Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill

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

Volume 1

Simplifying record-keeping requirements for businesses
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Policy matters

SIMPLIFYING RECORD-KEEPING REQUIREMENTS FOR BUSINESSES

Clause 103

Overview

The bill contains amendments to modernise the record-keeping requirements of businesses by making it easier for taxpayers to store records offshore through applications from their data storage providers, and by allowing taxpayers who submit returns electronically to store them electronically.

Issue: The form of the record

Submission

(Matter raised by officials)

The words "in an electronic form" should be removed and replaced with "in a form approved by the Commissioner".

Comment

Clause 103 allows for a person to hold for taxpayers, records in an electronic form, at places outside New Zealand.

The reference to "in an electronic form" should be removed, as although it is highly likely that most applications by a taxpayer or person (on behalf of a taxpayer) will be for records that are in an electronic form, there may be a rare circumstance when the application to the Commissioner will be for records in another form, such as paper or a non-electronic form. The Commissioner should have the flexibility to approve what type of form a record may be kept outside of New Zealand as part of the conditions imposed for authorisation.

Recommendation

That the submission be accepted.

Issue: Removal of the application of the Electronic Transactions Act 2002

Submission
(Matter raised by officials)

The cross-reference to section 25 of the Electronic Transactions Act 2002 (ETA) should be removed so that the Commissioner is able to specify the form (e.g. paper or electronic) that the records must be kept outside of New Zealand. In addition, the Commissioner should be able to specify as a condition the way the records are to be accessible to the Commissioner.

Comment

Clause 103 allows for a person to hold for taxpayers, records in an electronic form, at places outside New Zealand, in a manner consistent with section 25 of the ETA. Although the reference to section 25 of the ETA is incorrect, and it should be section 26, officials consider that the reference to the ETA should be removed. This will allow the Commissioner to specify the form in which the records must be kept overseas.

Furthermore, as the ability for the Commissioner to access the records is a key pre-requisite for such authorisation, clause 103 should be amended to provide for this.

Recommendation

That the submission be accepted.

Issue: The conditions for authorisation should also apply to individual taxpayers

Submission
(Matter raised by officials)

The conditions imposed by the Commissioner in new section 22(9) of the Income Tax Act should apply to all taxpayers seeking to keep records offshore under subsection (8).

Comment

Clause 103 allows the Commissioner to impose reasonable conditions on a person (on behalf of a taxpayer) who applies for the authorisation to keep records outside of New Zealand. However, these conditions do not apply to individual taxpayers who apply for this authorisation under new section 22(8). Therefore to ensure consistency, it is proposed that the conditions apply to all those who apply under subsection (8).

Recommendation

That the submission be accepted.

Issue: Protecting the privacy of a taxpayer's records held outside of New Zealand

Submission
(Matter raised by the Committee)

At the briefing on the bill on 8 February 2012, some members of the Committee expressed concerns about the keeping of tax records offshore and the need for privacy.

Comment

The changes proposed by clause 103 refer to a taxpayer satisfying their record-keeping obligations and the Commissioner's discretions, to ensure on-going access to taxpayer records by the Commissioner when required.

Ultimately it is the taxpayer's responsibility to ensure the privacy of their business records. The security risks associated with storing records offshore is a commercial matter for the taxpayer to consider with their offshore storage provider.

The privacy of taxpayer information and data held by Inland Revenue is not within the scope of clause 103 and is covered by other provisions such as section 81 of the Tax Administration Act.

Recommendation

That the submission be noted.

Issue: The Commissioner should be restricted from requesting information that is over seven years old

Submission
(New Zealand Institute of Chartered Accountants)

The Commissioner should be restricted, under statute, to the seven-year record-retention period when requesting information from taxpayers in all circumstances.

Comment

A taxpayer is required to retain records for seven years and, in certain circumstances, for an additional three years if given notice by the Commissioner. However, the Commissioner is not restricted to requesting records or information that is over the seven or 10-year periods if in fact the information exists. Examples of when such a request would be made include when certainty or the reconstruction of income is required or when a taxpayer may be fraudulent, or wilfully misleading the Commissioner. Many older documents may also remain relevant to the tax affairs of taxpayers in more recent periods.

Recommendation

That the submission be declined.

PROFIT DISTRIBUTION PLANS

Issue: Policy considerations

Submissions
(Corporate Taxpayers Group, Contact Energy, KPMG, New Zealand Institute of Chartered Accountants)

The legislative reforms to profit distribution plans (PDPs) should not proceed for the following reasons:

- The underlying policy rationale behind the proposed reform is based on an incorrect view of the legal form and substance of PDPs vis-à-vis dividend reinvestment plans. *(Corporate Taxpayers Group)*
- Economically like investments should be treated the same to ensure the integrity of the tax system. However the proposed changes should not proceed as the key commercial driver for PDPs is to retain capital within the company, and this justifies a different tax treatment. *(KPMG)*
- We support aligning the tax treatment of economically equivalent things, however PDPs are sufficiently different from other (taxable) distribution policies and this warrants a different tax outcome. *(New Zealand Institute of Chartered Accountants)*
- Officials' imputation credit streaming concerns should be addressed through targeted reform rather than a wholesale change to the tax treatment of PDPs *(Corporate Taxpayers Group).* A better option would have been to debit the company imputation credit account with an amount sufficient to capture the tax liability *(New Zealand Institute of Chartered Accountants).*
- The concern that shareholders may not be taxed at their correct personal tax rate is not sufficient to justify the wholesale tax reform as proposed. *(Corporate Taxpayers Group)*
- The changes are inconsistent with the notion of a dividend: a dividend is a distribution of profit, whereas shares issued under a PDP are a share split that does not alter each shareholder's underlying interest in the company. *(Contact Energy, New Zealand Institute of Chartered Accountants)*
- The reforms will have the effect of disestablishing a highly effective mechanism for corporates to retain capital and an effective savings mechanism for shareholders. *(Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants)*
- The changes are contrary to tax simplification and add additional compliance costs on taxpayers. *(New Zealand Institute of Chartered Accountants)*
- Eliminating the ability of companies to undertake PDPs is inconsistent with the Government's focus on helping businesses through the current financial crisis. *(New Zealand Institute of Chartered Accountants)*

- The consultation process undertaken by officials was limited and the submission points were rejected for minor reasons. The only comments made to support officials' position that PDPs should have the same tax treatment as "substitutes" came from the Capital Market Development Taskforce, which did not have the benefit of reviewing private sector submissions. *(Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants)*

Comment

The proposed changes to the tax treatment of PDPs are consistent with, and an extension of, existing policy around imputation credit streaming and the taxation of bonus issues.

Imputation credit streaming

New Zealand-resident companies earn tax credits from the payment of their company tax and from the imputation credits attached to dividends they receive from other New Zealand-resident companies. These credits can be attached by the company to dividends paid to its shareholders. This prevents double taxation so that income earned by the company is not taxed in the hands of both the company and its shareholders. It also means that company income is eventually taxed at the personal tax rates of its shareholders if that income has been distributed to the shareholders with full imputation credits attached.

The value of imputation credits is not the same for all shareholders. For some shareholders, imputation credits have little or no value. New Zealand-resident shareholders that pay tax can use the credits to reduce their New Zealand tax payable. However, tax-exempt New Zealand shareholders and foreign shareholders who have no New Zealand income tax against which to apply imputation credits do not benefit from imputation credits. This creates an incentive to direct the credits to those shareholders best able to use them – a practice commonly called imputation credit "streaming". The current tax legislation contains rules that prevent streaming. One such rule requires that imputation credits must be paid out pro-rata to shareholders in relation to their shareholding proportion in the company.

