered in the context of a review of the international tax rules, not on an isolated basis.

Recommendation

That the submission be declined.

Issue: Requirement for non-residents to register for GST

Submission
(35 – PricewaterhouseCoopers)

Non-residents should not be required to register for GST in New Zealand solely because they have trades in emission units on the New Zealand register. However, they should have an option to register voluntarily for GST.

Comment

The sale of emission units on the New Zealand register by non-residents does not automatically create an obligation to register for GST. Generally, the sale of intangible property by a non-resident who is outside New Zealand at the time of supply is treated as outside the scope of the GST Act.

It is possible, however, that sales of emission units by non-residents to New Zealand residents may be treated for GST purposes as imported services. If the supply is treated as imported services, the recipient may need to consider the application of the "reverse charge", which imposes GST on certain imported services. This outcome does not require the non-resident to register for GST.

In the event that the non-resident is present in New Zealand when selling emission units, the supply may continue to be treated as supplied outside New Zealand if the recipient of the supply is a registered person, unless the parties agree otherwise.

Officials note that the current rules allow non-residents that carry on a taxable activity to voluntary register for GST in New Zealand if they choose.

Recommendation

That the submission be declined.

Other policy matters

Issue: Treatment of Large Budget Screen Production Grant payments

Clauses 36, 45 and 63

Submission
(4 – Pieter Holl & Associates Ltd, 53 – Ernst & Young)

The application of standard grant treatment to films receiving Large Budget Screen Production Grant payments should not proceed as this will cause this grant to be less competitive with its Australian equivalent.

Comment

The Large Budget Screen Production Grant (LBSPG) was designed to be a response to Australia's "location" refundable tax rebate and intentionally adopted the same tax treatment as Australia. The tax base (cost) for a LBSPG film includes the costs that are reimbursed by the LBSPG. This treatment results in artificial tax losses for the special purpose company that makes the film. In some cases these losses are being offset against non-film taxable income (for example, income of a finance company).

Reverting to the standard grant treatment will result in there being no artificial losses. This has the effect of reducing the subsidy from 19.5% to 15% for the particular film studio where the losses can be used. All film studios should receive an equal incentive for making a film in New Zealand.

Tax deductions are not designed to act as an indirect subsidy for particular industries and any subsidies should be explicit. Therefore, it has been decided to bring the treatment of this grant under standard grant treatment.

Recommendation

That the submission be declined.

Issue: Timing of introduction of measures applying to Large Budget Screen Production Grant payments

Clause 2(22)

Submission
(4 – Pieter Holl & Associates Ltd, 53 – Ernst & Young)

The application date of changes to the Large Budget Screen Production Grant payment tax treatment should be deferred so as not to apply to projects that began pre-production or production before this bill was introduced.

Comment

The issue revolves around giving the industry sufficient notice of the change without unnecessarily exposing the revenue base.

At the moment the bill proposes that the amendment apply from 1 April 2009. We note that this is not as helpful as it could be.

Accordingly, while not accepting the submission, we recommend that the application date be changed so the amendment applies when the final application for the grant is made on or after 1 October 2009. This should go some way towards meeting the submitters' concerns as well as providing a more coherent cut-off for films that do or do not qualify.

Officials have also been made aware of a project that was begun before 1 July 2008 and will not be completed until, at earliest, December 2009. Expenditure for this film should be grandparented and officials therefore also recommend that films that incurred at least $3 million in film-related expenditure by 1 July 2008 should come under the treatment proposed in this bill.

Recommendation

That the application date be changed so the amendment applies when the final application for the grant is made on or after 1 October 2009 except when the project incurred at least $3 million in film-related expenditure by 1 July 2008.

Issue: Deductibility of Screen Production Incentive Fund payments

Clause 69

Submission
(51 – Screen Production and Development Association)

Producers should continue to be allowed to permit deductions for expenditure in the year of completion of the film, rather than over 24 months.

Comment

The Screen Production and Development Association (SPADA) is concerned about inconsistencies between the tax treatment of Screen Production Incentive Fund (SPIF) grants and non-SPIF funded productions. Its argument is that a number of films have until now been government-funded, and have still qualified for the immediate tax write-off upon completion. This is correct, but the quality of the government funding has changed from limited-recourse loan, to an absolute grant with no claw-back.

