Taxation (GST and Remedial Matters) Bill

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

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Prepared by the Policy Advice Division of Inland Revenue and the Treasury

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OVERVIEW

This bill introduces a new rule to require GST-registered vendors in most cases to charge GST at the rate of zero percent on the supply to a registered person involving land or in which land is a component. The bill also streamlines transactions involving nominated persons, clarifies the boundaries of the definition of "dwelling" and "commercial dwelling" and simplifies the method for apportioning input tax deductions for goods and services that are used for both taxable and non-taxable purposes.

Other matters in the bill include amending the "on premises" fringe benefit tax exemption, allowing deduction by the Commissioner of Inland Revenue to make deductions of tax from joint bank accounts and various other remedial matters relating to a broad range of subject matter, including the tax treatment of emissions trading and the Auckland council restructuring.

Sixteen submissions were received on the amendments. Most submissions supported the intent of the bill, but raised concerns around the practical application of the proposed GST rules.

This report sets out officials' detailed responses to those submissions. Officials have taken into account the recommendations in submissions seeking further simplification and certainty in relation to the proposed GST rules. As a result, numerous changes to the bill of a largely technical nature are recommended. Officials have not, however, recommended changes to the fundamental design and structure of key policies reflected in the bill.

GST: zero-rating of land

SECTION 11(1)(mb) – REQUIREMENTS FOR ZERO-RATING LAND TRANSACTIONS

Clause 10

Issue: Transitional provision for zero-rating rules

Submission
(Russell McVeagh)

A transaction may be documented before the legislation is enacted, with a time of supply after 1 April 2011. In these circumstances, there will be contractual uncertainty as to the transaction document, given that the zero-rating rules will likely to be in "draft" form at the time of the contract. Since it will not be a straightforward matter to vary contracts already entered into, there should be an ability to preserve existing GST treatment at the parties' option, or upon application by the parties to the Commissioner.

Comment

We consider that a transitional provision is needed for transactions to which the zero-rating rules would apply that are entered into before 1 April 2011. The supplier would have the option of either using the new rules or applying the legislation in existence before 1 April 2011 even if the time of supply is triggered after 1 April 2011.

Recommendation

That the submission be accepted.

Issue: Application of zero-rating to components other than land

Submissions
(KPMG, Ernst & Young)

The legislation should be clarified as to whether the requirement to zero-rate a supply in section 11(1)(mb) of the Goods and Services Tax Act 1985 ("the GST Act") applies to all goods and services supplied with land or just land and buildings (except if the building is a residential building which is excluded from the application of the zero-rating rules by section 5(15)). *(KPMG)*

The submitter seeks clarification as to which goods supplied as part of a supply involving land must be intended to be used for making taxable supplies. *(Ernst & Young)*

Comment

By referring to a supply that "wholly or partly consists of land", section 11(1)(mb) intends that a supply should be zero-rated in full if any part of that supply consists of land (unless it is a principal place of residence of the recipient of the supply). For example, in the sale of a farming business, any livestock sold as part of the supply will also be zero-rated under the section, even if the transaction is not a supply of a going concern.

The goods and services supplied under a transaction may be in part for making taxable supplies and in part not – in that case zero-rating would still apply. However, if the supply includes portions that are used for non-taxable purposes, an apportionment of the non-taxable and taxable components will be required. Thus the purchaser will be required to pay GST on any non-taxable portion under proposed section 20(3I). Moreover, section 5(15) of the GST Act already requires a private residence as part of wider supply to be treated as a separate supply.

Recommendation

That the submissions be declined.

Issue: The required extent of taxable supplies

Submission
(Ernst & Young)

Clarification is needed about the extent of taxable supplies for which recipients must intend using the land and other components of the transaction, as distinct from other types of supply.

Comment

The requirement in section 11(1)(mb)(i) that a recipient must intend to use the land and other components of the supply for making taxable supplies will be satisfied unless the recipient intends the use to be wholly for exempt and/or private purposes.

Section 11(1)(mb)(i) seems to be sufficiently clear in this regard.

Recommendation

That the submission be declined.

Issue: The timing of the registration status of the recipient

Submissions
(PricewaterhouseCoopers, Ernst & Young)

Clarification is required as to when the parties' registration status and the recipient's intentions in respect of land are to be measured for the purposes of new section 11(1)(mb). The current wording is unclear on whether the recipient's intention is required to be tested immediately or in the future (depending on what the ultimate intention is).

Comment

Officials agree with the submission. It is recommended that a purchaser be required to make representations regarding their registration status or that of the ultimate recipient, and their intentions in relation to land as they are expected to be at the time of settlement. By being able to make representations on a prospective basis, the purchaser will be required to provide information that they predict will be correct at the time of settlement. The purchaser will be responsible for any tax unpaid as a result of the representation not being correct.

Recommendation

That the submissions be accepted.

DEFINITION OF "LAND" FOR THE PURPOSES OF SECTION 11(1)(MB)

Clause 4(5)

Issue: Leases and periodic payments

Submissions
(Corporate Taxpayers Group, KPMG, PricewaterhouseCoopers, New Zealand Bankers' Association, New Zealand Institute of Chartered Accountants)

The Corporate Taxpayers Group is concerned that the definition of "land" in the bill is too wide, and may catch transactions that are not intended by officials to be zero-rated. The concern is specifically about the meaning of "interest in land", which will form part of the definition of "land". Under ordinary legal principles, an interest in land will include leases. The creation or transfer of a leasehold interest should be within the zero-rating provisions, given that such a transaction is effectively a quasi sale and purchase of land. However, ongoing lease payments should be carved out. In order to achieve this outcome, the submitter suggests that there should be a bright-line test applying the zero-rating provisions to the creation or transfer of a leasehold interest that meets a particular threshold. An appropriate bright-line test would be to zero-rate the creation or transfer of leasehold interests which are 20 percent or more of the total market value of the land. Ongoing rental payments under a lease arising from such a transaction should be carved out and not subject to the zero-rating provisions. *(Corporate Taxpayers Group)*

The definition of "land" should expressly exclude payments for the supply of a commercial dwelling that are subject to the time of supply rules in section 9(3)(a) of the GST Act (that is, periodic payments). *(KPMG)*

Normal commercial leasehold interests should not be captured by the zero-rating regime. Officials' concerns in respect of leases being used for "phoenix" schemes could be addressed by zero-rating only transfers of leases and prepayments of more than 12 months on leases. *(New Zealand Bankers' Association)*

The zero-rating rules should not apply to successive supplies of a commercial dwelling subject to a lease. The definition of "land" will need to be amended to exclude these transactions. *(New Zealand Institute of Chartered Accountants)*

Further consideration could be given to whether periodic supplies of land, such as commercial leases, should be included in the application of the new zero-rating provisions. *(PricewaterhouseCoopers)*

Comment

Submitters consider that periodic supplies of land, especially commercial leases, should be excluded from the definition of "land" used for the zero-rating amendments. The key issue is the compliance costs that would arise from existing commercial leases or other periodic supplies of land having to be altered to take account of the zero-rate, even though the contract is unlikely to generate a phoenix fraud risk. Most submitters do recognise, on the other hand, that for new transactions leasehold interests could relatively easily become a substitute for freehold interests and give rise to the possibility of such a risk.

Officials agree that the definition of "land" in the bill is too broad and should exclude most leases of land and other periodic supplies such as easements over land. The solution, however, must strike a balance that addresses both the compliance cost and the tax base risk concerns. The solution should also provide as much certainty as possible regarding which transactions should be zero-rated and which transactions should be standard-rated.

Officials recommend an amendment to the definition of land that uses a "bright-line" test to exclude periodic or ongoing supplies of interests in land. The test would be based on whether, after 1 April 2011, more than 25 percent of the total consideration under the agreement is provided in advance of, or contemporaneously with, the provision of the land, in addition to the regular ongoing payments under the agreement. If the 25 percent threshold is exceeded, the whole transaction (or remaining part of the transaction) would have to be zero-rated. If not, the transaction would be standard-rated.

The 25 percent figure should therefore apply to zero-rate all transactions with unusual commercial terms that could provide an incentive for phoenix fraud. We prefer basing the test on rental payments rather than the market value of the land as this should remove the compliance cost of any additional valuation.

Officials have considered whether a transitional rule is needed that would allow the provisions in the bill to not apply to periodic supply contracts that met the 25 percent test and that were entered into before 1 April 2011. Given the limited number of agreements that would fall into this category, and that the issue is one of compliance costs only, we do not think that such a provision is warranted.

Recommendation

That the submissions be accepted.

That the definition of "land" be amended to exclude interests in land that involve more than 25 percent of the total consideration under the agreement provided in advance of, or contemporaneously with, the provision of the land, in addition to the regular ongoing payments under the agreement.

Issue: Clarifying whether certain supplies constitute “land”

Submission
(Ernst & Young)

Further thought is required as to how the proposed definition of “land” will impact on any supplies involving some element of land or rights which are related to land in some way, with express clarification of the statutory provisions and publications of adequate examples to ensure there is clarity and certainty for taxpayers. For example, there may be considerable uncertainty and compliance costs to taxpayers in determining whether a variety of transactions with some connection to land include the supply of “land” for the purposes of section 11(1)(mb) (for example, supplies of timber rights, telecommunication lines, building fixtures, etc).

Comment

Officials accept that further certainty is required regarding the ambit of the definition of “land” used in section 11(1)(mb) and recommend that Inland Revenue publish guidelines on the matter.

Recommendation

That the submission be accepted.

Issue: Flat- and office-owing companies

Submission
(Matter raised by officials)

Officials recommend that shares in “flat-owning companies” or “office-owning companies” should be included within the proposed definition of “land”.

Comment

The GST Act specifically excludes shares in “flat-owning companies” or “office-owning companies” (as defined in the Land Transfer Act) from the GST definition of “financial services”. This exclusion was introduced to prevent taxpayers from incorporating such companies, acquiring land and then transferring shares in the company (without having to charge GST), rather than transferring the underlying asset (which would have attracted GST).

However, this presents an issue in relation to the proposed rules, which seek to zero-rate all interests in land. If the shares in these companies are not “land” and are not “financial services”, a supply of the shares will attract the standard rate of GST. There is therefore a risk that these shares could be transferred between registered persons in a “phoenix” transaction.

Officials recommend including shares in flat-owning or office-owning companies within the proposed definition of "land" to clarify that the transfer of these shares should be zero-rated. Officials consider this is consistent with the policy intent of the changes and may prevent the zero-rating rules being circumvented by the imposition of company structures in certain cases.

Recommendation

That the submission be accepted.

VENDOR'S INFORMATION-GATHERING OBLIGATIONS UNDER SECTION 78F

Clause 20

Issue: Limiting information to registration status

Submission
(KPMG)

The vendor's obligation should be limited to obtaining the purchaser's registration details. If a supply is zero-rated and the purchaser does not acquire the land with the sole intention of using it for making taxable supplies, the new change-in-use provisions would require the purchaser to account for the non-taxable use of the land. Therefore, the requirement to confirm the intentions of the purchaser in relation to the land imposes additional compliance costs on the vendor with no additional tax revenue to the Government.

Comment

If the purchaser does not intend to use the goods or services for making taxable supplies and the relevant information is provided to the vendor, it is preferable, and more in keeping with the scheme of the GST Act, that the correct standard-rated treatment of the transaction applies from the outset.

Furthermore, the recommended changes to section 78F will simply require a vendor to obtain a written representation, rather than confirmation from the purchaser regarding the purchaser's intentions in respect of the land. Officials consider that this obligation on the vendor will not greatly increase their compliance costs.

Recommendation

That the submission be declined.

Issue: Reducing the vendor's obligations

Submissions
(Corporate Taxpayers Group, Deloitte, KPMG, New Zealand Bankers' Association, Russell McVeagh, Ernst & Young)

The legislation as currently drafted does not provide sufficient commercial certainty as to the GST treatment applying at the time of a transaction. The proposed obligation on supplies in section 78F may be onerous, particularly the obligation to confirm the intentions of the purchaser. The submitters recommend:

- removing the requirement on the vendor to confirm the relevant details, and allow the vendor to rely on the written representation of the purchaser.
- replacing the reference to the purchaser's "registration details" with the purchaser's "registration status".
- removing or clarifying subsections (3) and (5) (relating to misrepresentations by either party) from the bill.

Comment

Officials agree that draft section 78F has a range of issues that need to be resolved. This is best achieved by reconsidering the section as a whole and what it is intended to achieve.

It is important to recognise that there are in essence only two problematic situations that can practically arise under the zero-rating provisions – the supply being zero-rated when it should have been standard-rated, and the supply being standard-rated when it should have been zero-rated.

The information that the supplier must obtain under proposed section 78F consists of:

- the recipient's registration details;
- confirmation that the recipient is acquiring the goods with the intention of making taxable supplies; and
- confirmation that the goods are not intended to be used as a principal place of residence of the recipient or a relative of the recipient.

These requirements will, for the most part, be met through completion of the standard sale and purchase agreements, in which the purchaser would verify these matters.

Section 78F(2), however, requires confirmation from the vendor of the above and submitters have expressed concern about the vendor's ability in this respect. Subsections (3) and (5), which are also of concern to submitters, outline a number of consequences that may arise if this information is not obtained in the first instance, or is incorrect.

Officials agree that information requirements should be as easy to comply with as possible, and compliance with the requirements should not generally have regard to the intentions or behaviour of either the vendor or purchaser.

Officials therefore recommend an alternative approach that does not require an examination of whether the vendor has made sufficient enquiries to obtain the information. The alternative approach would recognise that the vendor will have either:

1. obtained all the information to zero-rate and the information is correct; or
2. for any reason, not obtained all the information or obtained incorrect information.

If the purchaser is in fact registered for GST and has met the other tests, zero-rating has achieved the right outcome. Such purchasers have the incentive to provide the correct information otherwise they will risk GST being charged at the standard rate.

It is for the second situation that the legislation may need to provide further clarification of the parties' obligations. In this situation, the vendor could either zero-rate the transaction (because they believe the information to be correct even though it later transpires that it is not) or charge GST at the standard rate (which would be the usual expected outcome).

Information not correct/not obtained and the vendor zero-rates

If the vendor zero-rates the transaction but the information was incorrect and the transaction should have been standard-rated, clause 6 of the bill (proposed section 5(23)) imposes the obligation on the purchaser to register and pay GST. As noted later, however, proposed section 5(23) would be amended to apply to all situations in which the transaction should not have been zero-rated. It would require the purchaser to register for GST but allow for deregistration without further tax cost once the tax had been paid.

Information not correct/not obtained and the vendor standard-rates

If the vendor standard-rates the transaction one of two outcomes could result:

- the purchaser is not registered and/or does not meet the other tests; or
- it transpires that the purchaser is registered for GST and meets the other tests.

If the purchaser is not registered for GST and/or does not meet the other tests, standard-rating has achieved the right outcome.