Taxation of bonus issues

A bonus issue is an issue of shares by the company when nothing is provided in return. A bonus issue can either be taxable or non-taxable. The policy rationale behind treating some bonus issues as taxable and some as non-taxable is to maintain the integrity of the imputation system and ensure that taxpayers ultimately pay tax on company income at their marginal tax rate.

Non-taxable bonus issues

One example of a non-taxable bonus issue occurs when a company issues new shares to all shareholders on a pro-rata basis, so that all shareholders retain their proportionate shareholding in the company. This is analogous to a share split, where there has been no change in substance, only a proportionate change in the number of shares held by each shareholder.

Taxable bonus issues

A special provision allows a company to elect to treat a bonus issue that would otherwise be non-taxable as a taxable dividend. The policy rationale behind allowing companies to elect for a bonus issue to be taxable is to allow the company to pass out imputation credits to its shareholders without the need to pay a cash dividend. This policy is consistent with the principle of integration of the tax system and may be advantageous to the company, for example, just before a reorganisation or merger that would result in a breach of continuity and a loss of imputation credits.

Bonus issues in lieu

A bonus issue in lieu occurs when a company gives its shareholders a choice of whether to receive a bonus issue or money, or money's worth, and the shareholder elects to receive the bonus issue. Even though a bonus issue in lieu can have the form of a non-taxable bonus issue, the current rules treat it as taxable. This is because it is part of an arrangement that could undermine the policy intention of the imputation system. The bonus issue in lieu arrangement which gives shareholders a choice, rather than making a pro-rata distribution of shares, undermines the policy intention of the imputation system in two ways. First, it can provide a tax rate advantage to shareholders with higher marginal tax rates; secondly, it can allow streaming of imputation credits.

If a bonus issue in lieu were not taxable, taxpayers on lower tax rates could opt for a cash payment, which would be treated as a taxable dividend. Since the personal tax on the dividend would be less than the imputation credits attached, the taxpayer could use the excess imputation credits to offset tax on other income, as intended under the imputation system. On the other hand, higher tax rate shareholders may choose to receive bonus shares, which could be sold on-market for cash with no tax payable (provided the shares are held on capital account). By treating a bonus issue in lieu as taxable, this ensures that shareholders must pay the difference between the tax payable at their personal tax rate and the underlying company tax. While there are other arrangements in the tax system when taxpayers are not necessarily taxed at their correct personal tax rates, these have resulted from specific policy decisions being made. No such decision has been made for PDPs.

Further, the potential for imputation credit streaming arises because, as noted earlier, for some shareholders, imputation credits have little or no value. In the absence of the rules that tax bonus issues in lieu, those shareholders that are unable to utilise imputation credits (such as foreign shareholders) could elect to receive the bonus shares rather than the monetary amount. If the bonus shares are non-taxable, imputation credits will not be attached, and this preserves the credits for shareholders who can best use them. This defeats the current policy settings that are in place for the imputation system.

The PDP arrangement is substantially similar to a bonus issue in lieu as it effectively provides shareholders with a choice of receiving a bonus issue of shares, or a cash amount. Accordingly, a PDP is not analogous to an ordinary (non-taxable) share split. Even though the legal form of a PDP means that all shareholders initially receive a bonus issue, the substance of the arrangement is that the shareholders are effectively given a choice of whether to receive bonus shares or a cash amount.

While PDPs have non-tax commercial purposes, such as the retention of cash in the company, officials consider that the proposed extension of the bonus issues in lieu treatment to PDPs does not frustrate these uses. It merely removes an unintended tax subsidy from the arrangement.

Alternatives considered by officials

Officials have considered alternative solutions to address the concerns with PDPs. In general, these alternative solutions lead to equity and fiscal concerns. One alternative considered was to require companies to reduce their imputation credit account balance by the maximum imputation ratio (ordinarily 28%) of the value of the bonus shares that are retained by recipient shareholders. This option sufficiently addresses the issue related to imputation credit streaming. However, officials have two main concerns with this option.

First, there are equity concerns. Under this option, shareholders who retained bonus shares under a PDP would effectively be taxed at a final tax rate of 28%. Individual shareholders on lower tax rates (those on 10.5% and 17.5%) would effectively be taxed at the higher rate of 28% and, unlike the proposed new tax treatment, these shareholders will be unable to use excess imputation credits under this alternative option. It also means that higher-rate individual shareholders (those on 30% and 33%) are effectively taxed at a lower rate of 28%.

In addition, the bonus issue income is not counted for social assistance purposes (such as Working for Families entitlements) which may mean that taxpayers receive benefits that they would not receive if the payment was taxable.

The second concern is that this option is fiscally negative, with an estimated fiscal cost of $7 million per annum, should there be a tenfold increase in the use of PDPs. This predicted revenue loss is largely due to the expected increased take-up of PDPs if they are given what is effectively a concessionary tax treatment. This is a cost that would be borne by the Government.

Officials note that the change to the tax treatment of PDPs is not an ad hoc change to the tax treatment of capital. It is consistent with the policy behind the tax treatment of bonus issues in lieu, and as such, is simply an extension of the current policy on imputation credit streaming.

Compliance costs for taxpayers

Officials do not consider the changes to PDPs to be contrary to tax simplification. In general, the changes around tax simplification amend the way in which taxpayers file tax returns rather than the income that is included in tax returns.

The proposed change to treat bonus shares issued under PDPs as taxable dividends increases compliance costs for taxpayers, however these costs are no higher than if a cash dividend was paid. This is because publicly listed companies generally already have mechanisms in place for withholding resident withholding tax (RWT) or non-resident withholding tax (NRWT) on dividends. If RWT is correctly deducted, a resident shareholder will typically not be required to file a tax return, simply because they receive a dividend under a PDP (assuming their total dividend income for the year is $200 or less or they are on the top marginal tax rate of 33%). A resident shareholder will only have to put the dividend in their tax return if they are already filing a tax return for another reason. For these shareholders, due to the rate of RWT on dividends, it is unlikely that the shareholders would face a tax liability as a result of the dividend.

Consultation process

Consultation was undertaken by officials throughout the policy development process. An officials' issues paper was released for public consultation in 2009. After the first round of consultation, the Capital Market Development Taskforce reported. The Taskforce was industry-led and comprised a number of individuals from both the public and private sectors. Following the Taskforce's report, officials consulted on a solution that provided for a more consistent tax treatment across similar transactions. In addition to these two formal consultation rounds, the Minister of Revenue has on a number of occasions announced the progression of work on PDPs, and officials have been involved in a number of discussions with interested parties.

Recommendation

That the submissions be declined.

Issue: Support for proposed profit distribution plan changes

Submission
(New Zealand Law Society)

The Law Society generally accepts the Government's rationale for making the tax treatment of PDPs the same as the tax treatment of bonus issues.

Recommendation

That the submission be noted.

Issue: Rules for non-cash dividends

Submission
(New Zealand Institute of Chartered Accountants)

The rules for non-cash dividends should be reviewed. The existing and proposed laws relating to RWT on non-cash dividends is confusing. There needs to be a review of the application of RWT to non-cash dividends to ensure the rules operate in a clear and user-friendly manner.

Comment

The clarity of the rules for non-cash dividends has been raised with officials in the past. While officials accept that there is benefit in reviewing the rules, the timing of any such review will depend on the Government's priorities for the Tax Policy Work Programme.

Recommendation

That the submission be noted.