SPADA is also concerned about how producers will fund their films between the production date and receiving the grant. However, this is a problem with the grant itself, which is exacerbated by the taxation change recommended. Previously, government funding was paid out on a percentage completion basis, whereas the grant is paid out after completion. SPADA is concerned private investors will be discouraged from investing in films by their inability to immediately offset their film tax losses to the same extent, and that producers will be less able to fund other projects because the timing of their tax refund will be pushed out.

Taxation is not designed to be an indirect subsidy to producers and the screen production industry. Any subsidies should be made explicitly.

Recommendation

That the submission be declined.

Issue: Application date for Screen Production Incentive Fund payments

Clause 2(18)

Submission
(51 – Screen Production and Development Association)

The proposed date of implementation of the scheme for deduction of Screen Production Incentive Fund (SPIF) payments should be deferred to the beginning of the 2010–11 tax year, which is 1 April 2010.

Comment

SPIF was implemented on 1 July 2008 and during the period of delay caused by the later enactment of this bill there is uncertainty over how the deduction rules will apply. Given this uncertainty, it would be unfair to those few productions underway to be caught by the new rules. Delaying the implementation date would allow productions currently held up to proceed with certainty over their tax treatment.

Recommendation

That the submission be partially accepted, with a new application date of 1 January 2010, the date suggested to the industry by the Minister of Revenue in August 2008.

Issue: Application date of information sharing and secrecy provisions

Submission
(Matter raised by officials)

The proposed date of application for new information sharing and secrecy provisions between Inland Revenue and the Film Commission should be deferred from 1 July 2008 to the date of enactment of this bill.

Comment

Officials have realised that the dates currently proposed in the bill for application of the new provisions that override standard Inland Revenue secrecy are retrospective. The override is necessary to allow Inland Revenue to verify film expenditure for the Film Commission for the SPIF grant. Officials do not believe it is appropriate for such provisions to have retrospective application and recommend that their application be moved from 1 July 2008 to the date of enactment of this bill.

Recommendation

That the submission be accepted.

MIGRANT WORKERS – TAX RATE THAT APPLIES

Clauses 383, 422 and 445

Submission
(32 – KPMG)

The submitter supports the proposed initiative to reduce the compliance costs for migrant workers, but also notes that some additional compliance costs will be imposed on employers and payroll software developers.

They also submit that migrant workers will not receive a high income for the period they are in New Zealand and therefore the proposed flat tax rate of 19% in the bill is too high and should be reduced.

Comment

The bill introduces a full and final flat tax rate of 19% which would apply to migrant workers. Since the introduction of the bill, the tax rates for individuals have been reduced twice and the 19% rate is now too high. A more appropriate flat tax rate for an average migrant worker in a normal picking season would be 15%. This rate should apply from date of assent of the legislation.

Recommendation

That the submission be accepted, and the flat tax rate that applies to migrant workers be reduced from 19% to 15%, and apply from date of assent of the legislation.

BANKING CONTINUITY ISSUES

Clauses 408 and 416

Issue: Ownership interest requirements

Submission
(29 – Russell McVeagh)

The proposed legislation refers to the "new parent" holding all ownership interests in the "initial parent", and the "initial parent" holding all ownership interests in its direct and indirect subsidiaries. Exceptions need to be made to these ownership requirements to deal with instruments that are regarded as equity for tax purposes that do not convey real ownership interests.

Comment

Officials agree that certain exceptions will need to be considered if the proposed legislation is to carry out its intended policy objectives. Officials have considered the carve-outs proposed and agree they are necessary.

Recommendation

That the submission be accepted.

Submission
(29 – Russell McVeagh)

The present definition of "ownership interest" in the proposed legislation means either a voting interest or a market value interest, but not both. The definition should not be mutually exclusive and the continuity of both voting interests and market value interests should be preserved.

Comment

Officials agree that the continuity of both voting interests and market value interests should be preserved.

Recommendation

That the submission be accepted.

Issue: References to execution, beginning and ending of a non-operating holding company restructure

Submission
(29 – Russell McVeagh)

Terms such as "execution", "beginning" and "end" should not be used in the proposed legislation. This is because it is difficult to determine the exact timing of a restructure.

Comment

Officials accept that it may be difficult to determine the exact timing of the beginning and end-date for this type of restructure. We agree that the legislation should reflect the fact that there will not be a single clear-cut beginning or end-date for this type of restructuring.

Recommendation

That the submission be accepted.

Issue: Other drafting matters

Submission
(29 – Russell McVeagh)

A number of technical changes need to be made to the current draft legislation. The majority of those are minor drafting matters that are needed to ensure the draft legislation is applicable to taxpayers.