If the transaction is standard-rated but should have been zero-rated because the relevant tests were in fact met, the vendor will have overpaid GST and should be able to recover it from Inland Revenue in the usual manner – using the process in the GST legislation of providing credit notes. (We recommend later in this report that the credit note provision, section 25, should be amended to explicitly apply in these situations.) The purchaser will not be entitled to an input tax deduction since the position under the legislation is that the transaction is zero-rated. It is the legislation that determines that a transaction is zero-rated, not the written representation of the purchaser, which merely enables the vendor to decide how the transaction should, in the first instance, be treated.

Recommendation

That the submissions be accepted. Officials further recommend that:

- in subsection (2) of proposed section 78F, the reference to the supplier having to "confirm" the information in question be replaced by a reference to the supplier being able to rely on the written representation of the recipient;
- in subsection (2) "registration details" be replaced with "registration status"; and
- subsections (3) and (5) of proposed section 78F be omitted.

ALTERATION OF AGREED PRICE

Submission
(Corporate Taxpayers Group)

Section 78E (alteration of agreed price in relation to a supply mistakenly believed to be of a going concern) should be amended to refer not only to section 11(1)(m) ("going concern" rules), but also to the proposed section 11(1)(mb) or to zero-rating in general.

Comment

Officials consider that if the vendor, based on incorrect representations by the purchaser, does not zero-rate the transaction and GST is paid, this can be dealt with under section 25 of the GST Act which provides the credit note mechanism (and which we later recommend should be amended to provide more certainty about its application).

Recommendation

That the submission be declined.

PURCHASERS' OBLIGATIONS TO ACCOUNT FOR OUTPUT TAX IF A SUPPLY WAS INCORRECTLY ZERO-RATED – PROPOSED SECTIONS 5(23), 20(4B) AND 51B(4)

Clauses 6(2), 13, 15 and 17

Issue: Implications of incorrect zero-rating

Submission
(Russell McVeagh)

New section 5(23) deems a recipient to make a supply chargeable at the standard rate if they have provided incorrect information relating to whether they are GST-registered. It is submitted that the provision should also apply if the recipient has provided incorrect information regarding their intentions in relation to land.

Comment

In situations when a zero-rated supply is made to an unregistered person, the person, without further legislation, would acquire the supply free of GST. Proposed sections 51B(4) and 5(23) will therefore require the person to register for GST and to account for the output tax on the supply.

If a recipient of a zero-rated supply is already registered for GST, but does not satisfy the other requirements of section 11(1)(mb) (that is, they do not intend to use the land for making taxable supplies or intend to use the land as a principal place of residence), the proposed apportionment rules in section 20(3I) would require them to account to Inland Revenue for the non-taxable use of the goods and services. As a consequence, the recipient would be required to account for the output tax on the supply under that provision.

However, to ensure that the consequences of not satisfying the zero-rating requirements are all in one place, officials agree that section 5(23) should be amended to apply to all situations of incorrect or insufficient information being provided.

Recommendation

That the submission be accepted.

Issue: Requirement for purchaser to register

Submission
(New Zealand Institute of Chartered Accountants)

Under new section 5(23) of the GST Act, a purchaser supplying incorrect information to a vendor is treated as though they were a supplier making a supply that is chargeable with GST at the standard rate. It seems unnecessary to require the purchaser to also register for GST under section 51B(4) to recover a payment of a GST amount.

Comment

The registration of unregistered purchasers who incorrectly purchase land at a zero-rate is necessary to ensure that a payment of output tax made by the purchaser under section 5(23) can be processed by Inland Revenue's accounting systems.

To ensure that the purchaser does not suffer any unexpected costs from the compulsory registration, the bill should allow for an immediate deregistration of the purchaser without further tax liability once the tax has been paid.

Recommendation

That the submission be declined. However, officials recommend that once the tax is paid, the purchaser should be able to deregister without incurring any further tax liabilities.

Issue: Timing of registration under section 51B(4)

Submission
(Ernst & Young)

Clarification is needed regarding the time at which recipients are to be treated as registered under section 51B(4) and making taxable supplies under the proposed new section 5(23).

Comment

Since the ultimate recipient of the supply may not be known until the time of settlement, it may not be known before then whether the decision to zero-rate the transaction is correct. Therefore, a recipient will be treated as making a supply under section 5(23) at the time of settlement. Section 5(23) should be clarified to that effect.

Officials also consider that the proposed section 51B should clarify that a recipient is treated as registered from the date of the supply made under section 5(23), and not from the time when the original supply was made, if different.

Recommendation

That the submission be accepted.

Issue: Entitlement to input tax

Submission

(Ernst & Young)

The proposed input tax denial in section 20(4B) in respect of supplies made under section 5(23) should be qualified to ensure that recipients of section 11(1)(mb) supplies are not precluded from claiming input tax if they become GST-registered after the GST time of supply under section 11(1)(mb).

Comment

When a supply of land which should have been standard-rated is zero-rated, new sections 51B(4) and 5(23) require the recipient to register for GST and account for the output tax on the supply. To ensure that the newly registered recipient does not immediately claim back the GST paid as an input tax deduction, new section 20(4B) denies them a deduction in relation to the supply. Having accounted for GST under section 5(23), officials have recommended that the recipient will be deregistered at no further cost.

Officials accept that if a recipient, having been required to account for output tax under section 5(23), later registers for GST and starts using the goods and services in question for making taxable supplies, they should be allowed an input tax deduction in respect of those goods and services under the new apportionment rules proposed in this bill. Officials' responses to the submissions on the proposed apportionment rules recommend that the legislation be clarified to ensure that an input tax deduction is allowed in these circumstances.

Recommendation

That the submission be accepted.

Issue: Searchable register of GST registered persons

Submissions

(New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

The law should allow a searchable register of GST-registered persons to be established so that taxpayers or their tax agent can identify the GST-registration status of either party. This will assist in reducing compliance costs for taxpayers transacting in land.

As an alternative, or a concurrent change, a certification approach could be adopted that requires the vendor and the purchaser to certify their GST registration status (or that of their nominee if applicable) on the contractual documentation. *(New Zealand Institute of Chartered Accountants)*

Consideration should be given to updating Inland Revenue's systems and processes to allow suppliers to validate GST registration numbers provided by customers. For example, Inland Revenue should be able to provide the recipient's registration details at the request of the supplier. *(PricewaterhouseCoopers)*

Comment

Owing to the Commissioner's obligations to maintain secrecy regarding taxpayer-related information, it is not currently possible to establish a public register of GST-registered persons.

Officials consider that owing to the proposed relaxation of vendors' obligations to identify purchasers' details (as proposed in this report), vendors should not suffer substantial compliance costs as a result of the zero-rating rules.

Recommendation

That the submissions be declined.

Issue: Possible tax base risks

Submission
(Corporate Taxpayers Group)

The Group acknowledges that the proposed changes resolve officials' principal concerns with "phoenix" transactions. However, there is a risk that fraudulent GST activity has, in effect, only been moved to another area.

Specifically, the GST risk has moved to sales by a commercial vendor to the end consumer when false declarations are made by the purchaser regarding their registration status and intentions in relation to land.

The Group suggests that Inland Revenue consider other non-tax legislative measures for penalising vendors that entice purchasers to misrepresent that they are GST registered or otherwise avoid the requirements of section 78F.

Comment

Officials acknowledge the submitter's concern and consider that adequate policing will be necessary to minimise the risk of zero-rating rules being used inappropriately. At this stage, officials are not recommending the inclusion of any specific measures in the bill to deal with this potential issue, but will monitor the situation.

Recommendation

That the submission be noted.

Issue: Inland Revenue advice

Submission
(New Zealand Institute of Chartered Accountants)

NZICA submits that material should be made available warning purchasers of arrangements that involve them registering for GST when they are acquiring land, or using their GST registration as a means of acquiring land inappropriately at a zero rate.

Comment

Officials agree that Inland Revenue advice for taxpayers will be beneficial for ensuring a smooth transition into the new rules.

Recommendation

That the submission be accepted.

INTERACTION OF ZERO-RATING RULES WITH THE "GOING CONCERN" RULES

Clause 10

Submission
(Ernst & Young)

Sales of businesses which include a transfer of land could be zero-rated under the proposed section 11(1)(mb) (zero-rating of land) or the existing section 11(1)(m) (sale of a going concern). Clarification of the interaction of the proposed section 11(1)(mb) and the existing section 11(1)(m) is required.

Comment

The new zero-rating rules will apply to any supply that involves land. This will affect many supplies of going concerns, as these frequently involve transfers of land. This will remove the need to determine whether a going concern is being supplied and to meet the other requirements for zero-rating a going concern in these cases.

It is expected that the zero-rating rules will be easier to apply then the going concern rules as, among other things, the parties will not have to establish the existence or otherwise of a going concern or decide whether to apply the new provisions (as they are mandatory). Therefore, a specific exclusion from the going concern rules is not necessary.

Recommendation

That the submission be declined.

OTHER DRAFTING MATTERS

Issue: Treatment of services supplied as part of a transaction involving land

Submission
(Corporate Taxpayers Group)

Since the proposed zero-rating changes may apply to supplies consisting of both goods and services, and section 11 applies only to goods, consideration should be given to inserting a provision (similar to section 5(21) in the GST Act) that would treat any services provided as part of a transaction involving land as "goods", in order to fall within proposed section 11(1)(mb).

Comment

Officials agree with the submission but note that the exact wording is a drafting matter.

Recommendation

That the submission be accepted.

Issue: Minor drafting matters

Submissions
(New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers, 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 that the legislation works as intended.

Comment

Officials have considered all the changes proposed in the submission and agree that most of them are necessary. They will be raised with the bill's draftsperson.

Recommendation

That the submissions be noted.

GST: transactions involving nominations

ZERO-RATING TRANSACTIONS WHEN THE RECIPIENT IS NOT KNOWN AT THE TIME A CONTRACT IS ENTERED INTO

Clauses 10, 18 and 20

Issue: Vendor's obligations

Submissions
(Corporate Taxpayers Group, Deloitte, Russell McVeagh, KPMG, Ernst & Young)

It is not uncommon for sale and purchase agreements to be entered by a "purchaser or nominee".

When a nominee is involved, the vendor will likely need to determine the GST registration status and other information requirements of both the purchaser and their nominee, as it may not immediately be clear who will be the actual purchaser in the transaction. A further complication arises when a nominee is not known at the time the contract is entered into.

Submitters consider that vendors' obligations should be clarified for transactions involving a nominee.

Comment

The nomination rules proposed in the bill will determine whether a supply should be treated as made to a contractual purchaser or a nominee, depending on which party to a transaction provides consideration for the supply. These rules are expected to work well in transactions that do not involve land, as the GST treatment of those supplies would not depend on the nomination and will simply help to determine which party is eligible to claim deductions.

In respect of transactions that involve supplies of land, the vendor has to obtain a representation from the purchaser that they:

- are registered for GST;
- are acquiring the land to be used for making taxable supplies; and
- do not intend to use the land as a principal place of residence.

On the basis of those representations, the vendor must be able to determine whether a supply should be standard-rated or zero-rated. The use of the land can really only be based on the intentions of the ultimate recipient.

In order to avoid any confusion regarding which supply should determine the correct GST treatment in transactions that involve land, officials recommend that, in those transactions, the supply should always be treated as between the vendor and the nominee (that is, the ultimate recipient).

In addition, for the purposes of the proposed section 78F, the purchaser should be able to provide representations to the vendor regarding the registration status and intentions of the ultimate recipient of the supply on a prospective basis.

If the purchaser does not intend to receive the land themselves but knows the identity of the nominee who will settle the transaction, they will be able to make representations to the vendor regarding the registration status and the intentions of the nominee.

The vendor will be able to rely absolutely on representations made by the contractual purchaser, and to apply the GST treatment on the basis of the information provided.

If the purchaser does not have the relevant information about the nominee and the time of supply is triggered earlier than the date of settlement, the correct tax treatment of the transaction may have to be reconsidered.

If a supply is zero-rated and the ultimate recipient is registered for GST and has met the other tests, zero-rating has achieved the right outcome.

If a supply is zero-rated and the ultimate recipient is not registered for GST, the correct outcome has not been achieved. As a consequence, the recipient would be required to register for GST and account for the output tax on the transaction under proposed section 5(23).

Alternatively, if the supply was standard-rated this will either achieve the correct outcome or given rise to the need for a vendor credit note.

Recommendation

That the submissions be accepted and:

- that in nominee transactions involving land, the supply always be treated as being made from the vendor to the nominee (the ultimate recipient); and
- the purchaser should, on a prospective basis, be able to make representations regarding the registration status and intentions of the relevant recipient of the supply if it is a person other than the purchaser (a nominee).

Issue: Transactions involving an undisclosed agent

Submission
(Russell McVeagh)

It is submitted that in some situations, there may be a need for the anonymity of the ultimate recipient of a supply, such as for commercial or competition reasons. In these circumstances, the ultimate recipient of a supply (undisclosed principal) may, for commercial or competition reasons, be acting through an undisclosed agent to acquire land. It is not practical for the agent to disclose the registration details of the undisclosed principal or to inform the supplier that they act for an undisclosed principal. The question arises as to how the new zero-rating rules will apply to transactions where land is acquired by an undisclosed agent.

Comment

As noted earlier in this report, officials recommend that the vendor may absolutely rely on representations made by the purchaser regarding their registration status and intentions in respect of land, and to apply the appropriate GST treatment on the basis of those representations. If those representations are not made, the ultimate recipient either will be liable to account for the outstanding output tax under section 5(23) (if the supply is incorrectly zero-rated) or (more likely) will be able to seek redress from the vendor if the GST has been paid to the vendor and the transaction is one that should have been zero-rated.

It is considered that the proposed rules provide a sufficient mechanism for transactions to be conducted by undisclosed agents.

Recommendation

That the submission be noted.

Issue: Ability to issue debit/credit notes

Submissions
(PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)

Inland Revenue should confirm that debit and credit notes can be issued to correct situations when a tax invoice has been issued to the wrong party to the transaction so that the nominations provisions can work as intended. *(New Zealand Institute of Chartered Accountants)*

The application of the zero-rating rules will depend on to whom the supply is made. The question is whether section 25 (relating to the provision of debit/credit notes on a change to a supply) is robust and flexible enough to deal with recasting nominee transactions that were initially zero-rated and that need to be charged with the GST at the standard-rate, or vice versa. *(PricewaterhouseCoopers)*

Comment

Officials have recommended an amendment to the bill to allow a vendor to rely on representations made by a contractual purchaser regarding the registration status and intentions of the ultimate recipient (nominee).

However, it is important to provide a mechanism for the parties to change the GST treatment of a supply prior to settlement or to rectify the incorrect GST treatment following settlement if a nomination or the provision of incorrect (or no) information triggers a different GST treatment. Section 25 ought to allow for the vendor, following settlement, to adjust the GST on the supply to provide the correct outcome. For example, if a transaction is standard-rated when it should have been zero-rated, the vendor should issue the purchaser a credit note and claim back the GST.