Issue: Definition of "profit distribution plan"

Submission
(New Zealand Law Society)

The definition of a "profit distribution plan" in clause 88(14) requires all shareholders to be notified of the issue of shares. This is an unnecessary requirement. It is not clear that notification of shareholders other than those receiving the shares should be required, nor why failure to notify one or more of those shareholders who are receiving the shares should take the transaction outside the PDP definition. The key element is that the company makes a bonus issue of shares and gives the shareholders an option to have some or all of the shares repurchased or redeemed.

Comment

As far as officials are aware, in practice PDPs have been offered to all shareholders and all shareholders are notified of the offer. However, officials agree that from a policy perspective, the new rules should apply regardless of whether all shareholders are notified or not. If all shareholders were required to be notified, this would mean companies could easily get around the new rules by simply notifying some, but not all, shareholders.

While officials agree with the submission in principle, officials recommend that a different drafting solution to that put forward by the submitter be adopted.

Recommendation

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

Issue: Application date of proposed changes

Submissions
(Contact Energy, KPMG)

If the legislative changes do proceed, Contact Energy seeks a change in the timing of the effective date of the legislative changes from 1 July 2012 to 1 October 2012. This is to allow a reasonable transitional period as the current application date of 1 July 2012 has significant commercial ramifications for Contact Energy.

If the legislative changes do proceed, KPMG submits that the application date should be deferred to 1 April 2013. This allows time for replacement capital raising measures to be considered and employed by affected parties, and aligns with the imputation year.

Comment

There are arguments both for deferring and retaining the 1 July 2012 application date.

The application date of 1 July 2012 currently in the bill was originally chosen because it is expected to be soon after enactment of the bill. The change to the tax treatment of PDPs has been well signalled and is an issue that has been discussed with interested parties on a number of occasions since 2009.

In officials' discussions with taxpayers during consultation there have been concerns raised around the need to provide certainty on the tax treatment of PDPs, particularly given the original product ruling issued by Inland Revenue (which provided tax certainty) has expired. Officials understand this uncertainty has led to a number of companies not offering PDPs.

The uncertain tax treatment is also a concern for shareholders in companies that offer PDPs. From a shareholder's perspective, it is important to have certainty around the dividend-paying policies of the company and the resulting tax consequences for them in respect of the dividends they receive.

One argument against retaining the 1 July application date is that it may be complex from the shareholder's perspective because it may mean that they receive two dividends from Contact Energy that have different tax treatments (interim in March and final in September). However, officials consider that from a tax perspective, the complexity is lessened for taxpayers because it means the two dividends that were received in the standard tax year (1April 2012 – 31 March 2013) will be subject to the same tax treatment.

Deferring the application date will have a fiscal cost. The PDP change is estimated to result in a fiscal gain for the 2012–13 year onwards of $0.76 million per year. This costing was based on an application date of 1 July 2012. If the application date was deferred, as suggested by the submitters, this would reduce the $0.76 million fiscal gain that was originally reported for the 2012–13 year. The amount of the reduction would depend on how long the application date is deferred. The deferral requested by Contact Energy to 1 October 2012, for example, would reduce the fiscal gain for the

2012–13 year by half. The fiscal gain that was reported for years from 2013–14 onwards would be unaffected.

On the other hand, the deferral sought by Contact Energy is relatively small. Officials have had further discussions with Contact Energy to clarify the implications it would face if the application date is not deferred as requested. Contact Energy generally carries out two dividend payments per year (March and September). A 1 July application date would affect Contact Energy's September 2012 dividend payment given that the September dividend is not determined until the results from the financial year ending 30 June 2012 are available. Contact Energy has communicated that it needs approximately four months from enactment of the bill to carry out a number of steps, including confirming the implications of any decision for its non-resident shareholders with foreign jurisdictions, making decisions regarding the form that future dividend payments will take, and communicating the changes to shareholders. These steps cannot be carried out until the date of enactment because of the uncertainty around whether and when the bill will be enacted.

While Contact Energy would be able to pay its September 2012 dividend if the 1 July application date was retained, this would involve increased shareholder communications overall because interim decisions would potentially need to be taken rather than decisions about the appropriate distribution mechanism for the medium term.

On balance, officials consider that the arguments for a small deferral to the application date favour those over retaining the application date. Therefore, officials recommend that Contact Energy's submission that the application date be deferred to 1 October 2012 be accepted.

Officials recommend that KPMG's submission that the application date be deferred to 1 April 2013 be declined on the basis that Contact Energy is the only company officials are aware of that is currently using PDPs. This is the only affected party that has put forward a submission on the application date of the PDP changes.

Furthermore, while a 1 April 2013 date would align with the imputation year, officials consider that a further six-month deferral may result in increased uncertainty and negative fiscal effects.

Recommendation

That the submissions be accepted in part, and that the application date of 1 October 2012 be accepted, and the application date of 1 April 2013 be declined.

Issue: Shares repurchased under a profit distribution plan

Submission

(New Zealand Institute of Chartered Accountants)

Proposed section CD 23B of the Income Tax Act 2007 stipulates that the amount paid by a company when a shareholder elects to have a share issued under a PDP repurchased by the company is not a dividend. If the changes do proceed, while NZICA supports the proposals in section CD 23B, it submits that the relationship between proposed section CD 23B and CD 22 should be clarified. It also seeks clarity on whether section CD 23B applies to on-market repurchases.

Comment

New section CD 23B is intended to prevent cash amounts under a PDP from being taxed twice. If a shareholder elects for their bonus shares to be repurchased under a PDP, section CD 23B ensures that the cash proceeds are not taxable under the ordinary dividend rules. That is, it is only the bonus issue that is the taxable event.

Section CD 22 generally applies when a company pays an amount to shareholders, other than on liquidation, because of the off-market cancellation of shares in the company. This section allows the available subscribed capital of the company (generally equal to the amount paid to the company to subscribe for its shares) to be returned to shareholders tax-free if certain criteria are met. Section CD 22 is not intended to apply to section CD 23B and officials consider that legislative clarification of this point is not necessary. Section CD 23B applies only to share repurchases under a PDP. Section CD 7B states that shares issued under PDPs are dividends. That section also clearly states that section CD 22 does not apply in relation to a share issued under a PDP and repurchased by the company under that plan.

Section CD 23B is not intended to apply to on-market repurchases. Officials consider that legislative clarification is not needed, because as noted in the section heading, section CD 23B is only intended to apply to shares that are repurchased under PDPs and not to share repurchases generally.

While officials do not consider that legislative clarification of these issues is required, an explanation of the provisions will be provided in a *Tax Information Bulletin* article following enactment of the bill.

Recommendation

That the submission be declined.

Issue: Definition of “bonus issue”

Submission
(New Zealand Institute of Chartered Accountants)

NZICA seeks clarification on why it is necessary to amend the definition of “bonus issue” given that necessary amendments are already being made to the relevant statutory provisions to ensure PDPs are taxed and RWT tax is deducted. It submits that amending the definition of “bonus issue” risks confusing matters.

Comment

The definition of “bonus issue” in section YA 1 of the Income Tax Act 2007 is being amended to clarify that a bonus issue includes the issue of shares under a PDP. Along with the amendment to section CD 8, this amendment is necessary as it clarifies that the issue of shares under a PDP constitutes a taxable bonus issue. This ensures the tax treatment fully aligns with bonus issues in lieu, as intended.

Recommendation

That the submission be declined.