Comment

Officials have considered all the changes proposed in the submission and agree they are necessary.

Recommendation

That the submission be accepted.

Submission
(Matter raised by officials)

The proposed legislation should also include a requirement that the shareholders will need to hold the same proportion of ownership interests in the new parent company as they had done in the initial company once the restructured arrangement is completed.

Comment

The amendment will further improve the integrity of the proposed legislation.

Recommendation

That the submission be accepted.

CHARITABLE DONEE STATUS

Clause 427

Submission
(37 – Inter Church Working Party on Taxation)

The proposed additions to Schedule 32 of the Income Tax Act 2007 are supported. However, the list of charities with an overseas focus is too limited.

Comment

Inclusion of a charitable organisation in Schedule 32 is dependant on that organisation coming within the criteria established by Cabinet. The submitter recognises it might not be appropriate to suggest making further amendments in this bill.

Recommendation

That the submission be noted.

TAX RECOVERY ARRANGEMENTS – APPLICATION DATE

Clause 508

Submission

(67 – New Zealand Institute of Chartered Accountants)

This legislation is penal and the amendment (that clarifies that changes such as interest, administrative penalties and costs may be collected under New Zealand's tax recovery arrangements) should not apply retrospectively. It should only apply from the date of assent of the current legislation. Clearly this legislation was not clear before that date, therefore taxpayers should not be punished by legislation that had not been passed at the time the act was undertaken.

Comment

The legislation is not unclear. New Zealand's tax recovery arrangements (generally forming part of a double tax agreement although, in one case, established as a stand-alone convention) all expressly state that penalties and certain other costs may be recovered. Those arrangements have been given overriding effect by Order in Council to become part of New Zealand law. The amendment to the Tax Administration Act 1994 is being sought to prevent the possibility of a highly technical argument being made that certain provisions of the Act (chiefly the definition of "tax") can be construed as presenting an obstacle to the recovery of penalties. Such an argument would run counter to the clear intention that penalties can be recovered. Given that New Zealand's treaty obligations under tax recovery arrangements came into effect from 1 April 2008, it is appropriate to ensure that the amendment also has effect from 1 April 2008.

Recommendation

That the submission be declined.

PUBLIC AUTHORITIES AND GST

Clause 519(4)

Submission
(67 – New Zealand Institute of Chartered Accountants)

The term "offices of Parliament" only applied from 1 July 1991, so the legislation need only be made retrospective to that date. The term "offices of Parliament" came from the Public Finance Act 1989, in which it was defined to include the offices of the Auditor-General, Ombudsman and Parliamentary Commissioner for the Environment.

Comment

Officials note that the proposed legislation amends the definition of "public authority", and not the definition of "office of Parliament", by inserting a reference to the Parliamentary Services and the Office of the Clerk. Since the definition of "public authority" applied from the introduction of the original GST legislation, the proposed legislation is drafted to apply from the dates when the Parliamentary Services and the Office of the Clerk were first meant to charge GST on their supplies.

Recommendation

That the submission be declined.

GST ON CERTAIN LOYALTY POINTS

Clauses 519(3), 520, 521 and 525

Submission
(23 – American Express, 24 – New Zealand Law Society, 62 – Minter Ellison Rudd Watts)

The proposed ability of operators of loyalty programmes to defer charging GST on the supply of loyalty points should also apply when the GST "reverse charge" provisions in the GST Act apply.

Comment

A number of submissions note that the legislation should make it clear that the proposed rules allowing deferral of GST on loyalty points until the loyalty points are redeemed will apply when the GST "reverse charge" provisions in the GST Act treat the New Zealand-resident purchaser of the loyalty points as supplying the points. Since the resident purchaser will be liable for the GST on the supply of the loyalty points, it should also be able to choose whether to defer the payment of the GST until those points are redeemed.

Officials agree that the deferral should be available to resident purchasers of loyalty points in situations where they are liable to account for GST under the reverse charge rules. The proposed legislation should be clarified to give effect to that intention.

Recommendation

That the submission be accepted.

Submission
(32 – KPMG)

If a loyalty programme operator is able to identify at the time of the redemption of loyalty points whether or not GST has been imposed on the points or whether GST is deferred until redemption, there should be no reason to prohibit access to the new rule.

Comment

KPMG welcomes the proposed changes but considers there is no need to require that 25 percent or more of the loyalty programme operating business (or associated person's business) involves providing zero-rated goods or services.