Officials consider that section 25 should be amended to clarify that it does in fact apply in this way. This change would apply in all situations, not just when a nominee is involved.

Recommendation

That the submissions be accepted.

THE APPLICATION OF SECTION 60B

Clause 18

Issue: The ambit of the proposals

Submission
(Corporate Taxpayers Group)

The bill clarifies the applicable GST treatment for nominations; however, proposed section 60B does not appear to cover assignments. The Group assumes the bill was never intended to cover assignments of transactions, but notes that this is a further area of uncertainty similar in nature to the current issues with nominations.

While clarity as to the GST treatment of assignments is not required in this bill, it does seem the opportune forum in which to provide certainty. The Group suggests that the bill should simply apply the same clarification being given to nominations to assignments.

Comment

The proposed rules are intended to apply to transactions that involve nominations. The submission that there are remaining aspects of uncertainty for other transactions involving more than two parties is noted.

Recommendation

That the submission be noted.

Issue: Interaction between section 60 and section 60B

Submission
(Ernst & Young)

The interaction of the proposed rules with the existing agency provision in section 60 needs to be clarified.

Comment

Section 60 applies to agency arrangements whereas the proposed section 60B will apply to transactions that involve nominations. The determination as to which section applies to a transaction has to be made by reference to the relevant facts.

Recommendation

That the submission be noted.

Issue: Bare trustee

Submission

(PricewaterhouseCoopers)

Section 60B should not apply if the nominee is a bare trustee. Bare trustees are typically ignored for GST purposes and a supply is taken to be made to the principal (purchaser). It should be made clear that section 60B only applies if a nominee takes title in their own right.

Comment

A "bare" trustee is a trustee who has no active duty beyond conveying the property to the beneficiary at some future time determined by the trust. Officials consider that if the bill is changed to provide that the supply is always to the nominee in the case of land, the insertion of a bare trustee should be consistent with this approach.

Recommendation

That the submission be declined.

NOMINATION MADE AFTER THE TIME OF SUPPLY HAS BEEN TRIGGERED

Clauses 15 and 18

Issue: Nominations made after the time of supply

Submissions
(Corporate Taxpayers Group, Russell McVeagh)

While the proposed rules appear to work well for nominations that occur before the time of supply, it is not clear that the rules will work effectively when the nomination is made after the time of supply. It is submitted that the legislation needs to clarify the intended outcome in those situations. *(Russell McVeagh)*

The Group suggests that it is unclear as to what will occur when the time of supply has been triggered prior to the nominee being registered. There appears to be a risk that no GST credit will be able to be claimed. The Group would like officials to clarify the intended outcome when the time of supply has been triggered prior to the nominee being registered for GST. *(Corporate Taxpayers Group)*

Comment

Nomination will be most commonly used in transactions that involve supplies of land. In such transactions, we have recommended that the nominee always be treated as the end recipient and that prospective representations by the purchaser be allowed.

In transactions not involving land, the proposed nomination rules will clarify which party – the purchaser or the nominee – is entitled to a deduction.

It is suggested that if a nomination is made after the time of supply has been triggered, the possible outcomes are as follows.

- Both the purchaser and the nominee are registered. The purchaser contributes the full purchase price. The purchaser is entitled to the deduction.
- Both the purchaser and the nominee are registered. The nominee contributes the full purchase price. The nominee is entitled to the deduction.
- The purchaser is registered and the nominee is unregistered. Either the purchaser or the nominee contributes the full purchase price. Neither the purchaser nor the nominee is entitled to the deduction.
- The purchaser is unregistered and the nominee is registered. Either the purchaser or the nominee contributes the full purchase price. The nominee is entitled to the input tax deduction.

We do not consider that further clarification of the nominee provisions is warranted.

Recommendation

That the submissions be declined.

Issue: Timing of the registration status

Submission
(Ernst & Young)

The submitter seeks clarification of when B's (purchaser) and C's (nominee) registration status have to be compared for the purposes of section 60B.

Comment

It is expected that the registration status has to be confirmed at the relevant time of supply – in many cases, settlement. The ability to provide information about the recipient's registration status and the other relevant matters in land transactions should provide greater clarity in most cases.

Recommendation

That the submission be noted.

Issue: Tax invoices

Submission
(Ernst & Young)

The question is raised as to the effect on the supplier's obligation in respect of tax invoices under section 24, particularly in relation to the prohibition on issuing more than one tax invoice for each taxable supply and the requirement for most tax invoices to include details of the recipient of the supply. The proposed new section 24(7B) refers only to the nominated person's obligation to maintain records if a tax invoice is unavailable.

Comment

The Commissioner relies on tax invoices and other records for ensuring that a recipient of a supply is entitled to input tax deductions. In transactions that involve nominees, a tax invoice will commonly be issued by a vendor to the contractual purchaser, especially when the nominee is not yet known. In this circumstance, the proposed section 24(7B) will allow the nominee to rely on other records to establish the particulars of a supply and their entitlement to an input tax deduction.

For transactions involving land, the nominee will, as the ultimate recipient, generally not be entitled to deduct input tax because of the zero-rating treatment. For transactions not involving land, if the supply is deemed to be to the contractual purchaser, the contractual purchaser, having provided the consideration, should have the requisite tax invoice.

Recommendation

That the submission be declined.

OTHER DRAFTING MATTERS

Clause 18

Submissions
(New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers, 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 that the legislation works as intended.

Comment

Officials have considered all the changes proposed in the submission and agree that most of them are necessary. They will be raised with the bill's drafter.

Recommendation

That the submissions be noted.

GST: proposed apportionment rules

APPLICATION DATE OF THE NEW RULES AND COMPLIANCE COSTS TO TAXPAYERS

Clauses 5, 13 and 14

Submissions

(Corporate Taxpayers Group, Deloitte, KPMG, Ernst & Young, New Zealand Institute of Chartered Accountants)

Businesses should be able to opt out from the new rules and continue to use the current system. The new rules will be particularly complicated in practice for large, partly exempt organisations, such as financial institutions. *(KPMG, New Zealand Institute of Chartered Accountants)*

Another solution would be to defer the application date of the proposed changes until a later date to enable businesses making significant exempt supplies to fully understand the new rules and implement new systems as necessary. *(Corporate Taxpayers Group, KPMG, Ernst & Young)*

Alternatively, entities should be allowed to continue their current practice to make adjustments for GST under agreements already reached with Inland Revenue, such as the Bankers Memorandum of Understanding with Inland Revenue. *(New Zealand Institute of Chartered Accountants)*

The GST Act should explicitly allow Inland Revenue to negotiate fair and reasonable apportionment methods with taxpayers. *(Corporate Taxpayers Group, Deloitte)*

Comment

Officials do not agree that the application date of the proposed measures should be deferred, especially in view of the simplification benefits that have been noted in the submissions.

Providers of financial services are concerned that the proposed apportionment rules will give rise to significant compliance costs for them for little additional value. The main concern is that existing agreements with Inland Revenue or other practices that are compliant with the current legislation will be unduly altered.

Officials agree that the legislation needs to be workable in practice for financial services providers, given the very wide range of financial assets that are held by this industry. Retaining the current legislation for the benefit of some would undermine the objectives of the proposed rules. However, we recommend the following amendments to the bill to address submitters' concerns:

- For businesses that are principally in the business of supplying financial services, to allow apportionment to be based on either actual use or an alternative method approved by the Commissioner if the method provides a fair and reasonable result having regard to the proposed apportionment rules. This should provide the necessary flexibility for financial institutions to agree a workable approach with Inland Revenue and, for those within the industry who have existing apportionment agreements with Inland Revenue, to allow those agreements to continue with any necessary modifications.

- Businesses which would qualify for an alternative approved method would include a company group that meets the test of principally supplying financial services and a single entity that meets the test even if the group as a whole did not.

We have considered whether the recommended changes should apply more widely than the financial services sector and have concluded that this is unnecessary for the following reasons:

- The current provision that allows for an alternative method extends to all taxpayers. However, this is to reflect the uncertainty of the current apportionment provisions. The proposed apportionment rules should, on the other hand, provide greater certainty to most taxpayers – especially SMEs who need to apportion primarily to reflect the business and private use of assets. In addition, extending the ability to seek an alternative method beyond the financial services sector could give rise to additional administrative costs for Inland Revenue.
- Although no submissions have been received from the sector, the property sector is the other main sector affected by the apportionment rules. The number and range of assets held by this sector is necessarily far more limited than for the financial services sector. One issue that this sector could face is apportioning the concurrent use of assets – for example, when property that is being developed for sale is temporarily in whole or part rented out to tenants. However, the bill already provides a formula (draft section 21D) to deal with this situation and also provides the ability for the Commissioner to allow an alternative approach to the formula.

Recommendation

That the submissions be accepted in part. That the application date of the proposed rules should not be deferred.

However, the legislation should allow businesses which principally make supplies of financial services to agree with the Commissioner a fair and reasonable method of apportionment having regard to the apportionment provisions. A business that principally supplies financial services could be either a single entity or a company group that meets this test.

THE MECHANISM FOR TRANSITIONING INTO THE NEW RULES

Clause 14

Submissions
(Corporate Taxpayers Group, Deloitte, New Zealand Bankers' Association)

Submitters state that the transitional mechanism proposed in the bill will have a negative impact on taxpayers, as taxpayers that undertake this option will be required to account for output tax on the full market value of the supply at the time of the deemed sale, but will be able to claim input tax only for the portion of the estimated taxable use of the asset. This will result in a fiscal disincentive to transition into the new rules.

Comment

To transition into the new regime, the bill requires the registered person to account as though they had disposed of the relevant goods or services at market value (and account for output tax on the disposal) and then acquire the goods or services for the same market value under the new regime.

Officials note that owing to the fundamental differences in the way the two regimes operate, most transitional methods would result in a loss to either the taxpayer or the tax base. Furthermore, owing to the voluntary nature of the transitional rules, it might be expected that the rules will only be used when providing a positive result for the taxpayer – meaning that the outcome of transitions is likely to be revenue negative. It is therefore important that the method adopted be as tax neutral as possible.

Officials have considered three possible options for a transition to the new rules for current assets.

1. As currently provided in the bill, that current assets be deemed to have been sold at their market value and reacquired at that value for the purposes of the new rules.
2. That a recalculation be undertaken based on the original cost price and a retrospective application of the new rules. This would require an offset of deductions under the new rules with all deductions claimed under the existing rules.
3. Having a definite timeframe of five years from 1 April 2011 (1 April 2016), after which no further adjustments under the existing rules are required or allowed. This would not apply in the case of land, for which adjustments can be made for a much longer period.

We recommend option 3 as it is the simplest to apply and should not give rise to significant revenue losses or gains for the taxpayer.

Recommendation

That the submissions be accepted and new transitional rules provide for no further adjustments for current assets after 1 April 2016 (other than land).

TRACING INPUTS TO OUTPUTS

Clause 13

Submissions

(New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

That the word "used" where it appears in new sections 20(3C) and 20(3F) be deleted. Further, if it is the intention that there is no change to the approach in the existing law to input tax credits – that is, that it is not necessary to directly trace acquired goods and services to taxable supplies produced – it should be clearly stated in the Finance and Expenditure Committee report to Parliament on the bill that this is the case. Alternatively, if there is a change in law this too should be clearly stated. *(New Zealand Institute of Chartered Accountants)*

Consideration should be given to inserting a new purpose provision into the GST Act to deal with input tax deductions and the principle of GST neutrality. This would ensure that no direct tracing of inputs to outputs is necessary, which would simply preserve the current position. Alternatively, the "principal purpose" test should be retained for the point of acquisition, but subsequent changes to the use of the asset would be relevant under the new apportionment rules. *(PricewaterhouseCoopers)*

Comment

The aim of the proposed rules in respect of the apportionment of input tax is to change the method for calculating the extent to which input tax deductions may be claimed.

Officials note that the current legislation does not provide any specific rules for tracing inputs to outputs, but also adopts an asset-by-asset formulation. As this is a feature of the current system, we do not consider that the changes suggested by submitters are necessary.

As noted earlier, however, officials have recommended that financial services providers be able to apply to the Commissioner for a fair and reasonable method that not require an asset-by-asset determination. This should address most of the compliance cost concerns raised by the submitters.

Recommendation

That the submissions be declined.

EXCLUSION FROM THE REQUIREMENT TO MAKE ADJUSTMENTS UNDER SECTION 20(3D)

Clause 13

Submission
(Ernst & Young)

Section 20(3D) is intended to relieve taxpayers from having to apportion input tax if they make mixed supplies and have reasonable grounds to believe that they will make a minimal amount of GST-exempt supplies. Clarification is required regarding:

- whether the exclusion applies from the date of initial acquisition or at the end of an adjustment period; and
- the length of period over which the requirement of the section must be met.

Comment

A purchaser may be required to apportion input tax (i) on acquisition and (ii) at the end of each adjustment period. The exclusion provided by section 20(3D) is intended to relieve taxpayers from having to apportion input tax in either or both of these situations. The determination of use should be undertaken at the time of claiming the initial input tax deduction and again on making the adjustment. For the latter, the time frame should be the period of use since the last adjustment.

Officials suggest that Inland Revenue provide published guidance on this matter.

Recommendation

That the submission be noted.

THE MEANING OF THE TERM "ACQUISITION"

Clauses 5, 13 and 14

Submission
(Ernst & Young)

Clarification is required as to what is considered by the terms "acquired" and "time of acquisition".

Comment

The proposed legislation relies on the notion that input tax may only be claimed to the extent that an asset is used for making taxable supplies. In most situations, a purchaser will not be able to use goods or services until they obtain ownership of the goods and services. However, it is possible for goods and services to be acquired in other ways.

Officials consider that the terms "acquired" and "time of acquisition" should be given their normal meaning. We do not consider that attempting to define the terms would be helpful.

Recommendation

That the submission be declined.

AVAILABILITY OF INPUT TAX DEDUCTIONS FOLLOWING REGISTRATION

Clauses 13 and 14

Submission
(New Zealand Institute of Chartered Accountants)

Input tax credits should be allowed when an asset moves from non-taxable to taxable, or to a partially taxable state.

Comment

An unregistered person cannot claim as input tax the GST component of taxable acquisitions that they make. However, the person may later register for GST and start using the goods and services that they previously purchased in their unregistered capacity for making taxable supplies.

In these circumstances, the person should be able to claim an input tax deduction in respect of the previously acquired goods and services. The actual taxable use of the goods and services will have to be calculated from the date of the original acquisition and will take into account the previous non-taxable use of the goods and services.

Recommendation

That the submission be accepted.

MAKING CHANGE-IN-USE ADJUSTMENTS IN RESPECT OF SERVICES

Clause 14

Submission
(Corporate Taxpayers Group)

The proposal is to apportion input tax deductions in a "services" context in line with the actual use of those services. The submitter assumes that there will be no requirement for multiple GST change-in-use adjustments for services over a number of periods, but rather the supply of services will be treated as a one-off adjustment as is the case under the existing rules.