Issue: Minor technical drafting issues

Submission
(New Zealand Law Society)

The Law Society has identified two technical issues. First, clause 10 proposes to amend the definition of “returns” in section CD 43(2)(c) of the Income Tax Act 2007 so that it includes a new subparagraph (ii) referring specifically to repurchases of shares pursuant to a PDP. This is appropriate in concept, but the drafting is not appropriate. Paragraph (c) already refers to a cancellation of a share. A cancellation of a share is defined to include its acquisition by the issuing company, i.e. a repurchase. Accordingly, all that is required by way of amendment to paragraph (c) is to include a reference to new section CD 23B. The Law Society recommends clause 10 be amended, so that it simply inserts the words “, section CD 23B” after the words “section CD 22”.

Secondly, there is a typographical error in the currently proposed subparagraph (i) – after “section CD 24”, “of” should be “or”.

Comment

As noted by the submitter, the current definition of "cancellation" of a share includes the acquisition by the company. As such, the current drafting is not necessary and officials recommend that the amendment put forward by the submitter be accepted.

Officials recommend that the second issue also be accepted.

Recommendation

That the submission be accepted.

SOFTWARE DEVELOPMENT COSTS

Clauses 17 and 163

Issue: Ensuring legislative clarity

Submissions
(New Zealand Computer Society Inc., Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants)

While supportive of the bill as written, the submitters believe that clause 17 could be improved to provide certainty to taxpayers when a tax deduction is allowed. They suggest various minor amendments to new section DB 40B(1) of the draft legislation.

Comment

The provisions are intended to provide for expenditure on software that needs further development to become depreciable property. The important distinction is between software that can be depreciated if it is available for use and software that is not able to be used without further development. The provisions make it clear that a taxpayer may claim a deduction for expenditure on software development when the project is abandoned. The term “fit to be used” is referring to the state of development. While “availability” is not an equivalent term, the drafters will take into account the submitters’ suggestions in finalising the drafting of the provision.

Recommendation

That the submissions be noted.

Issue: The proposed rule should also apply to software acquired from another taxpayer

Submission
(Corporate Taxpayers Group)

The proposal should be extended to include situations when a taxpayer acquires partially completed software from another taxpayer. Currently, the proposal is limited to situations when the taxpayer has developed the software or has commissioned the development of the software. Whether a person is allowed a deduction for unsuccessful development should not be determined by whether a person develops the software themselves or whether they acquire it from another person.

Comment

The original policy applied to software developed in-house for use in a business or when a taxpayer commissioned software development from an external party.

Conceptually, a deduction could also be allowed when a person acquires an incomplete software development from another taxpayer if the acquirer should subsequently decide to abandon the project.

However, the submitter’s proposal to extend the policy would have a revenue cost to the Crown. Additionally, if the policy were to be extended, officials would also want to consider the current tax treatment of proceeds from the disposal of abandoned software development projects in the hands of the vendor. Accordingly, while this matter should not be progressed as part of the bill, it could be considered for inclusion in a future Tax Policy Work Programme.

Recommendation

That the submission be noted.

Issue: Division of responsibilities within Inland Revenue

Submission
(KPMG)

It is important that Inland Revenue, when reviewing old policy statements, should not only examine what the law is, but also what the law should be. If there is a divergence, there should be a process for resolution that gives taxpayers greater certainty.

Comment

Inland Revenue tries to ensure that its view of tax law is clear and well understood, and continues to seek improvement in the way that matters are co-ordinated across Inland Revenue to give greater certainty to taxpayers.

Recommendation

That the submission be noted.

Issue: Correction of application date

Submission
(New Zealand Institute of Chartered Accountants)

Proposed section DB 31B of the Income Tax Act should apply from the 2006–07 income year rather than 2007–08.

Comment

Officials recommend that the application date be amended to give effect to the policy of ensuring the Commissioner is time-barred from amending an assessment when a taxpayer has previously relied upon the Commissioner's 1993 policy statement.

Recommendation

That the submission be accepted.

Issue: KiwiSaver employer and employee contribution rates

Submission
(New Zealand Institute of Chartered Accountants)

NZICA supports the increase of the default and minimum employee contribution rates to KiwiSaver and complying superannuation funds from 2% to 3%, and the increase in the compulsory employer contribution rate from 2% to 3%. However, it suggests that the application date should be postponed for 12 months, until 1 April 2014, in light of the current economic downturn.

Comment

The increase in the default and minimum employee contribution rates, and the compulsory employer contribution rates from 1 April 2013 were announced as part of Budget 2011. KiwiSaver members and employers will have nearly two years to plan for the 1% increase in contribution rates.

Recommendation

That the submission be declined.

Issue: Revision of prospectuses and investment statements

Submission
(New Zealand Institute of Chartered Accountants)

The current drafting of this clause is not clear on whether prospectuses and investment statements issued on or before the date of the bill's assent must be revised to reflect the new contribution rates.

Comment

Officials do not agree that there is any uncertainty here. The first part of the clause gives KiwiSaver providers two months to update any new prospectuses. The second part of the clause removes the need to reissue statements or prospectuses that have already been registered at the date of Royal assent, and so ensures securities allotted under those prospectuses are not void. The drafting is consistent with two other provisions in the KiwiSaver Act relating to previous Government-initiated changes to KiwiSaver. This provision has been discussed with the Financial Markets Authority, which is content with the current drafting.

Recommendation

That the submission be declined.

Issue: KiwiSaver membership start date for employees enrolled via their employer

Submission
(Matter raised by officials)

The KiwiSaver Act 2006 should clarify the start date for employees who are enrolled in KiwiSaver to their employers, either by being automatically enrolled or by giving their employer an opt-in notice. It is necessary to know the start date in order to calculate minimum membership periods which apply when determining eligibility to make withdrawals from KiwiSaver.

Membership should be counted from the 15th of the month in which the employee's first KiwiSaver contribution is deducted, not the date on which the employee is finally allocated to a KiwiSaver scheme, which occurs approximately three months later. This will ensure that the same start date is used for all employee contribution and interest calculation purposes.

Comment

The membership start date is relevant for determining certain minimum membership periods in relation to the KiwiSaver withdrawal rules. For example, KiwiSaver funds are locked in until the later of the date on which the member turns 65, or of five years from the start of membership.

Under the KiwiSaver Act an employer must automatically enrol new employees into KiwiSaver. Employees can also join KiwiSaver by giving their employer a deduction notice. Using either joining method, the employer then deducts KiwiSaver contributions from the employee's salary or wages, and pays these to Inland Revenue. These deductions are recorded on the employer monthly schedule (EMS) as part of the standard PAYE process.

The Commissioner holds all initial KiwiSaver contributions for a period of up to three months from the date the first contribution is received. For automatically enrolled employees, this is because they may choose to opt out of KiwiSaver between days 14 and 56 of their employment (although later opt-outs may also be permitted in some circumstances). If the employee opts out of KiwiSaver, Inland Revenue will return any employee and employer contributions already received back to the respective parties.

Unless the employee or employer has chosen their own scheme, Inland Revenue provisionally allocates employees who enrol via their employers to one of six default KiwiSaver providers during the initial three-month period. This allocation will become final if the employee does not opt out within the timeframe. In either case, it is only after final allocation (three months later) that Inland Revenue sends the employee's details and initial three months' worth of contributions to the relevant KiwiSaver provider.

However, the employee should be considered to have become a member of KiwiSaver from the month they started making KiwiSaver contributions, not when their allocation to a particular KiwiSaver provider is finalised three months later.
To overcome this problem, an amendment to the KiwiSaver Act is proposed, to clarify that the membership start date for an employee who is enrolled into KiwiSaver via their employer is taken from the date on which their first contribution is received by Inland Revenue.