The proposed rules defer the imposition of GST until the nature of the loyalty reward is known. The rules are meant to ensure that the supplier of the loyalty points does not charge the standard rate of GST on loyalty points if there is some possibility that the reward provided on redemption is a zero-rated supply – for example, air travel that could be either domestic (and standard-rated) or international (zero-rated). Therefore, by requiring that a proportion of the loyalty programme operator's business involves the provision of zero-rated goods and services, the rules ensure that there is some likelihood that the underlying reward is a zero-rated supply.

Removal of the requirement that loyalty programme operators must provide zero-rated supplies as part of their business would allow loyalty programme operators who do not redeem their loyalty points for any zero-rated rewards to defer the imposition of GST until the redemption of the loyalty points. Since, on redemption, these operators would still be required to charge GST at 12.5%, including them in the proposed rules would unnecessarily delay the payment of GST, with consequent (unquantifiable) fiscal implications.

Recommendation

That the submission be declined.

Submission

(35 – PricewaterhouseCoopers)

The GST treatment of loyalty point transactions should be reviewed, and specific legislation enacted to cover the GST implications of loyalty point schemes more comprehensively.

Because there is little case law on the GST treatment of loyalty points, the New Zealand GST position regarding the issue and subsequent redemption of loyalty points is very uncertain. There are three specific areas of concern:

- whether the issue of loyalty points to customers is a supply for GST purposes;
- a possibility that a redemption of points in consideration for a supply or services could be a supply for a consideration upon which GST is payable, which would result in a double GST impost; and
- that the above uncertainties are complicated even further when loyalty points issued outside New Zealand can be redeemed for goods and services in New Zealand and when loyalty points issued in New Zealand can be redeemed for goods and services in another jurisdiction.

Comment

Officials note the first and third concerns regarding the need for clarity over the tax treatment of loyalty points received by a loyalty programme customer directly from a loyalty programme operator for acquiring goods from that operator and consider that further work is required on this issue.

Officials note, however, that there is no such uncertainty in situations to which the proposed legislation will apply (which is necessary to avoid over-taxation).

In relation to PWC's second concern, officials agree that GST should not be imposed on both the issue of loyalty points and their subsequent redemption for goods and services. Conversely, officials consider that a loyalty programme operator will charge GST on redemption of loyalty points only in situations when they choose to defer the imposition of the GST under the proposed legislation.

Recommendation

That the submission be noted.

Submission
(67 – New Zealand Institute of Chartered Accountants)

The implementation date of the amendment should be grandparented so that any entities that have treated past loyalty programmes as proposed in the bill will not be subject to Inland Revenue scrutiny or penalty.

Comments

Officials do not consider there are sufficient grounds for making the changes retrospective. The policy of imposing GST on the form of business transactions has always been clear and the fact that some arrangements have given rise to an unwarranted tax impost does not in itself justify retrospectivity.

Recommendation

That the submission be declined.

Submission
(68A – Corporate Taxpayers Group)

The Group is supportive of the proposed amendments to allow the deferral of GST on certain loyalty transactions and sees the changes as a pragmatic approach for both taxpayer and government.

Recommendation

That the submission be noted.

GST AND EXPORTED SECOND-HAND GOODS

Clauses 522 and 523

Under the Goods and Services Tax Act 1985, a GST-registered person who purchases second-hand goods from an unregistered person may claim an input tax deduction for the tax fraction (one-ninth) of the purchase price which has been paid. As a base integrity measure, second-hand goods that have been the subject of such an input tax deduction cannot be zero-rated if they are exported.

The amendment changes this outcome and allows exported second-hand goods to be zero-rated if the registered person obtains a written declaration from the recipient of the goods that they or an associate will not cause the goods to be brought back to New Zealand. This declaration is necessary to ensure that Inland Revenue has sufficient information to determine when goods form part of an export/reimport arrangement that seeks to create second-hand goods input tax deductions.

Submissions agree with the amendment but recommend that it apply from 1 April 2004. Officials disagree with this recommendation.

A drafting matter has been identified with the amendment that needs to be changed to specify that the amendments apply to GST-registered persons.

Issue: Support for the proposed amendment

Submissions
(As per form letter 8: SimsPacific Metals Limited, Wellington Scrap Metals Ltd, 14 – The Scrap Metal Recycling Association of New Zealand Inc and W Macaulay Ltd, 68A – Corporate Taxpayers Group)

Submissions note their support for the proposed change subject to the amendment having retrospective application to 1 April 2004.