Comment

The proposed apportionment rules are intended to apportion input tax deductions in respect of goods and services in accordance with the taxpayer's actual use of those goods and services until they are fully consumed or disposed of.

It is not proposed to introduce special rules for limiting the number of adjustments that have to be made in respect of services. Under the current change-in-use adjustments legislation, services are subject to the same general rules as goods.

It should be noted that, unlike goods, most services have a short lifespan and are generally consumed soon after acquisition. In the same way as under the current change-in-use regime, these services will normally require just one initial adjustment.

Some services may, however, last for longer periods. These services typically relate to intellectual property rights – for example, a licence to use a copyright may be used for a number of years. Under the proposed rules, the input tax in relation to such services will be adjusted throughout their use (up to the maximum number of adjustments as prescribed by the proposed legislation). Again, this requirement to make continuous adjustments to input tax relating to services is a feature of the current regime.

Recommendation

That the submission be noted.

THE MEANING OF THE TERM "DISPOSE"

Clause 14

Submission
(Ernst & Young)

Clarification is required as to how and when taxpayers might be considered to "dispose" of services so as to trigger a final adjustment of the nature provided in the proposed section 21E.

Comment

The term "dispose" is intended to apply to sales of goods and services, or any other disposition of goods and services, including a deemed disposition under the GST Act. The latter would include the deregistration of a GST-registered person.

The exact circumstances of how and when taxpayers might be considered to "dispose" of services will depend on the relevant facts. Officials do not consider that the issue warrants legislative clarification.

Recommendation

That the submission be declined.

ADJUSTMENT PERIODS

Clause 14

Issue: Time of first adjustment period

Submissions
(Corporate Taxpayers Group, KPMG, Russell McVeagh)

Requiring the first adjustment period for an asset to be between 12 and 24 months will cause material compliance issues. This is because assets in their first adjustment period will not be able to be grouped with existing assets for the purposes of applying the taxable portion percentage for a year, but will need to be tracked individually and have a weighted average actual use percentage calculated over the two periods.

The submitters suggest that a practical solution would be for the first adjustment period to be the time from acquisition to the first balance date.

Comment

Officials agree that allowing taxpayers to group acquired assets with existing assets would provide a compliance cost saving from not having to track assets on an individual basis. We note, however, that a shorter initial adjustment period could cause other problems – especially for the concurrent use of land provision. Therefore, while we accept the submission, taxpayers should have the option of the first adjustment period being the first balance date or the balance date which is at least 12 months after acquisition.

Recommendation

That the submissions be accepted subject to officials' comments.

Issue: The effect of a change of balance date on adjustment periods

Submission
(Ernst & Young)

Clarification is required of the effect of a taxpayer changing their balance date on the definitions of "first adjustment period" and "subsequent adjustment period" in section 21F(2).

Comment

As a compliance cost saving measure, section 21F(2) aligns taxpayers' balance dates and dates for making adjustments by stating that a taxpayer's first adjustment period should end on the date that corresponds with the taxpayer's balance date (subsection (a)) and subsequent adjustment periods should be periods that run at 12-month intervals after the first adjustment period (subsection (b)).

If a taxpayer changes their balance date without being able to also change the dates of subsequent adjustment periods, the compliance cost saving will not be achieved.

The proposals should allow that if a taxpayer changes their balance date, they have an option of realigning their adjustment periods by reference to the new balance date.

Thus, if in an adjustment period a taxpayer changes their balance date by moving it backwards (so as to effectively increase the length of the relevant adjustment period), their current adjustment period will end at the new balance date. In contrast, if in an adjustment period a taxpayer changes their balance date by moving it forwards (so as to effectively reduce the length of the relevant adjustment period), their current adjustment period will end at their new balance date of the following year.

Once the taxpayer has realigned their adjustment periods with the new balance date, their subsequent adjustment periods would be identified by reference to the proposed section 21F(2) in the bill.

Recommendation

That the submission be accepted.

THRESHOLDS

Clause 14

Issue: Increase of thresholds for number of adjustment periods

Submission
(Corporate Taxpayers Group, KPMG)

The thresholds governing the number of adjustment periods should be increased further.

Comment

Under the proposed rules, a taxpayer's entitlement to an input tax deduction will depend on the extent to which they use the relevant goods and services for making taxable supplies. For this reason, the taxpayer will be required to estimate their actual use of the acquired goods and services, and to use those estimations in making adjustments to their input tax.

Depending on the value of the goods and services acquired, the number of adjustments that have to be made for substantial changes in the use of goods and services will be either nil, two, five or ten. The higher the value of an asset, the greater number of adjustments the taxpayer will have to make over a longer period of time. By requiring taxpayers to make adjustments in relation to high-value assets for longer periods of time, the proposed rules aim to minimise the possibility of taxpayers under- or over-claiming input tax in relation to those assets, so that the final amount of the input tax claimed by the taxpayer corresponds as closely as possible with the actual taxable use of the asset in question.

Although relaxing the thresholds would reduce compliance costs to taxpayers stemming from having to make continuous adjustments for changes in use, it would also reduce the accuracy of the final amounts of input tax claimed by taxpayers. Officials consider that the thresholds proposed in the bill strike a good balance between the need for accuracy and the reduction of compliance costs.

Officials note that the recommended amendment to allow calculation of the first adjustment period from the date of acquisition to the first balance date (rather than to the balance date which is at least 12 months after the date of acquisition) will reduce the time period during which taxpayers have to make adjustments.

Officials also note that, in most cases, the use of an asset will not vary significantly and only one initial adjustment will, in practice, be required. In comparison, the current change-in-use adjustment regime does not provide any limits for the number of adjustments that have to be made. Therefore, the new rules should, despite the numbers of adjustments that may be required, result in compliance cost savings.

Recommendation

That the submissions be declined.

Issue: “Taxable value”

Submissions
(KPMG, PricewaterhouseCoopers)

The word “taxable” should be deleted so that proposed section 21(2)(b) includes “the value of the goods and services”. This is consistent with the wording used in section 10(2) of the Act (being a GST-exclusive amount). *(KPMG)*

The phrase “taxable value” in section 21(2)(b) should be defined. It is understood that it refers to the GST-exclusive value of goods and services. *(PricewaterhouseCoopers)*

Comments

Section 21(2)(b) allows businesses to not make adjustments for change in use if the value of acquired goods or services does not exceed $5,000.

Officials agree with the suggestion to clarify that the “taxable value” refers to the GST-exclusive value of goods and services.

Recommendation

That the submissions be accepted.

Issue: Increase of threshold for no adjustments

Submission
(KPMG)

Section 21(2)(b) allows businesses to not make adjustments for change in use if the value of acquired goods or services does not exceed $5,000.

KPMG suggests increasing the threshold, for example, to $20,000.

Comment

On acquisition of an asset, a taxpayer would need to make a fair and reasonable estimation of the extent to which goods and services are to be used for making taxable supplies. Typically, if it later transpires that the actual taxable use of the asset differs from the taxable use of the asset as estimated on acquisition, the taxpayer will be required to make subsequent change-in-use adjustments in relation to the asset. A subsequent change-in-use adjustment will, however, not be required if the GST-exclusive value of the asset is less than $5,000.

Although this exclusion will act as a compliance and administration cost-saving mechanism, it may potentially result in a loss to the tax base. For example, a taxpayer may purchase an asset for a GST-exclusive value of $5,000 and claim the full available input tax of $750 (at 15%). If, immediately following the acquisition, the taxpayer changes their use of the asset to solely private use, the taxpayer will not be required to make a subsequent change-in-use adjustment and will therefore have claimed $750 more in input tax than they would have claimed if they were required to make ongoing adjustments.

Increasing the de minimis threshold to $20,000 would increase the potential losses described above to $3,000. At this level, the requirement to make adjustments seems warranted.

Recommendation

That the submission be declined.

Issue: Removal of $10,000 de minimis threshold

Submission
(KPMG)

A person is not required to make a subsequent change-in-use adjustment if the exclusion in section 21(2)(c) applies – that is, if the difference between the actual taxable use of goods and services and the intended actual use of goods and services is less than 10%, and the monetary value of the adjustment is less than $1,000.

The submitter considers that the $1,000 threshold is redundant and should be removed.

Comment

Depending on the value of goods or services and the GST component involved, a change of 10% may amount to a significant change in monetary terms. For example, a supply made for a GST-exclusive consideration of $10m would be subject to $1.5m of GST at 15%. A 9% change in the taxable use of the asset would therefore result in a potential adjustment of $135,000.

The monetary value of the adjustment threshold is therefore necessary to ensure that adjustments for changes in use are made when the monetary value involved is substantial.

Recommendation

That the submission be declined.

Issue: Clarification of de minimis threshold

Submission
(KPMG)

Clarification is needed about whether the 10 percent figure referred to in the new subsection 21(2)(c) relates to 10 percentage points or a percentage change from year to year.

In addition, the proposed legislation states that if the 10 percent threshold in section 21(2)(c) is exceeded in an adjustment period, the person must make an adjustment for any percentage difference in all later adjustment periods. It is submitted that this reduces the effectiveness of the exclusion, as a business must continue to make the adjustment even if the amount is nominal.

Comment

The 10 percent threshold, as drafted in the bill, compares the percentage actual use of the goods and services (calculated from the date of acquisition until the end of the latest adjustment period) with the percentage of the intended use of the goods and services as estimated on acquisition. Officials recommend that the legislation clarify this.

Officials agree that a further compliance cost saving may be achieved if taxpayers are not required to apportion the input tax when the change in use of the goods and services and the amount of the adjustment are not substantial.

For this reason, we recommend amending the requirement for ongoing adjustments if the 10 percent threshold is exceeded, to provide a further de minimis exclusion. The exclusion would apply to any adjustment period if the difference between the use calculated at the end of the relevant adjustment period and the percentage previous use calculated in the period when the taxpayer was last required to make an adjustment does not exceed 10% and the monetary value of the adjustment does not amount to more than $1,000.

Recommendation

That the submissions be accepted.

Issue: 5 percent safe harbour threshold

Submission
(New Zealand Bankers' Association)

The 5 percent safe harbour threshold that was proposed in the 2009 discussion document *Accounting for land and other high value assets* should be retained.

Comment

The threshold proposed in the discussion document would allow a person to not make a subsequent change-in-use adjustment in relation to goods or services if the actual taxable use of goods or services differed from the intended use of goods or services by 5 percent or less.

Depending on the value of goods or services involved, a change of 10% in respect of the GST component of the supply may amount to a significant change in monetary terms. Therefore, having considered the issue further, officials propose to raise the threshold to 10% but limit the exclusion to situations where the monetary value of the change does not exceed $1,000.

Recommendation

That the submission be declined.

Issue: Clarification of threshold for periodic supplies of goods and services

Submission
(Ernst & Young)

Clarification is needed as to whether, in cases of periodic supplies of goods and services provided under section 9(3) (such as electricity, rates), the $5,000 threshold applies to each separate supply of goods and services received.

Comment

Periodic supplies under section 9(3) are treated as separate supplies for GST purposes. Therefore, the threshold in section 21(2)(b) would be able to be applied to each individual supply. We do not consider further clarification is needed.

Recommendation

That the submission be declined.

CONCURRENT USE OF LAND

Clause 14

Issue: Application of the concurrent use approach

Submissions
(New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

That the rules for concurrent use of land be removed. The rules in section 21D are based on very similar principles to the previous change-in-use rules. Under the new approach, input tax is claimed based on how the taxpayer intends to use the goods and services. Under the new apportionment model, it is no longer appropriate to seek an adjustment when an asset is fully employed in the taxable activity. The asset, namely land and improvements, is fully committed to the taxable activity at all times. While the approach in section 21D for concurrent uses of land may be valid in a change-of-use model, there is no place in an apportionment model for requiring adjustments of this nature. *(New Zealand Institute of Chartered Accountants)*

A concessionary period of 12 months, when no adjustment is required, should be considered for the purposes of the concurrent usage of land adjustment in section 21D. Otherwise, the rule may discourage property developers and other taxpayers in similar situations from renting their properties pending sale, as a portion of their initial input tax deduction will be reduced due to the derivation of the exempt rental income. *(PricewaterhouseCoopers)*

Comment

Under the proposed apportionment approach, the portion of a deduction that a person should be entitled to must correspond with the extent to which the asset is used for taxable purposes. If the taxable use of the asset fluctuates, adjustments to the input tax deductions already claimed will have to be made to ensure that the overall amount of the deduction claimed corresponds with the actual taxable use of the asset from the date of the acquisition until the date when the adjustment is made.

In most situations, an asset may only be used for either taxable or non-taxable purposes at one point in time. For example, at any given time a motor vehicle may be used either for making deliveries of goods and services or for taking children to school – but usually not both at the same time.

In some circumstances, however, an asset may be used for taxable and non-taxable purposes at the same point in time – for example, a property developer may supply a house as a rental dwelling for a few months while advertising the house for sale. Thus, for the duration of the rental period, the asset is not only fully committed to the taxable activity (the sale), but is also simultaneously fully committed to the exempt activity (residential rental income). In this situation, it would be incorrect to simply ignore the non-taxable use of the property, considering that there is a chance that the property may never actually be sold.

Section 21D aims to provide guidance regarding the methodology to be used to apportion between concurrent uses of land for taxable and non-taxable purposes during adjustment periods when the land was so used. It allows taxpayers to apply to the Commissioner for an alternative approach if the formula is not workable in the circumstances.

Officials understand that the predominant concern of the submitters is the compliance cost of adjusting for the exempt use when the exempt use is temporary and/or will not be reflected in the final wash-up calculation when the asset in question is disposed of.

Officials consider that this concern would be partially addressed by the fact that the legislation would allow the first adjustment to be made after the second balance date. This should mean that in many cases of temporary exempt use, the adjustment will not be required.

Recommendation

That the submissions be declined.

Issue: Application of the rules

Submissions
(KMPG, New Zealand Institute of Chartered Accountants)

The application of section 21D is unclear and should be amended to reflect the policy intentions. For example, it should be clarified whether it will apply to all organisations that are covered by the new change-in-use adjustment rules as they will be making both taxable and non-taxable supplies, or is it only intended to apply when residential rental income is derived by a business that mainly makes taxable supplies? *(KPMG)*

As drafted, new section 21D applies to all entities that make both taxable and non-taxable supplies. However, it is understood that the policy is that it applies only to when rental income is derived. *(New Zealand Institute of Chartered Accountants)*

Comment

Section 21D is intended to assist taxpayers in identifying the extent of their taxable use in respect of land that is used concurrently for taxable and non-taxable purposes. The "concurrent" application of the land will happen when the land is simultaneously used for both a taxable function and a non-taxable function.

This situation will most commonly arise in property developer situations, that is, when a developer derives rental income (exempt use) from a property while simultaneously advertising it for sale (taxable use). Officials are not aware of a vast number of other situations in which concurrent use arises. We therefore consider that limiting the formula to land only (as the proposed section 21D currently does) provides sufficient certainty to taxpayers regarding its application.