All KiwiSaver contributions will be treated as received by Inland Revenue on the 15th of the month in which deduction was made; the date is standardised because of inbuilt time-delays between payroll periods and the filing and processing of the EMS.

This will also bring the position of employees closer to that of members who enrol directly with a provider. In the latter case, the membership start date is generally taken from the date the person's application to a KiwiSaver scheme is accepted.

This amendment will clarify the legislative position; for practical purposes this is already an accepted start date for employees that is used by KiwiSaver providers and Inland Revenue. It will also more closely accord with employees' understanding of when they became KiwiSaver members.

The proposed amendment should apply from 1 July 2012.

Recommendation

That the submission be accepted.

Issue: Process for making KiwiSaver employee contributions after the employee's end payment date

Submission
(Matter raised by officials)

An amendment is proposed to simplify the process for KiwiSaver members who have reached their end payment date (and so are able to make withdrawals from KiwiSaver) to choose whether or not to have employee contributions deducted by their employer.

These members should not be required to apply to Inland Revenue to record their choice, as it is a matter for the employee and employer in the first instance.

Comment

Most employees who are KiwiSaver members contribute to KiwiSaver via their employer's payroll. Their employer deducts the employee contributions at the employee's selected rate (2%, 4% or 8%) from their salary or wages, and pays them to Inland Revenue. The deductions are recorded on the employer monthly schedule (EMS) as part of the standard PAYE process.

KiwiSaver members who have reached their “end payment date” – which is the later of the date on which the member turns 65, or five years from the start of membership – have two options. They may either:

- withdraw their accumulated funds and close their KiwiSaver accounts; or
- keep their accounts open and remain members of KiwiSaver.

If they choose to remain in KiwiSaver after reaching their end payment date, members can continue to make contributions to their KiwiSaver scheme. These members will also be able to access their accumulated funds, and officials understand that many KiwiSaver providers intend to allow members to make partial withdrawals after the end payment date, while keeping their KiwiSaver accounts open.

Members who have reached their end payment date and are still employed should have the option of continuing to have employee contributions deducted from their salary and wages.[1] Other members will wish to cease making regular employee contributions at this point, because they have access to their KiwiSaver funds. They may cease contributing altogether or choose to make contributions on a more ad hoc basis, directly to their provider.

The proposed amendment will simplify the administrative process for employees in choosing whether to carry on making employee contributions after their end payments date, and provide for direct communication of their decision from the employee to the employer.

Officials recommend the proposed amendment apply from 1 July 2012.

Recommendation

That the submission be accepted.

[1] The requirement for the employer to make compulsory employer contributions ceases at the end payment date, although employers may choose to continue making employer contributions. The entitlement to member tax credits (MTCs) also ceases at end payment date.

WORKING FOR FAMILIES

Issue: In-work tax credit and ACC survivor spouse payments

Submission
(New Zealand Institute of Chartered Accountants)

The drafting should make the link between hours worked and ACC income clearer, especially to ensure the surviving spouse's hours are not overridden.

Comment

This amendment deals with a drafting issue of who is covered by the "ACC special rule" for hours worked. Currently, a person receiving ACC compensation can claim the hours they previously worked as counting towards the hours test. The rule had been intended to cover all situations when ACC weekly compensation is paid, but the language does not clearly include the situation of a surviving spouse weekly compensation.

The amendment seeks to confirm that when the accident compensation received relates to the death of a spouse, the deceased spouse's prior work hours can be counted towards the hours test of the surviving spouse. Officials consider that the current provision clearly links the hours worked by the deceased spouse to the ACC income being received. Officials will provide amended drafting to make clear that the hours worked relating to the ACC payment are added to any hours worked by the spouse in their own right, and do not override them.

Recommendation

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

Issue: In-work tax credit and major shareholder employees of close companies

Submission
(New Zealand Institute of Chartered Accountants)

NZICA supports the amendment but recommends the commencement date be made retrospective to 1 April 2008, when the issue was first raised. This will allow affected people to claim for prior years. Alternatively, a savings provision should be included to prevent people having to repay tax credits inadvertently received for prior years.

Comment

Making the change retrospective would allow for affected people to reapply for past year tax credits if they can meet the new criteria. The change is not arising from a technical error, omission or dispute but a change in the policy boundary for situations that can qualify for assistance. Additionally, there are unknown fiscal, administrative and compliance costs to making the change retrospective as people revisit previous applications, although the fiscal cost is likely to be relatively small in terms of total spending on the in-work tax credit. The general approach is to make changes prospectively unless there is a strong case for retrospectivity. As this is a policy change there is not a strong case for backdating the change.

A savings provision is in effect the same as a retrospective change but limited in this case to those who applied the law incorrectly at the time, and should likewise be used sparingly.

The application date could be amended to 1 April 2011 with limited impact on fiscal, administrative and compliance costs for affected persons. This is because applications for an in-work tax credit can be lodged after the end of the tax year to receive payment as a year-end lump sum. Most applications for shareholder-employees would be received after June 2012 or later if tax agents are used. The bill is expected to be passed in July 2012. Shareholder-employees would be able to apply for interim payments from the 2013–14 tax year, if they wish.

Recommendation

That the submission to have the change apply from 2008 be declined, and that the application date be changed from 1 April 2012 to 1 April 2011.

Issue: In-work tax credit and trust owned companies

Submission
(New Zealand Institute of Chartered Accountants)

The amendment to allow major shareholder employees of a close company to claim the in-work tax credit should be extended to apply also to a full-time earner employed by a close company that is owned by the full-time earner's family trust.

Comment

Trust arrangements are far more complicated than arrangements involving companies, where there is a clear and identifiable link between the company and its owners. For example, a trust can have several settlors and beneficiaries, making it unclear if a trust is "the full-time earner's family trust". There is insufficient time to consider the implications of extending the provision to unpaid workers of companies owned by a trust established by the worker, for inclusion in this bill.

Recommendation

That the submission be declined.

Issue: Excluding repayments from debtors from "Other payments" category

Submission
(New Zealand Institute of Chartered Accountants)

Family scheme income should exclude repayments of amounts standing to the credit of a person that falls within the ambit of section MB 13(1) of the Income Tax Act 2007. In particular, amounts received by company shareholders from current account repayments should be excluded.

Comment

Section MB 13(1) captures other payments in the nature of family income that a person might receive and use to replace wages or meet their usual family living expenses. Section MB 13(2) sets out types of payments that are excluded from the rule. The rule is not intended to catch payments relating to changes in how assets are held, such as the sale of an asset or taking out a commercial loan. Repayments from debtors of amounts standing to the credit of the person are not specifically excluded, although small amounts may fall under the $5,000 threshold in section MB 13(3).

Payments received where the person is in credit appears to be similar in nature to the existing exemption for proceeds from disposal of property. Further consideration is required to consider how to word the exemption to avoid unintended consequences. The Income Tax Act, for example, does not define a shareholder's current account. Officials will consider the issue for inclusion in a future tax bill.

Recommendation

That the submission be noted.

Issue: Withdrawals from KiwiSaver and complying superannuation funds

Submission
(New Zealand Institute of Chartered Accountants)

NZICA supports the amendment made for KiwiSaver and complying superannuation funds (CSFs) which stops withdrawals from these schemes being included in taxable income for the purposes of calculating family scheme income.

The amendment should also apply to other superannuation schemes in which members are locked in until retirement and may only exit the scheme in defined circumstances.