Recommendation

That the submissions be noted.

Issue: Retrospective application

Submissions

(As per form letter 8: SimsPacific Metals Limited, Wellington Scrap Metals Ltd, 14 – The Scrap Metal Recycling Association of New Zealand Inc and W Macaulay Ltd, 53 – Ernst & Young)

The application of the proposed changes should be backdated to 1 April 2004.

The amendment removes a point of difference between Inland Revenue and taxpayers about whether certain supplies of exported scrap metal are subject to GST at the standard rate of 12.5%. The effect of the amendment negates the need to consider whether the exported scrap metal was new, second-hand or modified to such an extent that it was "new" compared with its original purchase condition. Backdating the amendment would therefore protect those taxpayers that have zero-rated exported scrap metal and produce an equitable result for dealers in the scrap metal industry.

It is further noted that:

- There is no constitutional objection for retrospective application as the amendment confers a benefit to taxpayers.
- The benefit conferred by the amendment should not be delayed until enactment.
- There is little or no revenue risk connected with backdating the amendment to 1 April 2004 because of the costs associated with transporting scrap metal.
- Inland Revenue is prevented, in situations other than avoidance, from amending assessments that are more than four years old (the four-year time-bar). Backdating the amendment to 1 April 2004 with application to taxpayers that have zero-rated the exports in question is consistent with the time-bar.

Comment

Officials consider that the amendment is new policy and does not clarify an existing uncertainty with the treatment of exported second-hand goods – it modifies the application of an existing anti-avoidance provision. The amendment also does not deal with the question of what are "second-hand goods", which is currently being considered by Inland Revenue. The change therefore does not remove the different GST treatment of exported second-hand goods and all other exported goods.

We note Inland Revenue is investigating taxpayers that have zero-rated exports potentially involving the supply of second-hand goods.

Decisions about whether legislative changes should have retrospective application need to be made on a case-by-case basis. In this particular case, we consider that backdating the amendment is not appropriate for the following reasons:

- The requirement to charge GST on exported second-hand goods that have been subject to a second-hand goods input tax deduction has been present in the Act since its enactment. The application of the relevant sections in the GST Act and its role as an anti-avoidance measure has also been confirmed by the New Zealand courts.[1] Most taxpayers should therefore have a reasonable expectation that exported second-hand goods cannot be zero-rated like other exported goods.
- The amendment applies to all exported second-hand goods, not just scrap metal. Backdating the amendment is likely to create unintended consequences and potentially give rise to windfall gains. While there may be a limited revenue risk associated with exported scrap metal, we consider it would be inappropriate to backdate the amendment for the benefit of the scrap-metal industry and not for other dealers in exported second-hand goods.
- Backdating the amendment, as suggested by submissions, to taxpayers who have taken a zero-rated tax position in connection with exported second-hand goods (thereby limiting the scope for unintended consequences) would create an inequity between taxpayers in similar fact situations depending on whether or not they zero-rated or charged GST on the export. We are unable to estimate the number of taxpayers (and amounts in question) that would fall into each situation.
- Affected exporters are unlikely to be able to retrospectively comply with the record-keeping requirements demanded by the amendment before the export can be zero-rated. Submissions note that this requirement should not apply for the retrospective period because of the costs involved. We are of the view that removing the need to keep records about the recipient's intended use of the goods would undermine the integrity of the amendment.
- Based on our estimates of the revenue cost of the amendment being $4 million each year, there would likely be a revenue cost of $20 million or more if the amendment were backdated to 1 April 2004.

Recommendation

That the submissions be declined.

Issue: Scrap metal is not "second-hand goods"

Submission
(14A – The Scrap Metal Recycling Association of New Zealand Inc and W Macaulay Ltd)

Scrap metal is not second-hand goods.

[1] *Case N66* (1991) 13 NZTC 3,495.

Comment

The GST Act defines the term “second-hand goods” to mean:

> “Secondhand goods, does not include—
> (a) Secondhand goods consisting of any fine metal; or
> (b) Secondhand goods which are, or to the extent to which they are, manufactured or made from gold, silver or platinum, or any other substance, if they were of the required fineness, would be fine metal; or
> (c) Livestock:”

The Court of Appeal in LR McLean[2] noted that there is nothing in the purpose or scheme of the Act that would justify ignoring the ordinary meaning of the words “second-hand goods”. The ordinary meaning of “second-hand” was described by the Taxation Review Authority as: “…used or treated or stored by a previous owner in such a manner that it can no longer be regarded as new”.[3]

This would suggest that breaking down goods into individual components does not of itself create “new” goods. For example, removing a door from a second-hand motor vehicle for re-sale does not make the door the sale of new goods.