Recommendation

That the submissions be declined.

Issue: Formula – application

Submission
(Corporate Taxpayers Group)

In the formula in section 21D, the rental should only be the GST-exempt rental.

Similarly, if the land is not rented, the "total consideration for supply" should not include the market value of the land upon which rental income would have been derived if the land had been rented. The only adjustment should be in relation to the GST-exempt rental actually derived, not the potential GST-exempt rental.

Comment

The reference to "rental income" in the bill is intended to refer to any rental income derived from the exempt activity – typically, from the supply of accommodation in a "dwelling". Furthermore, the requirement to calculate the "market value of rental income that would have been derived if the land had been used for that purpose" is intended to apply to situations when the land is used for a non-taxable purpose that may not provide the person with any income, for example, a developer using the property as their own residential accommodation prior to the sale.

Section 21D will be amended to clarify that it is only for the purposes of taking into account exempt or non-taxable supplies.

Recommendation

That the submission be accepted.

Issue: Compliance costs of obtaining market value of land

Submissions

(New Zealand Institute of Chartered Accountants, Corporate Taxpayers Group)

Obtaining the market value of land at the time of making the adjustment can be costly if an accurate assessment is required. For the purposes of determining the adjustment for land required when the land is also used for non-taxable purposes, the land rating valuation would provide a reasonable estimate if used on a consistent basis. *(New Zealand Institute of Chartered Accountants)*

The requirement to obtain the above market valuations on an ongoing basis (when an adjustment is required) will result in material compliance costs. *(Corporate Taxpayers Group)*

Comment

Officials concur with the submission that if the market value of the land is not readily identifiable, the requirement should be able be satisfied by using other fair and reasonable methods that may provide a reasonable approximation of the market value of the land and the bill should be amended accordingly.

Recommendation

That the submissions be accepted in part.

GST TREATMENT OF GOODS AND SERVICES ON DISPOSAL

Clause 14

Submission
(KPMG)

The legislation should clarify whether an entity that is making exempt supplies is still required to make an adjustment under section 21E.

Comment

If a registered person disposes of, or is treated as disposing of, goods or services, they may be able to claim an additional amount of input tax (new section 21E). The amount that can be claimed on disposal cannot exceed the total amount of input tax to which the person would be entitled if they had acquired the goods or services solely for making taxable supplies.

Section 21E(1)(b) specifies that the adjustment is required only if the person disposes of the goods or services in the course or furtherance of a taxable activity. Therefore, the adjustment will not be required if the disposal is in the course or furtherance of making exempt supplies.

Officials consider that the legislation is sufficiently clear in this regard.

Recommendation

That the submission be declined.

MAKING ADJUSTMENTS IN RESPECT OF GOODS NOT YET USED

Clause 13

Submission
(Ernst & Young)

Section 20(3C) refers to the extent to which the goods and services "are used" for making taxable supplies. The question arises whether this terminology intended to include items intended to be used for such purposes, but which are not yet applied in the taxable period in which they are acquired (such as raw materials not yet used for making goods).

Comment

Officials accept that taxpayers should be able to claim a full deduction in respect of goods and services "available for use" for making taxable supplies, and the proposed legislation should be amended to that effect.

Recommendation

That the submission be accepted.

OTHER DRAFTING MATTERS

Clauses 13 and 14

Submissions
(PricewaterhouseCoopers, Russell McVeagh, Ernst & Young)

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 that the legislation works as intended.

Comment

Officials have considered all the changes proposed in the submission and agree that most of them are necessary.

Recommendation

That the submissions be accepted.

INPUT TAX DEDUCTIONS IN RESPECT OF SECOND-HAND GOODS

Submission
(BDO Wellington)

Section 3A(3)(a)(i) of the GST Act should be amended so that the input tax is limited to the GST output tax paid by the last registered seller of those goods, if in fact there was any previous GST output tax.

Comment

Officials note that the submission is outside the scope of the matters in the bill. Officials will consider whether the issue should be recommended for inclusion in the Government's policy work programme.

Recommendation

That the submission be noted.

GST: definitions of “dwelling” and “commercial dwelling”

DEFINITION OF "DWELLING"

Clause 4(4)

Issue: General

Submission
(Ernst & Young)

By focusing on a recipient's use, rather than on the nature of the premises, the proposed new definition of "dwelling" could result in anomalous differences of treatment for owners/lessors/licensors, depending on the nature of the occupant/lessee/licensee and on particular occupants' use of premises.

Comment

The changes to the definitions of "dwelling" and "commercial dwelling" proposed in the bill are intended to clarify the boundaries of those definitions in line with the principles set out in the 1985 White Paper on GST. The amendments will provide a narrower definition of "dwelling" with the intention that supplies of accommodation that are closely substitutable with owning a home should be exempt from GST. To achieve this goal, the amendments focus on the nature of the supply made to the recipient and the recipient's use of the accommodation. It ensures that accommodation which is only of a temporary nature is excluded from the exemption.

The proposed amendments will also rectify anomalous situations where two similar supplies of accommodation of commercial nature (for example, a hotel and a homestay) may be treated differently for GST purposes.

Any boundary will naturally give rise to issues of interpretation and possibly minor distortions. However, we are not aware of any specific issues in this respect at this time. We will, however, monitor how the revised definition is applied in practice and make recommendations in the future for areas of significant concern.

Recommendation

That the submission be noted.

Issue: Definition of specific terms used

Submissions

(Campus Living Villages NZ, Ernst & Young, Grant Thornton New Zealand Limited, PricewaterhouseCoopers)

The terms "premises", "principal place of residence", "exclusive possession" and "appurtenances" should be defined.

Comment

To ensure that the new definition of "dwelling" only applies to those supplies of accommodation that have a semblance of living in one's own home, the supply of accommodation has to satisfy two new requirements that are characteristic of living at home – the tenant must occupy the accommodation as their principal place of residence and they must have exclusive possession of the accommodation.

The "principal place of residence" is intended to refer to a place that a person uses as their main or predominant residence. Officials accept that uncertainty may arise as to what period has to be considered for identifying whether accommodation is used as a person's principal place of residence. It is considered that the determination must be made by reference to the period for which the accommodation is supplied. For example, if an agreement stipulates that the accommodation be supplied for a period of six months, to be a "dwelling" the accommodation must be or be intended to be the recipient's principal place of residence during that six-month period.

"Exclusive possession" refers to the possession of land which enables the tenant to exclude not only strangers but also the landlord unless the landlord is exercising rights to enter the land granted under the tenancy agreement. "Exclusive possession" is an important element of a leasehold tenancy, and is one of the characteristics that distinguish a "lease" from a "licence". However, to provide greater certainty, "exclusive possession" would be better replaced with "quiet enjoyment", as that phrase is used in section 38 of the Residential Tenancies Act 1986.

The term "premises" should also be defined by reference to the Residential Tenancies Act.

Officials do not agree with defining the term "appurtenances" as it is currently the subject of interpretation by Inland Revenue. Any statutory definition of the term could therefore introduce new uncertainty.

Recommendation

That the submissions be accepted in part:

- the term "principal place of residence" should be defined in the GST Act;
- the term "exclusive possession" should be changed to "quiet enjoyment" as used in the Residential Tenancies Act; and
- the term "premises" should also be defined by reference to the Residential Tenancies Act.

DEFINITION OF "COMMERCIAL DWELLING"

Clause 4(3)

Issue: Reference to "dwelling" in "commercial dwelling" definition

Submissions
(KPMG, New Zealand Institute of Chartered Accountants, Russell McVeagh)

The commercial dwelling definition at (a)(vi) includes "premises other than a dwelling". At (a)(v) the definition includes "premises of a similar kind to those referred to in subparagraphs (i) to (iv). It is considered that the reference in (a)(vi) to "premises other than a dwelling" is already covered by subparagraph (v), when it refers to premises of a similar kind. *(New Zealand Institute of Chartered Accountants)*

Submitters also consider that paragraph (a)(vi) is unnecessary because the definition of dwelling already excludes a commercial dwelling. *(KPMG, Russell McVeagh)*

Comment

Officials agree that paragraph (a)(vi) in the definition of "commercial dwelling" is not necessary.

Recommendation

That the submission be accepted and paragraph (a)(vi) of the definition of "commercial dwelling" be removed.

Issue: Possible conflict in "commercial dwelling" definition

Submission
(Ernst & Young)

There may be questions as to whether serviced apartments or other accommodation in retirement villages or rest home complexes would constitute "commercial dwellings" within subparagraph (a)(ii) of the proposed definition or be excluded from the definition under subparagraph (b)(ii) of the same definition.

Comment

Officials do not consider that there is a conflict between paragraphs (a)(ii) and (b)(ii) in the definition of "commercial dwelling". By adding the already existing paragraph (b)(ii) to the new definition of "commercial dwelling", the definition maintains current practice by ensuring that dwellings situated within a retirement village or a rest home complex are governed by the same rules as other dwellings – that is, the supply of accommodation is exempt.

Recommendation

That the submission be noted.

Issue: The definition of "serviced apartments"

Submission
(Russell McVeagh)

The definition of commercial dwelling includes "serviced apartments", for which services in addition to the supply of accommodation are provided, but these other services are not defined or clarified.

The definition also includes accommodation managed by a third party. The submitter does not consider that third party management should be a critical element of distinguishing commercial accommodation from a "dwelling".

Comment

The degree of services provided as part of a supply of accommodation in a serviced apartment may vary from minimal to much the same as that provided in a hotel or motel. For this reason, it is not proposed to define the extent or amount of services provided in the legislation as this will vary on a case-by-case basis.

It is, however, important that the services that are provided relate to the occupancy of accommodation – for example, cleaning, rubbish removal, the provision of consumables, and similar types of services.

On the second point raised by the submitter, officials note that the requirement for a third party manager is intended to provide a balance between the commercial provision of accommodation and what is essentially a dwelling in which only a minimal level of service is provided.

Recommendation

That the submission be declined.

GST TREATMENT OF STUDENT ACCOMMODATION

Clause 4(4)

Submissions
(Campus Living Villages NZ, Tax Team, Grant Thornton New Zealand Limited)

Student accommodation to tertiary students should be GST-exempt for the following reasons.

- Student accommodation, which includes but is not limited to hostel accommodation, is substitutable for living in a flat – in both cases the accommodation is the student's "home".
- Student accommodation is equivalent to accommodation in a retirement village which is exempt.
- The proposed legislation places student accommodation in a worse GST position than currently since it would not be possible to meet the "exclusive possession" test in most cases.
- The proposed legislation would provide even greater uncertainty for the sector. *(Campus Living Villages NZ, Tax Team)*

As tertiary institutions provide a wide range of accommodation types, there may be some confusion as to whether a specific type of accommodation should be treated as a "dwelling" or a "commercial dwelling". The submitter recommends, in order of preference:

- exempting student accommodation from the definition of "commercial dwelling";
- allowing the apportionment of student accommodation if a portion relates to the supply of residential accommodation (exempt) and a portion relates to the supply of services to students (subject to GST); or
- removing the words "or other accommodation" from the definition of "serviced apartments" in paragraph (a)(ii) of the definition of "commercial dwelling" as these could create considerable issues for providers of student accommodation in terms of the varying degrees of onsite management occurring in some student accommodation. *(Grant Thornton)*

Comment

Officials agree that the words "or other accommodation" should be removed from paragraph (a)(ii) of the definition of "commercial dwelling" as there is a catch-all provision to include accommodation that is similar to the kinds specified.

Officials do not agree with the remaining submissions, based on the following considerations.

- Both the current and proposed definitions of "dwelling" and "commercial dwelling" describe the nature of the accommodation rather than the types of occupant of the premises. This provides greater certainty, as a particular category of person – in this case, tertiary students – is likely to occupy a wide range of accommodation. Across the tertiary student sector, some forms of accommodation will be temporary in nature and at the other end of the spectrum some will provide fully catered services. Officials consider that the amendment suggested by submitters would be an undesirable departure from the current approach. In addition, following consultation with the Ministry of Education, we are concerned that it would be very difficult to adequately define in the legislation a term such as "tertiary student accommodation".
- Retirement villages are exempt only to the extent of any "dwelling" situated on the complex. The "dwelling" is the part of the complex in which the resident actually lives. The occupancy is of a permanent nature and, we understand, would provide the occupant with "exclusive possession" or "quiet enjoyment". We do not consider the comparison between student accommodation and retirement villages in this respect to be particularly valid. We do note, however, that retirement villages have a concessionary 60 percent GST rate for the part of the complex that does not consist of a "dwelling" to provide a straightforward way of reflecting additional exempt use. This concessionary rate would also likely apply to a range of tertiary accommodation.
- It may be the case that the proposed legislation does place further limitations on the extent to which student accommodation is GST-exempt because the "exclusive possession" or "quiet enjoyment" test will not be satisfied. However, this is an expected outcome in reinforcing the underlying policy of a broad-based tax with minimal exemptions.
- There is always a degree of uncertainty in definitions such as those for "dwelling" and "commercial dwelling". The bill aims to reduce this uncertainty overall. While we understand the submitters' concerns with new definitions, it is not clear that less certainty is generated from the proposals than exists at present.

Recommendation

That the words "or other accommodation" should be removed from paragraph (a)(ii) of the definition of "commercial dwelling". That the submissions otherwise be declined.

Other GST matters

GST SPECIAL RETURNS

Clause 11

Submission
(Ernst & Young)

That the provision should apply prospectively only or, alternatively, there should be an amnesty from use of money interest and penalties for taxpayers who pay all outstanding amounts within one month of enactment of the current bill.

Comment

Officials consider this is a clear case where retrospective application is justified. The amendment is simply designed to clarify a due date for payment and correct an obvious legislative oversight. As the submitter has conceded, the current provision does not remove a creditor's liability to pay the GST – its "failing" is that it arguably does not specifically state the due date for such a payment.

The practice of filing special returns and paying the appropriate GST has, so far as officials are aware, always been applied by taxpayers in a manner consistent with the policy intent of the provision – an intent that this amendment will reinforce. Given that officials are not aware of anyone actually being adversely affected by the retrospective nature of this provision, it is considered appropriate that the proposed application date be kept to provide clarity in the legislation through all tax periods.

Recommendation

That the submission be declined.

AMENDMENT TO THE REVERSE CHARGE PROVISION

Clause 7

Submission
(PricewaterhouseCoopers)

That the references to "use" should be to "taxable use" if the provision is to achieve the desired outcome.

Comment

The provision refers to "percentage intended use" and "percentage actual use". These terms are defined in the bill and those definitions incorporate the notion of "taxable use". Any change would take the words in the provision outside of the defined terms and potentially cause more confusion.

Recommendation

That the submission be declined.

RELATIONSHIP BETWEEN GST AND INCOME TAX

Clauses 25, 29 and 35

Submission
(Russell McVeagh)

That the clauses do not achieve their stated policy intent in every instance.