Comment

The existing Working for Families (WFF) rule prevents people from diverting employment income into superannuation schemes (and later receiving it as a tax-free distribution) to maximise their entitlement to tax credits. The rule addresses situations when a person's taxable income is apparently reduced by channelling income through these schemes. It is of an anti-avoidance nature and is aimed largely at situations in which the employer, employee and scheme are closely connected.

The rule applies only when the individual continues to work for the employer after the distribution. Many employer-based superannuation schemes make distributions only after the person has left employment – for example, as retirement or serious (terminal) illness benefits. These distributions are not included in family scheme income under the current rule and so these individuals are not affected by the amendment proposed in the bill.

The amendment overrides the WFF rule in order to support early withdrawals that are a deliberate design feature of KiwiSaver – for example, the first home withdrawal facility. Counting distributions made under the first-home withdrawal facility as family scheme income, and thereby reducing WFF tax credit entitlements, is not consistent with the KiwiSaver objective of encouraging home purchase nor the WFF objective of supporting day-to-day living expenses.

These early withdrawal features are heavily prescribed in KiwiSaver legislation, and are carefully regulated. Other employer-based superannuation schemes that allow early withdrawals do so in circumstances permitted by their trust deed which may not be as prescribed as those under the KiwiSaver and CSF rules. It is these early withdrawal situations that the WFF anti-avoidance rule is aimed at; restricting this amendment to KiwiSaver and CSFs provides an appropriate balance between the policy intention of WFF tax credits and the KiwiSaver policy for permitted early withdrawals.

Recommendation

That the submission be declined.

GST AND LATE PAYMENT FEES

Clause 137

Issue: The changes extend the scope of GST

Submissions
(PricewaterhouseCoopers, KPMG, New Zealand Institute of Chartered Accountants)

The proposed amendment to charge GST on late payment fees should not go ahead. Charging GST on late payment fees is contrary to the policy intent of the Goods and Services Tax Act 1985, which is to impose GST on the supply of goods and services. Late payment fees are not consideration for the supply of goods and services.

Comments

New Zealand has a broad-based GST. The over-arching policy behind this broad base is that supplies of goods and services should be subject to GST unless they are specifically excluded.

A flat late payment fee can be viewed as the on-charging of administration costs that a business incurs in chasing payment for the underlying taxable supply. In this respect, it is in effect an increased charge for the goods and services provided and should be subject to GST in the same way as the underlying supply. This can be contrasted with interest imposed on an outstanding amount, which represents the time value of the money unpaid. The interest is analogous to interest charged on borrowed money (in this case the money the customer retains rather than paying the bill on time) and is therefore GST-exempt.

By defining this boundary with more certainty, the proposed change will afford businesses the clear choice between charging a flat-fee for late payment (with this fee being subject to GST) or charging exempt penalty interest. Which method is chosen will be a business decision that can be made on a clearer understanding of the GST consequences for both the business and its customer base.

Charging GST on late payment fees also provides consistency with transactions involving prompt payment discounts – GST being built in as a charge in those transactions if payment is late.

Recommendation

That the submissions be declined.

Issue: Application date of the amendment

Submissions

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

The proposal should only apply prospectively. Retrospective application is inequitable as it disadvantages taxpayers who have historically accounted for GST on late payment fees vis-à-vis taxpayers who have not. *(PricewaterhouseCoopers)*

The application date of the savings provision should be extended to:

- 1 April 2013. *(Corporate Taxpayers Group)*
- The start of the taxpayer's next income year. *(New Zealand Institute of Chartered Accountants)*
- The first GST period commencing after the date of enactment. *(New Zealand Institute of Chartered Accountants)*

Comments

Officials are concerned that making this change prospective could result in numerous back-claims of GST charged on late payment fees over the last eight years. This would result in refunds of approximately $13.8 million for these periods. Unless the businesses concerned were to repay these refunds to the individual customers that are likely to have suffered the GST impost, such refunds will be windfall gains to the businesses at the expense of the Crown.

The proposed amendment will confirm that businesses that charged GST did the correct thing, while also saving the position of those businesses that, in good faith, did not charge GST over this period. The savings provision was intended to allow affected businesses the time to update their systems.

Officials do, however, accept that the proposed effective date of 1 April 2012 is administratively unworkable, given the likely progression of this bill through the remainder of the legislative process. Submissions seeking a delayed effective date are premised on the basis that businesses will need time following enactment of the bill to update their systems. Officials consider that an effective date of 1 January 2013 would be sufficient lead-in time to address these concerns.

Recommendation

That the retrospective application date and savings provision remain in place, but the effective date for the proposed amendment (and, correspondingly, the length of the savings provision) be extended to 1 January 2013.

Issue: Definition of "late payment fees" and the boundary between "late payment fees" and "penalty or default interest"

Submissions

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

The proposed legislation should explicitly exclude interest charges from late payment fees. *(Corporate Taxpayers Group)*

A specific definition of "late payment fee" is required to remove the ambiguity between such fees and the "penalty or default interest" concept in section 14(3)(a) of the GST Act. *(New Zealand Law Society)*

Guidance on the boundary between the late payment fee clause and penalty or default interest under section 14(3)(a) is required. *(New Zealand Institute of Chartered Accountants)*

Comment

It is not intended that clarifying the GST position of late payment fees will in any way narrow the scope of the penalty or default interest exemption in section 14(3)(a). To the extent that penalty or default interest is charged, it would not be caught by the proposed provision.

The key distinction is between interest charges (which are exempt) and other late payment fees (which should be subject to GST). Officials consider this distinction will be obvious in most cases. Attempting to define "late payment fee" could, as with many definitions, create additional confusion. This could particularly be the case when a fee falls outside of any definition proposed but still could not easily be categorised as "interest".

However, in order to avoid confusion, officials recommend that the proposed charging provision in clause 137 of the bill be made explicitly subject to the "penalty or default interest" exemption in section 14(3)(a) of the GST Act.

To the extent that there is some confusion between "penalties" and "penalty interest", officials agree that clarification would be useful. More specifically, there should not be scope for businesses to avoid charging GST on late payment fees simply by labelling them as "penalties" instead.

Recommendations

That the submissions be accepted to the extent that clause 137 be made subject to section 14(3)(a). Clarification should also be made to ensure that non-interest penalties, however labelled, fall within the scope of the proposed provision.

Issue: Late payment fees linked to the underlying supply

Submissions
(Corporate Taxpayers Group, New Zealand Law Society, KPMG, New Zealand Institute of Chartered Accountants)

To be consistent with policy, the legislation should specifically exclude GST from applying to late payment fees when the underlying supply is outside the scope of GST – for example, if the underlying supply is an exempt supply of financial services.

Comment

Officials consider late payment fees to be, in effect, an increase in consideration for the underlying goods and services to reflect the non-payment of an invoice. On this basis, if the underlying supply does not attract GST, or is zero-rated, the tax treatment of the late payment fee should be consistent with that. The bill should be amended to reflect this.

Recommendation

That the submissions be accepted.

Issue: Time of supply and invoice requirements

Submissions
(KPMG, Corporate Taxpayers Group)

It is not clear from the draft legislation that a new time of supply will arise, and this should be clarified. *(KPMG)*

There should be no requirement for a separate tax invoice to be issued in respect of the late payment fee. *(Corporate Taxpayers Group)*

Comments

The default position under the GST Act is that a time of supply will arise at the earlier of an invoice being issued or payment received. Officials consider that this default rule should adequately cater for late payment fees. Take, for example, a supplier that charges a late payment fee of $20 plus GST. If a customer fails to pay their bill on time for a month, the late payment fee will presumably be added to their invoice for the following month. The issuing of this subsequent month's invoice will trigger a time of supply for the late payment fee (unless of course the customer has proactively paid the fee before receiving their invoice).