While the question of whether specific goods are second-hand or new is a question of fact and law, policy discussions with representatives from the scrap-metal industry have been on the basis that the goods in question are second-hand for GST purposes, giving rise to the problem that this amendment is intended to address.

Recommendation

That the submission be noted.

Issue: Drafting matter – “registered person”

Submission

(Matter raised by officials)

The amendment inserting new section 11(3B) makes reference to the “supplier”. This term should be corrected to read “registered person”. The reason for the change is that the section is intended to have effect when second-hand goods are exported by a registered person. The term “supplier” means “the person making the supply” and can refer to a registered person or an unregistered person. The change is recommended as it specifies that the section should apply to registered persons only.

Recommendation

That the submission be accepted.

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[2] *LR McLean and Co Ltd and Ors* v *Commissioner of Inland Revenue* (1994) 16 NZTC 11,211.
[3] *Case N16* (1991) 13 NZTC 3,142 at 3,147.

Issue: Application date should be specified

Submission
(53 – Ernst & Young)

It should be specified that the amendment applies to supplies made on and after a specified date rather than have the change apply from the date of enactment. Simply having the amendment apply from date the bill is enacted can result in uncertainty and ambiguity – for example, over supplies made but not yet returned for GST purposes.

Comment

The GST Act contains a number of rules that determine the point in time when a GST-registered person must recognise a supply of goods and services that give rise to an output tax liability (including zero-rated supplies). The rules approximate when a transaction has been concluded and economic control of the goods and services has passed from the supplier to the recipient. In the majority of cases, the time of supply will be when the supplier issues an invoice or receives payment. This general rule is a mechanical provision that assists with the imposition and collection of that tax by determining such matters as when tax becomes payable.[4] The GST treatment of a supply is therefore determined by reference to these rules rather than when a registered person is required to file a return.

Recommendation

That the submission be declined.

Issue: Meaning of "substantially the same condition"

Submission
(67 – New Zealand Institute of Chartered Accountants)

Guidelines need to be published by Inland Revenue on the meaning of the phrase "substantially the same condition".

Comment

Officials will discuss with submitters the publication of guidelines.

Recommendation

That the submission be noted.

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[4] See *Pine* v *Commissioner of Inland Revenue* (1998) 18 NZTC 13,570 CA.

RAISING CERTAIN TAX THRESHOLDS

The proposals in the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill to make changes to tax thresholds for small and medium enterprises (as summarised on page 11 of the explanatory note to this bill) are to be withdrawn.

All these changes have now already been made as a result of the enactment of The Taxation (Business Tax Measures) Act 2009. The legislation was part of an urgent tax package for small and medium enterprises introduced by the government to make it easier for smaller businesses to manage their cash flows and meet their tax obligations. As part of this package, the tax threshold changes in this bill were brought forward so they could become effective as soon as possible, and in some cases further enhanced. The proposals are therefore no longer required in this bill.

ACC: TAXATION OF PERSONAL SERVICE REHABILITATION PAYMENTS – DRAFTING CLARIFICATION

Submission

(Matter raised by officials)

Amendments are necessary to correct three deficiencies or ambiguities in changes to the taxation of personal service rehabilitation payments that were made in the Taxation (Business Taxation and Remedial Matters) Act 2007.

Comment

The intention of the changes was to tax attendant care payments at the time they were made to claimants – when that person on-pays his or her carer(s) – or to the carer(s) themselves – when ACC pays them directly on behalf of the claimant. In the former situation, no tax was to be deducted when the claimant on-paid his or her carer(s). However, a drafting error occurred at the select committee stage of the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill, which effectively reversed the position – in other words, that ACC is not required to deduct tax, and that claimants who pay their caregivers directly are responsible. This effect negates the whole purpose of the amendments.

One of the criteria for qualifying for the in-work tax credit is that the person has earned income that is a "PAYE income payment". As personal service rehabilitation payments are excluded from this definition, full-time carers do not currently qualify for this credit.

There is doubt that the provisions apply to personal service rehabilitation payments made under provisions that applied in earlier Acts covering entitlements arising from accidents, which have been carried forward, but "grandparented", in the Injury Prevention, Rehabilitation, and Compensation Act 2001.

Recommendation

That the submission be accepted, and that the amendments apply from 1 July 2008.