Comment

Officials agree that certain aspects of the clauses may make them difficult to apply in certain circumstances. Officials do not agree with all the suggested wording provided in paragraph 5.5 of the submission, but have worked with the submitter to produce revised drafting that should be universal in its application.

Recommendation

That the submission be accepted to the extent necessary to reflect the desired policy intent of the provisions.

Other remedial matters

FBT "ON PREMISES" EXEMPTION

Clauses 28 and 89

Submissions

(PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants (NZICA), Ernst & Young)

The submissions agree that the wording change adequately reflects the policy intent of the exemption. However, they do not agree with the application date of 1 April 2005. Instead, the clauses should apply prospectively *(New Zealand Institute of Chartered Accountants and Ernst & Young)* or from 1 April 2010 *(PricewaterhouseCoopers)*.

NZICA also submitted that the amendment should have been referred to the Rewrite Advisory Panel.

Comment

Officials agree that retrospective legislation should not be introduced without strong justification, and competing considerations should always be balanced.

The factors in favour of prospective application were as follows.

- There is an underlying presumption that legislation should be prospective.
- Taxpayers should be able to rely on the statutory language.
- Inland Revenue is planning to dispute all cases where it considers abuse of the provision has taken place. If Inland Revenue were to win these disputes, this would have the same effect as retrospective legislation.

The factors in favour of retrospective application were as follows.

- The apparent law change was the result of a drafting error; it was not a policy change, and the Rewrite Advisory Panel did not indicate that a policy change was intended.
- The policy intent behind the provision has always been well understood by taxpayers – which may be the reason that only a few taxpayers exploited the drafting change.
- If Inland Revenue were to lose the disputes, there would be a fiscal cost associated with a drafting error.
- A retrospective change would reduce administration and potential litigation costs.

- Making the change retrospective reduces incentives for taxpayers to take aggressive positions based on what they understand to be drafting errors.
- Retrospective application arguably does not undermine the integrity of the tax system if it prevents taxpayers taking advantage of an obvious and unintended drafting error.

With regard to the Rewrite Advisory Panel, officials do not consider this is an amendment wholly within the Panel's terms of reference. An unrelated amendment to the relevant provision, effective from 2006, takes the provision outside of the transitional rules from that time. The known disputes on the relevant wording span periods post-2006.

Recommendation

That the submissions be declined.

JOINT BANK ACCOUNTS

Clauses 16, 86 and 105

Issue: Amendment should not proceed

Submission
(New Zealand Institute of Chartered Accountants)

The ambit of section 157 of the Tax Administration Act 1994 should not be extended to joint bank accounts.

Comment

When a taxpayer fails to pay any income tax, interest or civil penalty, the Commissioner may issue a written notice under section 157 of the Tax Administration Act 1994 to any third party, for example a bank, requiring the third party to deduct and pay to the Commissioner funds from any amounts payable to the defaulting taxpayer. The deductions may be in the form of a lump sum or instalments.

Section 157 is a critical tool in collecting unpaid tax debts.

Currently, section 157 of the Tax Administration Act 1994 does not refer to joint bank accounts. The courts have held that the Commissioner cannot issue a deduction notice to obtain funds from a joint account for an income tax debt owed by one of the joint bank account holders, because there is no authority to do so under section 157.[1] The High Court noted that the Social Security Act 1964 and the Child Support Act 1991 both contain deduction provisions that expressly refer to money held in joint bank accounts, whereas the Tax Administration Act 1994 does not. This raised an inference that a tax deduction provision like section 157 needed to contain an express reference to joint bank accounts for it to apply to such accounts.

The Child Support Act 1991 allows the Commissioner to require deductions from money payable to a liable parent to meet a child support debt. This deduction power extends to money held in joint bank accounts in the name of the liable parent and one or more other persons, when the liable parent can draw from that account without the signature of the other person.

The bill proposes to amend the provisions of some Inland Revenue Acts which allow deductions of tax from payments due to a defaulting taxpayer to allow the Commissioner to make deductions of tax from joint bank accounts. The amendments will allow deductions from a joint bank account if the defaulting taxpayer can make withdrawals from that account without the signature of the other person – in other words, they have unrestricted access to the funds in the account. The changes will ensure consistency of treatment for deductions from joint bank accounts.

Recommendation

That the submission be declined.

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[1] *ANZ Banking Group (New Zealand) Limited* v *CIR* (1998) 18 NZTC 13,643

Issue: Requiring consent of District Court Judge

Submission
(New Zealand Institute of Chartered Accountants)

The deduction provisions contained in section 12L of the Gaming Duties Act 1971, section 43 of the Goods and Services Tax Act 1985, and section 157 of the Tax Administration Act 1994 should be amended to require consent of a District Court Judge before the power can be exercised.

Comment

Since 1 July 2007 Inland Revenue has issued approximately 9000 deduction notices to banks. Requiring the consent of a District Court Judge would place a significant burden on the court system and also on Inland Revenue (in preparing the necessary documentation). It could also impede the collection of unpaid tax debts. In particular, if Inland Revenue becomes aware of a source of funds, it may need to move quickly. The funds could shift in the period it takes to get the consent of a District Court Judge.

Although officials consider section 157 is crucial in collecting unpaid tax debts, it should not be used inappropriately. There are systems in place which allow for concerns to be addressed, for example, the Complaints Management Service. In the first case mentioned in the submission, the submitter informed Inland Revenue and money was refunded, allowing the issue to be addressed and preventing inappropriate consequences. These systems are preferable to adding a judicial consent requirement that is resource intensive and could unnecessarily impede the effectiveness of the provision.

It is also a principle of administrative law that all public powers must be exercised in good faith.

Recommendation

That the submission be declined.

Issue: Application of provision to electronic transactions

Submission
(Matter raised by officials)

It should be made clear that the amendments also apply to joint accounts which are accessed electronically.

Comment

As currently drafted, the amendments will allow deductions from a joint bank account if the defaulting taxpayer can make withdrawals from that account without the signature of the other person. Some joint accounts are accessed electronically and require two or more persons to authorise payments. The amendments should also apply to these accounts.

Recommendation

That the submission be accepted.

CAP ON SHORTFALL PENALTIES

Clauses 84

Issue: Amendment should not proceed

Submission
(Ernst & Young, New Zealand Institute of Chartered Accountants)

The proposed express restriction to the $50,000 cap on certain shortfall penalties to voluntary disclosures made under section 141G of the Tax Administration Act 1994 should be deleted and the $50,000 cap should expressly apply both in cases of voluntary disclosure and in cases when adequate disclosure has been made at the time of taking the tax position. *(Ernst & Young)*

The proposal should not proceed. *(New Zealand Institute of Chartered Accountants)*

Comment

There are five shortfall penalties – not taking reasonable care (20%), unacceptable tax position (20%), gross carelessness (40%), abusive tax position (100%) and evasion or a similar act (150%). If a breach or default occurs, the relevant penalty is applied to the tax shortfall.

Shortfall penalties can be reduced for different reasons. For example, under section 141G, a shortfall penalty is reduced by between 40% and 100% if the shortfall is voluntarily disclosed before the beginning of an audit. Under section 141H, a shortfall penalty for an unacceptable tax position or an abusive tax position is reduced by 75% if the taxpayer makes adequate disclosure of their tax position at the time they take that tax position.

The unacceptable tax position penalty is imposed when the taxpayer's tax position does not meet the standard of being "about as likely as not to be correct". The penalty is applied only to significant income tax shortfalls – more than $50,000 and 1% of the taxpayer's total tax figure for the relevant period. An abusive tax position is an unacceptable tax position taken with a dominant purpose of avoiding tax.

The shortfall penalty for an unacceptable tax position is intended as a signal to taxpayers who take a particular tax position in which there is a significant amount of tax at stake. It does not require that the treatment a taxpayer gives to a particular matter must be the better view, or must be more likely than not the correct treatment. Rather, it must be a position to which a court would give serious consideration but not necessarily agree with. The taxpayer's argument should be sufficient to support a reasonable expectation that the taxpayer could succeed in court.

An aim of the shortfall penalty for an unacceptable tax position is to encourage taxpayers to get their tax position correct in terms of the law. This can be compared with the shortfall penalty for not taking reasonable care, which applies to a more general set of actions. When looking at whether a tax position is acceptable or not, the subjective elements, such as the effort the taxpayer went to, are not considered. In relation to the penalty for not taking reasonable care, taxpayers can argue that reasonable care has been taken by simply using a tax agent. This is not the case with the penalty for an unacceptable tax position – the penalty applies if the tax position taken fails to meet the required standard, irrespective of whether the taxpayer has engaged a tax agent.

The 75% reduction of the unacceptable tax position and abusive tax position shortfall penalties given for disclosures made at the time taxpayers take their tax positions reflects the complex nature of tax law, and not all taxpayers seek the certainty of a binding ruling when they are unsure of whether the position they are taking meets the standard of being about as likely as not to be correct.

Under section 141JAA(1) a shortfall penalty for not taking reasonable care or an unacceptable tax position can be limited to $50,000 if the taxpayer voluntarily discloses their tax position, or the Commissioner determines the shortfall, no later than the date that is the later of –

- the date that is three months after the due date of the return to which the shortfall relates; and
- the date that follows the due date of the return to which the shortfall relates by the lesser of –
  - one return period; and
  - six months.

This provision is aimed at ensuring that tax shortfalls which arise from the taxpayer not taking reasonable care or taking an unacceptable tax position and that are large in dollar terms, but which are speedily identified and corrected are not excessively penalised.

For example, a business taxpayer under-calculates their GST outputs by $45 million and, because no systems were in place to identify this shortfall, the under-calculation results in unpaid GST of $5 million. When the GST return is filed, Inland Revenue quickly identifies the shortfall and determines that the shortfall arose because the taxpayer did not take reasonable care. Because Inland Revenue quickly identified the shortfall the cap applies and the penalty is $50,000. If the cap did not apply, the penalty would be $1,000,000.

One of the reasons the cap was set at $50,000 was because that is the amount of the maximum criminal evasion penalty.

In 2007 amendments were made to the voluntary disclosure provisions. When a taxpayer makes a voluntary disclosure before being notified of an audit of a shortfall that arose from the taxpayer not taking reasonable care or taking an unacceptable tax position, the shortfall penalty is reduced by 100%. This amendment has led to an increase in voluntary disclosures being made. The number of disclosures of unacceptable tax positions made at the time the tax position is taken has fallen.

The cap is still relevant as it applies not only when the taxpayer makes a voluntary disclosure but also when the Commissioner identifies the shortfall within the time limit.

It is not clear that the limit in section 141JAA applies only to voluntary disclosures (under section 141G) and not to disclosures made when the tax position is taken (under section 141H) – when taxpayers make disclosures at the time the tax position is taken they are aware that the position taken might not meet the required standard.

It was never intended that the cap apply to disclosures made at the time the tax position is taken. If it applied to these disclosures, taxpayers could take tax positions that did not meet the standard of being "about as likely as not to be correct" (unacceptable tax position) knowing the maximum penalty they would face would be $50,000.

Recommendation

That the submission be declined.

AMENDMENTS TO THE PIE RULES

Clauses 42, 51 and 91

Issue: Interaction between new and existing timing rules

Submission
(KPMG)

It is not clear how the new sections HM 35B and HL 19B of the Income Tax Act 2007, introduced in the bill, are intended to interact with existing sections EG 3 (which applied prior to 1 April 2010) and HM 35(8) (which has applied since 1 April 2010).

It also appears that a timing rule for tax credits that was in section EG 3 has not been transferred to the post-rewrite version of the portfolio investment entity (PIE) rules.

Comment

The provisions introduced in the bill, sections HL 19B and HM 35B, are designed to supplement the existing timing provisions in sections EG 3 and HM 35(8).

The existing provisions stated that a PIE should allocate income and deductions to when they were reflected in its unit price (or its financial accounts, if the PIE did not calculate a unit price). However, it is unclear whether these provisions allow a PIE to allocate future income or deductions in this way.

The new provisions are designed to clarify that a PIE should allocate income and deductions to when they are reflected in its unit price, even if the income or deductions have yet to be incurred or derived. The existing timing rule still applies, but the new provisions clarify that future amounts can also be taken into account.

The issue of the tax credit timing rule has been raised as a rewrite amendment item and is addressed in the other remedial matters section of this report.

Recommendation

That the submission be noted.

Issue: Definition of "land investment company"

Submission
(KPMG)

The definition of "land investment company" in section YA 1 of the Income Tax Act 2007 should be amended to accommodate intra-group financing between land investment companies and PIEs in the same tax group.

Comment

This submission is not directly related to any items in the bill. The PIE rules do not prevent these intra-group financing arrangements for listed PIEs, for which these arrangements are most practical. Finally, this specific issue generally arises in international transactions involving debt-financed investment, which raises some concerns that need to be carefully considered before any amendments to the rules are made.

Recommendation

That the submission be declined.

Issue: Investor interest requirements

Submissions
(AMP Capital Investors, Ernst & Young, PricewaterhouseCoopers)

Amendments are required to allow certain widely held investors to hold an unlimited investment in a listed PIE. There does not appear to be any sound policy rationale for the current distinction, whereby such investors are not allowed to hold interests of more than 40% in a listed PIE but may hold unlimited interests in unlisted PIE entities. This change should be effective from the commencement of the PIE rules on 1 October 2007.

The application of the "public unit trust" rules to maximum investors' interests in PIEs should permit non-widely held investors to hold an interest of up to 25% in a listed PIE.

There is currently a five-year stand-down period that prevents an entity from becoming a PIE after losing PIE status. This stand-down period should not apply if an entity's loss of PIE status was due to it not meeting the maximum investors' interest requirements.

Provisions should be introduced to protect the tax position of investors if their presumed investment in a PIE changes due to the loss of PIE status by the entity in which they invested.

Comment

These submissions do not relate to the bill as introduced. Rather, they relate to the eligibility requirements under the PIE rules.

As a general principle, a PIE should be widely held. Therefore, the rules state that no single investor can hold more than 20% of a PIE.

- For unlisted PIEs, the 20% threshold does not apply if the investor itself is a widely held entity. This means that a PIE is able to own 100% of an unlisted PIE, allowing retail PIEs to invest in wholesale PIEs. In policy terms, it makes sense to waive the 20% threshold in these circumstances because, looking through to the ultimate investors, the PIE is still widely held.
- For listed PIEs, the 20% threshold is increased to only 40% for investors that are themselves widely held. At the time the rules were introduced, it was considered unlikely that a listed PIE would act as a wholesale fund. Increasing the threshold to 40% was therefore considered sufficient. However, officials do not have any policy objection to allowing a widely held investor to hold 100% of a listed PIE.

The background to these submissions is that a specific entity has been trading as a listed PIE when it fact it has failed to satisfy the eligibility criteria because the stake held in that entity by one of its investors exceeded the 40% threshold. The breach of this threshold was only recently identified by the entity in question.