The fact that a subsequent invoice is likely to be provided as a matter of course should also address the issue of whether a separate invoice for a late payment fee is necessary. Therefore, officials do not consider that a legislative exclusion from the invoicing requirements is necessary.

Recommendation

That the submissions be declined.

Issue: Ease of avoidance and fiscal implications

Submission
(Matter raised by officials)

The Committee asked officials to comment on how easily the proposed rule could be avoided and how the proposed amendment would affect the Government's fiscal position.

Comment

As noted by Committee members, GST on late payment fees could be avoided by businesses switching to a penalty interest regime for unpaid amounts (penalty interest being exempt from GST). However, as any GST on late payment fees will ultimately be borne by the customer, businesses may find it easier simply to on-charge the GST on these fees rather than going to the expense and effort of adopting different systems. As officials understand it, the majority of businesses that currently charge late payment fees do so on a plus-GST basis, despite the argument being potentially available that GST is not required to be charged.

It is anticipated that the proposed change will clarify for businesses the GST consequences of both options, so their choice can be an informed one.

The fiscal impact of the proposed amendment is an estimated increase in GST revenue of approximately $2.5 million per year. As previously noted, making the change retrospective ensures a further $13.8 million is not lost to the tax base through potential windfall gains.

Officials acknowledge that a behaviour shift from businesses away from late payment fees towards a penalty interest model will impact on the $2.5 million, but note that the main purpose of the proposed amendment going forward is to provide clarity for businesses and customers rather than raise significant revenue.

Recommendation

That the submission be noted.

Issue: Other matters

Submission
(PricewaterhouseCoopers)

In a business-to-business context, any GST charged on late payment fees will be deducted by the customer. Therefore, there is no revenue risk in that regard.

Comment

Officials agree with this statement, but note that there is a revenue risk when the GST is charged to non-registered persons.

Recommendation

That the submission be noted.

Submissions
(PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)

A lack of clarity around the existing rules is no reason to change the law. *(PricewaterhouseCoopers)*

Inland Revenue could clarify the issue by releasing an interpretation statement confirming late payment fees are not subject to GST. *(PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)*

Comment

As previously stated, officials consider that the broad-based nature of New Zealand's GST rules and their link to an underlying supply of goods and services suggest that late payment fees should be subject to GST. "Clarifying" the law to the opposite effect would therefore be contrary to what is, in officials' view, the best policy outcome.

Recommendation

That the submissions be declined.

LIQUIDATORS AND RECEIVERS CHANGING GST ACCOUNTING BASIS

Clause 140

Issue: Fiscal cost does not justify new rule

Submission
(PricewaterhouseCoopers)

The overall fiscal cost (estimated at $2.5 million) of allowing liquidators, receivers and voluntary administrators to switch accounting basis does not justify the new rule which will create an asymmetry in some situations. The policy objective is based on the assumption that there will be a negative impact on the Government's tax base if GST refunds are paid to liquidators and receivers.

The submitter notes that this may not always be the case, as suppliers on the invoice basis should already have accounted for output tax. Therefore, to ensure neutrality in these situations, liquidators and receivers should be entitled to claim GST deductions.

Comment

If a registered person meets certain conditions – for example, when the total value of taxable supplies for a 12-month period has not exceeded, or is not likely to exceed, $2 million, the registered person may account for GST on a payments basis. The majority of registered persons (approximately 80 percent) account for GST using the payments basis. The GST Act allows registered persons who are accounting for GST on a payments basis to change to the invoice basis by applying to the Commissioner. There are currently no restrictions on registered persons making this accounting basis change.

It has become standard practice for liquidators and receivers to adopt the invoice basis for accounting for GST, immediately upon becoming a liquidator or receiver of a registered person that accounts for GST on a payments basis. Moving to an invoice basis allows the liquidator or receiver to claim input tax credits for supplies received for which no payment has been made. A change of accounting basis for insolvent firms will typically give rise to a refund because a firm in this condition will generally have more unpaid suppliers than customers who have not paid them.

The current practice does not seem to have a non-tax commercial purpose other than to generate GST refunds.

The amendment precludes liquidators, receivers and voluntary administrators switching from the payments basis to the invoice basis when accounting for GST; they will still receive a tax credit for any supplies they pay for and therefore GST will not be overpaid.

If the supplier is on the invoice basis and has accounted for the sale and writes off all or part of the debt, they can make a credit adjustment in their GST return. This ensures neutrality.

Example

Cook accounts for GST on a payments basis.

Cook purchases goods from Baker. Cook is not entitled to a GST input tax credit until the goods are paid for.

Cook cannot pay for the goods because it is insolvent, and a liquidator is appointed. If the liquidator moved Cook to the invoice basis, an input tax credit could be claimed, even though the goods have not been paid for.

If Cook remained on the payments basis and paid for the goods, they could claim an input tax credit.

Baker is on the invoice basis.

Baker has paid output tax on Cook's purchase to Inland Revenue.

If Cook does not pay for the goods and Baker writes off the debt, Baker can claim back the tax from Inland Revenue.

Recommendation

That the submission be declined.

Issue: Amendment results in a "super-preference" for Inland Revenue

Submissions

(C & C Strategic Limited, Coalition of Insolvency Practitioners, Fisher White and Associates Limited, Gerry Rea Partners, Restructuring Services Limited)

The bill adopts a position that Inland Revenue should have a "super-preference" for GST, in priority to all other claims, including employees' wages and other taxes such as PAYE, cutting across well-established and carefully considered principles of both insolvency and GST law. *(Coalition of Insolvency Practitioners)*

The bill entitles Inland Revenue to GST for all income without offsetting GST on creditors that were used to earn that income. This creates a "super-preference" for Inland Revenue contrary to schedule 7 of the Companies Act 1993. It puts Inland Revenue ahead of employees' final pay, back pay, and holiday pay, denying many employees the chance of a pay-out. The social cost of this is will be borne by the taxpayer and affected families. *(Fisher White and Associates)*

The submitter cannot support the amendment because of the serious effect which the proposed change would have on the equitable entitlements of Inland Revenue, employees and secured and unsecured creditors in liquidations and receiverships.

The proposed clause will have the effect of artificially inflating the preferential GST claim of Inland Revenue in liquidations and receiverships of distressed companies which have been returning GST on the payments basis permitted by the GST Act. This will be achieved to the detriment of all other creditors including employees, who will receive a lower distribution than their equitable entitlement under the Companies Act 1993. *(C & C Strategic Limited, Gerry Rea Partners, Restructuring Services Limited)*

Comment

A super-preference is not being created. Schedule 7 of the Companies Act 1993, which sets out the creditors who have preferential claims in cases of liquidation, is not being amended.

Approximately 80 percent of registered persons account for GST using the payments basis. It has become standard practice on appointment for liquidators and receivers to adopt the invoice basis allowing the liquidator or receiver to claim input tax credits for supplies received for which no payment has been made. Inland Revenue has no concerns with the fees charged by insolvency practitioners (and if it did, as noted by submitters, there are other avenues for addressing such concerns). Rather, the amendment is aimed at ensuring the GST system is not used to fund liquidations.

The amendment maintains the status quo by preventing an insolvent firm changing its GST accounting basis from the payments basis to the invoice basis. These firms have typically been on the payment basis for their entire lifetime and a change is sought only in their wind-up phase. This change seems to have no non-tax commercial basis other than to generate a GST refund.