While the breach has no direct impact on the entity's own tax affairs, it impacts its investors. Retail investors on higher marginal tax rates become liable to pay top-up tax on distributions, which are treated as dividends from an ordinary company as opposed to exempt PIE distributions. Certain wholesale investors become liable for tax in relation to redemptions of their interests, which for tax purposes are again treated as taxable dividends. In addition, at least one wholesale investor into the entity will itself lose PIE status as a result of the entity not being a PIE: this is because of rules that limit the investments a PIE can hold in a non-PIE entity (under section HL 10 or HM 13). The consequential loss of PIE status for this investor will, in turn, impact on its own members. The impacts for investors affect current and previous tax years.

As noted above, officials agree with the first submission: that there is no strong policy rationale for allowing a widely held investor to hold only 40% of a listed PIE. It is the entity's breach of this threshold that has caused it to lose PIE status. Accordingly, we support the proposal that a widely held investor should be able to hold up to 100% of a listed PIE. This would bring the treatment of listed PIEs into line with the treatment of unlisted PIEs in this regard. Given the real downstream consequences for investors into the entity, who acted in the belief that the entity in question was a PIE, we also support the proposal to make this change retrospective from the commencement of the PIE rules on 1 October 2007.

If these proposals are accepted, then the changes proposed in the three other submissions are not necessary and officials do not support them.

- The decision to limit the application of the "public unit trust" concession to exclude the paragraph that would allow non-widely held investors to hold an interest of up to 25% in a listed PIE was a conscious one made at the time the PIE rules were introduced. Officials consider that neither the submissions nor the particular circumstances outlined above raise new issues that warrant that decision being revisited at this time.
- Provided that the threshold for widely held investors holding interests in listed PIEs is retrospectively increased to 100% (as in the first submission), it is not necessary to provide any exemption from the five-year stand-down period in order to deal with the particular case referred to above. Officials do not consider that the submissions make the case for a general relaxation of the stand-down period, which helps to maintain the integrity of the PIE regime.
- Likewise, if the first submission is accepted, then amendments to protect the tax position of investors into the entity concerned are not necessary. Officials would generally be cautious about making such changes, again because of the implications for the integrity of the PIE regime.

Recommendation

That the investors' interest requirements for PIEs be amended to allow a widely held investor to hold up to 100% of a listed PIE, and that this change apply retrospectively from the commencement of the PIE rules.

TAXATION OF GENERAL INSURANCE BUSINESS – TREATMENT OF EXPECTED REINSURANCE AND RECOVERIES

Issue: Discounting expected reinsurance and recovery amounts

Submission
(Insurance Council of New Zealand)

Change is needed to the Income Tax Act 2007 to require amounts that insurers expect to receive from third parties, by way of reinsurance or directly from those parties, to be discounted. These amounts affect the calculation of deductions for movements in an insurer's outstanding claims reserve (OCR) allowed under section DW 4 of the Income Tax Act 2007.

The change should have retrospective effect so that the tax treatment of these amounts aligns with when a taxpayer adopts International Financial Reporting Standard 4: *Insurance Contracts* (IFRS 4).

Comment

The Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 clarified that movements in a general insurer's OCR, as determined by applying IFRS 4, are deductible. The rules allow a deduction for claims paid in an income year and for the movement in the OCR between the beginning and the end of the year.

The OCR is the amount an insurance company sets aside which, when invested, will provide sufficient funds to cover the liabilities for outstanding claims in the future. The value of these claims is estimated, as either they have been reported but not paid at balance date, or an insured event has occurred but the insurer has not been notified about the claim by its balance date. The amount of expected future payments is discounted to reflect present value.

Estimates relating to reinsurance recoveries and non-reinsurance recoveries reduce the amount that can otherwise be deducted in connection with claims and movements in the OCR. For financial reporting purposes these amounts are treated as income and are discounted.

For taxation purposes, these amounts are not discounted and therefore reduce the amount that is otherwise deductible under section DW 4. The current rules therefore create a mismatch by overstating amounts connected with reinsurance and recoveries when compared to the discounting valuation rules that apply to claims estimates.

Recommendation

That the submission be accepted.

The change should apply from the first income year in which the taxpayer adopts IFRS 4 for financial reporting purposes.

Issue: Determination E12

Submission
(Insurance Council of New Zealand)

Paragraph (w) of Determination E12 should be removed as it is now superfluous following the enactment of section DW 4 of the Income Tax Act 2007.

Comment

While the Taxation (International Taxation, Life Insurance, and Remedial Matters) Act 2009 clarified that movements in a general insurer's outstanding claims reserve are deductible, the rule applies only to taxpayers that use IFRS 4.

Officials note that there are taxpayers who have general insurance functions that do not use IFRS 4 as they are not required to prepare general purpose financial reports. Determination E12 deals with prepayments and provisions. Paragraph (w) is relevant for these taxpayers as it allows a deduction for provisions made for outstanding insurance claims, if the amount of the claim does not exceed $65,000 (excluding GST). Without this rule, the deduction only becomes available when the taxpayer settles (pays) the claim.

Recommendation

That the submission be declined.

Issue: Grandparenting reinsurance contracts sold before the start of the new taxation rules for life insurance

Submission

(PricewaterhouseCoopers on behalf of Hanover Life Re, Munich Re, Gen Re, Swiss Re and RGA Re)

The grandparenting rules, as they apply to life reinsurance treaties, need to be simplified.

Comment

The policy intent behind the grandparenting rules is to preserve the tax effect of the old rules for life business sold before the start of the new taxation rules for life insurance which started on 1 July 2010. However, to reduce compliance costs, life insurers were able to elect into the new rules before that date if they wanted to align the start date of the tax changes with the beginning of their financial reporting year.

Reinsurance policies sold before the start of the life insurance taxation rules are intended to be grandparented to the extent that the life reinsurer can "look though" the policy to the underlying individual whose life was covered and if there is no material change to the life reinsurance policy or the amount of insurance cover.

Discussions with a number of life reinsurers about the operation of the new taxation rules indicate that the current transitional rules do not reflect how life reinsurance products work, in terms of:

- whether life reinsurers can in practical terms "look through" a life reinsurance policy to the underlying life policy and the individual whose life is insured;
- whether life reinsurance policies can be grandparented when the underlying life policy is fully reinsured, thereby taking the seller of the underlying life policy outside the definition of "life insurer" in section EY 10; and
- potential mismatches that are created. For example, a life insurer sells a life policy to an individual in March 2010. The cover under the policy is $595,000 in year one. In April 2010, the life insurer then reinsures the life risk for all policies that have a cover amount of up to $600,000. In year one, the life reinsurer has no risk exposure. In year two, the cover under the individual's life policy rises by CPI to $601,000 and the life reinsurer becomes "on-risk" for the $1,000 above $600,000. The increase in the reinsurance cover from $0 to $1,000 would breach the grandparenting rules and the contract would not receive transitional relief. In this situation, the underlying life policy continues to be grandparented, but the reinsurance policy is not even though it was sold before 1 July 2010.

To deal with the problems life insurers have identified, officials consider the grandparenting rules for life reinsurance should be simplified.

Transitional relief should apply to life reinsurance contracts in place before the start date of the new life insurance rules:

- to the extent that the underlying life policy is:
  - grandparented (this assumes the life reinsurer is able to use the information provided to it by the cedant life insurer about the underlying life policy); or
  - would be grandparented if the seller of the life policy was a "life insurer"; and
- if there are no material changes in the terms of the life reinsurance contract.

This solution would allow the life reinsurer to grandparent existing reinsurance contracts to the extent that the underlying life policy is also grandparented. Representatives from the life reinsurance sector have confirmed that the proposal aligns with their current practices and systems.

The changes should have effect from the date the new life insurance rules started: 1 July 2010 or an earlier income year that includes 1 July 2010.

Recommendation

That the submission be accepted.

Issue: Calculation of transitional relief under the grandparenting rules

Submission

(Matter raised by officials)

The formula in section EY 30(8) of the Income Tax Act 2007, which is used to calculate the value of transitional relief allowed under the grandparenting rules, includes references to the rules about the outstanding claims reserve (section EY 24) and the capital guarantee reserve (section EY 27).

Comment

The rules for calculating the transitional relief available for grandparented life policies include references to the various rules that apply to reserves. Reference to the rules relating to the calculation of the outstanding claims reserve (OCR) and the capital guarantee reserve (CGR) are not relevant to the calculation because they are not premium-related reserves but could give rise to a higher deduction than would otherwise be available. References to the OCR and CGR rules should be removed from the calculation of transitional relief. We note that taxpayers have not yet filed their first returns and have not yet taken a tax position under the new rules.

The changes should have effect from the date the new life insurance rules started: 1 July 2010 or an earlier income year that includes 1 July 2010.

Recommendation

That the submission be accepted. References to sections EY 24 and EY 27 should be removed from section EY 30(8)(b).

Issue: Definition of "profit participation policy"

Submission

(Matter raised by officials)

The scope of the definition of "profit participation policy" should be narrowed to life insurance policies that provide a savings facility to individuals.

Comment

Profit participating life policies allow policyholders to participate in the distributions of profit and were once the most common product offered by life insurance companies. The current definition of "profit participation policy" in the Income Tax Act 2007 is broad and could include life reinsurance policies and group life policies with risk cover. Officials consider this outcome is inappropriate because such policies have the characteristics of pure risk policies and, unlike traditional profit participation policies, do not contain a savings component. Such life reinsurance policies and group life policies (life insurance policies that insure multiple lives under the one policy, for example, workplace policies) should be taxed under the non-participating rules (premiums less claims) with any profit participation features being treated as other income or expenditure.

The changes should have effect from the date the new life insurance rules started: 1 July 2010 or an earlier income year that includes 1 July 2010.

Recommendation

That the submission be accepted. The definition of "profit participation policy" in section YA 1 should specifically exclude life insurance contracts that are "life reinsurance" and "multiple life polices" as defined in sections EY 12 and EY 30(14) respectively.

CARVE-OUT FROM "CFC ATTRIBUTABLE AMOUNT" FOR THIRD-PARTY ROYALTIES RECEIVED BY A LOWER-TIER CFC

Submission
(KPMG)

Section EX 20B(5)(d) of the Income Tax Act 2007 needs clarification to ensure that it is consistent with the policy intention of the new CFC rules. In particular, royalty income derived by a lower-tier CFC from a non-associated third party should also be excluded from attributable CFC amount.

Comment

Officials have noted the issue raised by the submission and agree in principle with the point made by the submitter. Officials consider, however, that the change would be more appropriately included with other legislative amendments to be made to the international tax rules later this year, rather than put in this bill.

Recommendation

That the submission be noted.

APPROVED ISSUER LEVY

Clauses 79, 102 and 103

Issue: Application date

Submission
(Corporate Taxpayers Group)

The amendments to the rules for approved issuer levy (AIL) should apply retrospectively so that taxpayers that have applied the pre-clarified law are not subject to the risk of penalisation by Inland Revenue. Alternatively, Inland Revenue could provide comfort in a future *Tax Information Bulletin*, or in the Officials' Report on the bill, that it will not pursue the matter if a taxpayer has paid AIL prior to 1 August 2010 (the application date for the amendments).

Comment

The bill makes technical changes to the rules for approved issuer levy, to ensure a better fit between domestic and treaty laws. The amendments are intended to make existing law more transparent, rather than to substantively alter its effect.

The submitter is concerned that, unless the changes apply retrospectively, a taxpayer that has paid AIL prior to 1 August 2010 in order to qualify for a treaty exemption for interest paid to a foreign bank may risk penalisation.

The relevant scenario involves interest payments to a foreign bank with a branch in New Zealand. In this case, the NRWT rules do not apply and the AIL regime is therefore not relevant domestically. Provided the interest is not connected with the New Zealand branch, the interest may still qualify for an exemption under a double tax agreement. The availability of this exemption depends on the borrower paying AIL – but only if the borrower is eligible to elect to pay AIL.

We consider that the borrower in this scenario is eligible, under existing law, to elect to pay AIL for the purposes of qualifying the interest for a treaty exemption. The bill clarifies this. We see no risk for a taxpayer that has relied on this interpretation of the law prior to the clarification taking effect. The treaty requires that, if a borrower is eligible to pay AIL, then the levy must be paid for the exemption to apply. This is not the same as the exemption being contingent on the borrower's eligibility to elect to pay AIL. As long as the borrower has paid AIL and the other requirements for the exemption are satisfied, we see no basis on which the exemption would be denied. There are no penalties for paying AIL in circumstances where this is not relevant for the purposes of the domestic NRWT rules.

Recommendations

That the application date of 1 August 2010 not be changed and that the foregoing analysis be reflected in a subsequent *Tax Information Bulletin*.

Issue: Related proposals

Submission

(Corporate Taxpayers Group)

Interest paid by a New Zealand borrower to a foreign bank in respect of property situated offshore should not have a New Zealand source, provided the interest is not connected with a New Zealand branch of the foreign bank. (The result would be to exempt the interest from the NRWT/AIL rules.)

Alternatively, certain practical changes should be made to the AIL regime: the non-resident bank should be able to register and pay AIL on behalf of the borrower; either the bank or the borrower should be able to register to pay AIL retrospectively; and it should be possible to pay AIL on an annual basis (rather than monthly).

Comment

Whereas the bill makes only limited technical changes to the AIL rules to clarify the relationship between domestic and treaty laws, these proposals would involve substantive changes to the scope of the tax base and the way the AIL regime operates. The submission notes that these proposals are outside the scope of the current bill and indicates that the submitter would be happy to discuss them separately with officials.

Recommendation

That officials meet with the Corporate Taxpayers Group to discuss wider policy issues related to NRWT/AIL on interest, with any further legislative changes being a matter for a later bill.

AUCKLAND COUNCIL RESTRUCTURING AMENDMENT

Clause 106

Submission
(Matter raised by officials)

Clause 106(20) of the bill should be amended to include a reference to section 19B of the Local Government (Tamaki Makaurau Reorganisation) Act 2009.

Comment

This amendment will ensure that the new Waterfront Development Agency which is established pursuant to an Order in Council made under section 19B of the Local Government (Tamaki Makaurau Reorganisation) Act 2009 is also covered by the proposed tax amendment. Therefore, like other new council-controlled organisations, the new Waterfront Development Agency would not be entitled to a deduction for the principal amount of the debt (that was transferred as part of the restructuring), but will still be entitled to an interest deduction.

Recommendation

That the submission be accepted.

EMISSIONS TRADING PROVISIONS

Clauses 22, 34 and 74(4)

Issue: Conversion of New Zealand Unit to Kyoto unit

Submission
(PricewaterhouseCoopers)

There is no provision which allows a deduction when a New Zealand Unit is converted to a Kyoto unit, which may result in the same unit being taxed twice.

Comment

The Climate Change Response Act 2002 includes provisions enabling a holder of a New Zealand Unit (NZU) to convert it to an Assigned Amount Unit (AAU), which they might want to do if they want to sell the unit outside New Zealand. The submitter points out that an Income Tax Act 2007 provision provides that, when such a conversion is made, the NZU is treated as being disposed of for market value. The submitter is concerned that no provision provides a contemporaneous deduction for the acquisition of the AAU. If this were correct, it would mean that a person who then sold that AAU would be taxed twice: once on the conversion of the NZU to the AAU and then again on the sale of the unit.

Officials consider that a deduction is available for the cost of the AAU. Emissions units (which include AAUs) are included within the definition of revenue account property in section YA 1. Section DB 23 of the Income Tax Act provides that a person is allowed a deduction for expenditure they incur as the cost of revenue account property. In this instance, the expenditure incurred by the person is the transfer of the NZU to the registry, and the amount of that expenditure is defined by income tax legislation as the market value of the NZU. Officials are therefore comfortable that no double taxation can arise here.

Recommendation

That the submission be declined.

Issue: Deductibility of underlying emissions obligations when free units are awarded

Submission
(PricewaterhouseCoopers)

The legislation should include a specific provision stating that the amount of the deduction which arises for an ETS obligation should be calculated by reference to the assessable income arising from the surrender or valuation of those units.

Comment

The following two examples explain the two circumstances in which a business may have an emissions obligation and be holding units awarded by the Government.

In the first situation, at the end of the income year the business has accrued a liability to surrender emissions units, which it has not yet satisfied by the transfer of units. At the end of the income year, it will need to value the liability at its best estimate, which (assuming it holds no units) will be the market value of an emissions unit on balance date. Assume the business later receives free emissions units, and uses them to meet its surrender obligation. This will be taxed as a disposal of the units at market value (in order to recognise for tax purposes the free unit awarded). However, if the market value of the units when surrendered is different from the market value of units used to work out the original deduction, an adjustment will be made.

In the second situation, the end of the emissions year occurs part-way through the income year, and the liability is met by the surrender of free (zero-value) emissions units, also during the course of the income year. Income will arise on the transfer of the free units equivalent to the market value of units on that date. The deduction for the liability will also be calculated by reference to the value of units surrendered, so no mismatch will arise. If instead the surrendered units were those which had previously been valued, the deduction would be calculated by reference to that previously-calculated value.

Accordingly, officials do not consider that any mismatch can arise.

Recommendation

That the submission be declined.

Issue: Application of accounting treatment for tax purposes

Submission
(PricewaterhouseCoopers)

It would be desirable in the future to align the tax treatment of emissions unit transactions with the accounting treatment. The development of accounting standards should be monitored so that this alignment can be made in the future.

Comment

Businesses incur compliance costs in accounting for emissions units transactions for both tax and financial reporting purposes. If the tax and accounting treatments could be aligned, businesses' compliance costs could be reduced.

The submitter suggests that such alignment will need to be deferred until accounting standards relating to emissions transactions and government grants are finalised.

Officials agree with this submission. It would be highly desirable from a compliance perspective to align tax treatment and accounting treatment. However, the accounting treatment is not yet sufficiently certain for officials to be confident that alignment ought to be allowed at this stage.

Officials will continue to monitor the development of accounting standards, with a view to allowing businesses to apply accounting rules for tax when they are confident that this will lead to appropriate outcomes.

Recommendation

That the submission be accepted.

Issue: Income tax treatment of certain emissions units received by NGA parties

Submission

(Matter raised officials)

The new rules for the recognition of income from the transfer of units by the Government to certain industrial and agricultural businesses should also be extended to emissions units transferred to Negotiated Greenhouse Agreement (NGA) participants to compensate them for the increased cost of their inputs.

Comment

Provisions in the bill deal with the income tax treatment of the transfers to industrial and agricultural businesses under the Climate Change Response Act 2002 (CCRA). It provides that the amount of income arising is determined by the business' entitlement under the CCRA, and values an appropriate number of the units transferred at market value.

NGAs were entered into between the Government and two industrial emitters in 2003 and 2005, prior to the introduction of the ETS. In order to meet its obligations under those original agreements, the Crown is in the process of entering into side agreements with these parties under which they will be transferred emissions units. These transfers will be on a similar basis to the transfers which are made under the CCRA to certain industrial and agricultural businesses.

The income tax treatment of these transfers is governed by ordinary law, which is unclear and will certainly give a different result to the statutory rules in the bill. There is no conceptual difference between the CCRA transfers and the NGA transfers, so officials consider that the new rules in the bill which apply to the CCRA transfers should also be extended to the NGA transfers.

Recommendation

That the submission be accepted.

Issue: Minor technical issues

The following matters are proposed by officials to deal with minor issues which have arisen in the tax legislation dealing with emissions trading.

Correction of drafting error in CB 36(7)

Officials submit that a drafting error in the amendments proposed to section CB 36(7) in the bill be corrected. An amendment is proposed to make it clear that the provision applies when an emissions unit is transferred to a person by the Government.

Capital account treatment of units allocated to owners of fishing quota

Officials submit that an amendment to section ED 1(7B) should be made to make it clear that where an emissions unit is allocated to a person who holds fishing quota on capital account, that unit has a value of zero at the end of the income year.

Recommendation

That the submissions be accepted.

EXTENSION OF THE RWT DEADLINE

Submission
(FNZ)

FNZ is one of a number of firms in New Zealand that provide investment administration services for their clients. These services include withholding resident withholding tax (RWT) on interest income received on behalf of clients and performing portfolio investment entity (PIE) tax calculations for clients' PIE investments and returning PIE tax to Inland Revenue. Firms performing these functions for clients are often known as "wrap account" providers.

An important aspect of these functions is providing information to investors concerning the amount of interest and PIE income earned and the amount of tax that has been deducted. This enables investors to complete their end-of-year tax returns.

It is efficient for wrap account providers to provide this information in a consolidated form to investors. Currently the Tax Administration Act requires that RWT information for a tax year is provided by the 20th of May following the end of the relevant tax year.

FNZ submits that this deadline should be extended to 15 June or, at a minimum, 31 May. This would provide more time for wrap account providers to consolidate the RWT information with PIE information – which may be provided by the PIE to the wrap account provider on or close to the current 20 May deadline for providing investors with RWT information.

Comment

Officials consider that the submission illustrates the need for the various legislative deadlines for providing RWT and PIE information to be reviewed in order to provide greater coherence. We do not recommend that the specific change suggested by FNZ should be made independently of such a review.

Recommendation

That the submission be noted and considered again when a comprehensive review of the deadlines for providing RWT and PIE information is conducted.

Issue: Transfer from complying superannuation fund to KiwiSaver scheme

Submission

(Matter raised by officials)

A person over the New Zealand Superannuation qualification age should not be entitled to the initial Crown contribution (the kick-start) if they transfer from a complying superannuation fund to join KiwiSaver for the first time.

Comment

The KiwiSaver Act 2006 contains rules that prevent persons over the age of entitlement to New Zealand Superannuation from joining KiwiSaver. They are not enrolled via the automatic enrolment rules when starting new employment, nor can they opt in directly. Thus they cannot receive the initial Crown contribution (the $1,000 kick-start payment).

But members of a complying superannuation fund may choose to transfer to a KiwiSaver scheme, including those over the New Zealand superannuation age. Also, members of a complying superannuation fund may be involuntarily transferred into KiwiSaver at any age, for example if the Government Actuary revokes approval of their existing fund.

To maintain equity with those who are not members of complying schemes, when a person who is over the New Zealand superannuation age transfers from a complying superannuation fund into KiwiSaver for the first time, they should not be entitled to the kick-start payment.

These amendments are remedial in nature and consistent with the policy intent of KiwiSaver.

Recommendation

That the submission be accepted.

Issue: Repayment of a member's tax credits following permanent emigration to Australia by member of a complying superannuation fund

Submission

(Matter raised by officials)

A member of a New Zealand complying superannuation fund which is not a KiwiSaver fund can apply to withdraw their funds, less any Government tax credits, following their permanent emigration to Australia. The New Zealand provider should return the amount of the member tax credit to the Government.

Comment

The Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 introduced new rules to allow a person who has retirement savings in both Australia and New Zealand to consolidate them in one account in their current country of residence.

KiwiSaver members transferring their retirement savings to Australia will be able to transfer accumulated member tax credits. However, at present, the ability to transfer these tax credits does not apply to complying superannuation schemes in New Zealand that are not KiwiSaver schemes; instead, the provider must return the amount of the member tax credit to the Government.

However, one of the amendments in the Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act means that the legislation governing the providers' return of the tax credit to the Government no longer covers situations where a member of a complying superannuation fund emigrates permanently to Australia. This was an unintended change.

The proposed amendment is remedial in nature, to ensure consistency with the policy intent of KiwiSaver.

Recommendation

That the submission be accepted.

Issue: Use of KiwiSaver first home withdrawal facility to purchase a "leasehold estate"

Submission

(Matter raised by officials)

A KiwiSaver member who is eligible for the first home withdrawal facility can withdraw their accumulated savings to purchase their first home. The property or "estate" they purchase should include a "leasehold estate".

Comment

The Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010 altered the eligibility criteria for the first home withdrawal, by removing "leasehold estate" from the definition of the word "estate" in clause 8(6) schedule 1 of the KiwiSaver Act 2006.

The change was intended to allow a KiwiSaver member who had previously been party to a leasehold residential tenancy, to meet the eligibility criteria for the first home withdrawal facility. The member could then withdraw their accumulated savings, less the one-off $1,000 Crown contribution and any member tax credits, to use for the purchase of their first home.

Officials have since noticed that the amendment means that the legislation now precludes a member who is purchasing a leasehold estate from accessing the first home withdrawal facility. This effect was not intended.

The proposed amendment is remedial in nature and is consistent with the policy intent of KiwiSaver. The amendment will apply from 1 July 2010.

Recommendation

That the submission be accepted.

REWRITE AMENDMENTS

Clauses 76 and 93

Issue: Low-interest loans to shareholder-employees and backdating of income not subject to withholding of taxation at source

Submission
(BDO and New Zealand Institute of Chartered Accountants)

If the policy intention of the low-interest loan backdated repayment rules is to permit shareholder-employees to retrospectively reduce the balance of low- or nil-interest loans by applying their own funds, the backdating rules should not depend on whether withholding tax is withheld from a payment of a dividend, or whether a dividend is fully imputed.

Comment

The amendments in clauses 76 and 93 are in response to a recommendation of the Rewrite Advisory Panel that a minor drafting change in the repayment rules for low- or nil-interest loans from the Income Tax Act 1994 to the 2004 Act (and re-enacted in the 2007 Act) should be retained, despite the drafting change being an unintended change in legislation. (The term "gross income" in the 1994 Act was replaced by the term "income" in the 2004 Act.) The amendments confirm that drafting change as an intended change.

However, the submissions relate to a matter that has been raised separately with the Minister of Revenue. NZICA and officials have agreed on a process to progress this matter, which incorporates a wider set of policy issues. Officials understand that BDO are aware of this agreed process, which includes the point raised in submission.

As the submissions are beyond the scope of the rewrite amendments, and relate to a wider policy problem, officials recommend that the submissions should be addressed within the agreed policy process for those issues.

Recommendation

That the submissions be declined.

Issue: PIE rules

Submission

(Matters raised by officials)

That the following rewritten provisions of the PIE rules be amended to correct minor drafting errors arising on the rewrite of these provisions, so as to correctly reflect their corresponding provisions in subpart HL of the Income Tax Act 2007.

These amendments should apply from the beginning of the 2010–2011 income year.

Comment

These items are included on the list of minor maintenance items under the processes adopted by the Rewrite Advisory Panel.

Definition of investor class

Section HM 5(4) should be amended to correctly reflect the outcome in the corresponding provision, section HL 5B(3) of the 2007 Act: that both paragraphs (a) and (b) must be satisfied before an investor is entitled to the benefit of the relief under this provision.

Definition of foreign PIE equivalent

Section HM 3(e) should be amended to correctly reflect the outcome in the corresponding provision, section HL 5(d). The amendment is that for a foreign investment vehicle to be considered a foreign PIE equivalent, the investor size requirement of section HM 15 only needs to be met for New Zealand residents. The other requirements remain unchanged.

PIE criteria – collective schemes

Section HM 9 should be amended to correctly reflect the pre-rewrite position: that trustees of a group investment fund in relation to category B income can elect to be a multi-rate PIE.

Recognition of tax credits

Section HM 35 should be amended to correctly reflect the corresponding provisions of section EG 3, so that:

- tax credits received by the PIE are taken into account in determining the amount “assessable income” in the formula in subsection (3); and
- tax credits are apportioned on the same basis as the income is apportioned under subsection (8).

Cross reference to "portfolio tax rate entity"

In section IC 3(1), the term "portfolio tax rate entity" should be replaced by the term "multi-rate PIE" consequential on the rewrite of the PIE rules.

Non-resident withholding tax

The cross-reference in section RF 2(2) to section CX 56C should be replaced by a cross-reference to sections CX 56B and 56C to correctly reflect the provisions of NG 1(2)(f) of the 2004 Act.

Definition of "land investment company"

The definition of "land investment company" in section YA 1 is the rewritten definition of portfolio land company.

The following minor drafting errors in the definition of land investment company should be corrected to correctly reflect its pre-rewrite meaning.

- Paragraphs (a) and (b) should be conjunctive (as per paragraphs (a) and (b) of the definition of portfolio land company).
- In paragraph (b), the $100,000 market value threshold should be determined by whether the value is "more than or equal to" $100,000, instead of "more than" as currently drafted (as per paragraph (b) of the definition of portfolio land company).
- In paragraph (b), the words "the market value" should be inserted between "90% of" and "that property" (as per paragraph (b)(ii) of the definition of portfolio land company).
- The definition should be amended to clarify that a company (company A) will not be a land investment company if it invests in another land investment company which in turn invests back into company A (as per paragraph (b)(i) of the definition of portfolio land company).

Tax Administration Act – portfolio investor allocated income

In section 33A(1)(b)(xi) of the Tax Administration Act 1994, the term "portfolio investor allocated income" should be amended to refer to "attributed PIE income" as a consequence of the rewrite of the PIE rules.

Recommendation

That the submissions be accepted.

Issue: Meaning of foreign income tax

Submission
(Matter raised by officials)

That the meaning of foreign income tax for the purposes of the foreign tax credit rules in the Income Tax Act 2007 be amended to correctly reflect the corresponding provisions in the Income Tax Act 2004.

This amendment should apply from the beginning of the 2008–2009 income year.

Comment

This item is included on the list of minor maintenance items under the processes adopted by the Rewrite Advisory Panel.

Section YA 2(5) of the Income Tax Act 2007 should be amended to ensure that income tax of a foreign country includes income tax imposed by a state or local government, as well as income tax imposed by a central government. This would reinstate the explicit reference to tax imposed by a central, state or local government that was contained in section OB 6(1)(c) of the Income Tax Act 2004.

Recommendation

That the submission be accepted.