Recommendation

That the submissions be declined.

Issue: Funds used to finance liquidations

Submissions
(Coalition of Insolvency Practitioners, HFK Limited)

The clause as drafted is a knee-jerk and disproportionate reaction to an incorrect perception that GST refunds post-insolvency are being used for the purpose of inappropriately funding insolvency practitioners. This perception is without a factual basis. Even if some insolvency practitioners have sought to change the GST basis inappropriately, the issue of whether the amendment is appropriate needs to be carefully thought through, particularly given the regulation of insolvency practitioners that is already proposed in the context of the Insolvency Practitioners Bill. *(Coalition of Insolvency Practitioners)*

If liquidators are unable to access the GST refund to fund their investigations, liquidators will refuse to accept these appointments unless the petitioning creditor agrees to fund the liquidator's time cost fee for undertaking investigations and taking action against the company or its directors and shareholders. Being unable to access this "fighting fund" may result in liquidators refusing to accept appointments unless funding is provided by their appointer. *(HFK Limited)*

Comment

Officials consider that it is not the purpose of the GST system to fund liquidations or receiverships. Liquidations and receiverships have been around long before GST was introduced. Providing a "fighting fund" for liquidators and receivers should not be a by-catch of the GST system.

The funding of liquidators and receivers is a separate issue from the administration of GST. The submissions note that more cases will be referred to the Officials Assignee and that petitioning creditors will have to fund liquidations. Officials consider that the funding of liquidations should be transparent – for example, if Inland Revenue is a petitioning creditor, the funding should be directly from Inland Revenue and not via the GST system.

Recommendation

That the submissions be declined.

Issue: There may be other reasons for changing the accounting basis

Submissions
(Coalition of Insolvency Practitioners, HFK Limited, New Zealand Law Society)

The amendment draws an artificial line, and one which on particular facts may not be appropriate. There may be genuine commercial reasons for a liquidator or receiver requesting a change in the GST accounting basis.

Comment

The current practice of changing the GST accounting basis does not seem to have a non-tax commercial purpose other than to generate GST refunds. In many cases liquidators and receivers are dealing with firms who have always been on the payments basis and only when the liquidator or receiver is appointed is a change sought.

Officials note the amendment does not alter the ability to obtain a tax credit under the payments basis – that is, if a supplier is paid by a liquidator or a receiver, a GST refund could still arise and GST will not be overpaid.

Recommendation

That the submissions be declined.

Issue: Amendment is not necessary because the Commissioner already has a discretion to deny application for change

Submissions
(HFK Limited, New Zealand Law Society)

The amendment may not be necessary as the current wording already provides the Commissioner with the discretion to deny a taxpayer's application to change their accounting basis. *(New Zealand Law Society)*

Rather than barring all liquidators, receivers or administrators from requesting a change of GST accounting basis, allowing the Commissioner discretion would be a middle ground option. *(HFK Limited)*

Comment

The default position for registered persons is that they must account for GST on the invoice basis. However, if certain criteria are met, they can account for GST using the payments basis. Approximately 80 percent (517,000) of registered persons (647,000) use the payments basis to account for GST. Relying on a discretion to stop liquidators, receivers and administrators from switching from the payments basis to the invoice basis would not be a feasible remedy. Officials consider switching the GST accounting basis in such cases should be prohibited.

Recommendation

That the submissions be declined.

Issue: No consultation

Submissions
(Coalition of Insolvency Practitioners, Fisher White & Associates Limited, New Zealand Institute of Chartered Accountants)

The insolvency industry was not consulted about the amendment under the Generic Tax Policy Process. Members of INSOL were consulted. Any INSOL committee members that were approached failed to communicate with membership that the bill existed or that they represented practitioners to Inland Revenue on this matter. Submitters are concerned that a lack of consultation results in the amendment failing to address a number of wider policy issues. *(Coalition of Insolvency Practitioners, Fisher White & Associates Limited)*

This matter should be put out for further consultation and appropriate analysis undertaken by Inland Revenue as part of the Generic Tax Policy Process. *(New Zealand Institute of Chartered Accountants)*

Comment

Officials discussed this issue with representatives from INSOL, the industry group for insolvency practitioners. These submissions would require the amendment to be removed from the bill to allow a further consultation. Given the prior consultation that has taken place and the strong policy basis for reform on this issue, officials do not support this suggestion.

Recommendation

That the submissions be declined.

Issue: Existing invoice basis companies

Submission
(HFK Limited)

The submitter seeks clarification on what is proposed to happen in the situation where the company is already on an invoice basis for accounting for GST at the appointment of the liquidator, receiver or administrator but the company has actually been preparing the GST returns on a payments basis. Is the company still able to get the refund associated with the unclaimed invoices?

Comment

The normal invoice basis rules would apply. If there were an entitlement to a refund, the refund would be given. However, if there were tax shortfalls in previous periods, the registered person could be liable also for use-of-money interest and, if the taxpayer is culpable, shortfall penalties.

Recommendation

That the submission be noted.

Issue: Inland Revenue's debt preference

Submission
(New Zealand Institute of Chartered Accountants)

The creditor preferences enjoyed by Inland Revenue in the Companies Act 1993 for employer-related debts (other than Child Support) and GST debts should not be available when Inland Revenue applies to the Courts to place a taxpayer company in liquidation.

GST should be removed as a creditor preference.

If the Select Committee believes that the above submission is beyond its terms of enquiry for the tax bill, NZICA submits that the Committee recommend that the Government consider this at a later time as a matter of priority.

Comment

Officials note that this submission raises issues that are separate to the issue of change of GST accounting basis by liquidators, receivers and administrators.

Recommendation

That the submission be declined.

CREDIT CARD SERVICE FEE AND GST

Clause 133

Issue: GST should apply to the credit card service fee

Submission
(New Zealand Institute of Chartered Accountants)

The scheme of the GST Act is that GST applies to all goods and services unless there are valid reasons from departing from this. We do not see a case for departing from the scheme of the GST Act, which the current wording of the bill would suggest.

Comment

The credit card service fee is not exempt from GST. The current wording of clause 133 "plus any GST" infers that GST does apply, but it is the rate of GST that may vary. For example, an overseas-based taxpayer who opts to pay their income tax debt by credit card will be subject to the credit card service fee plus GST, but because they are not resident in New Zealand, the rate at which GST is charged will be zero. Alternatively, a resident taxpayer who pays their income tax debt by credit card will be subject to the credit card service fee plus GST at a rate of 15%.

Recommendation

That the submission be noted.

Issue: Absorption of the credit card service fee

Submission
(New Zealand Institute of Chartered Accountants)

The fee of 1.42% should be absorbed by the Government.

Comment

The credit card service is one of many forms of payment options for domestic-based taxpayers. Taxpayers can choose whether to use this service and, in some cases, receive additional benefits (in the form of interest-free periods and travel points from credit card providers). The Commissioner will continue to charge the fee for domestic taxpayers who choose to use this service.

Recommendation

That the submission be declined.

OTHER GST MATTERS

Issue: Definition of "land"

Clause 135

Submissions

(New Zealand Law Society, Russell McVeagh, Matter raised by officials)

The exclusion from the zero-rating rules for certain transfers of interest in land should be contained in the zero-rating provisions themselves rather than being part of the "land" definition. *(New Zealand Law Society)*

Irrespective of where the exclusion is located, there are drafting issues that need to be addressed. In particular, the quantum of payments that triggers the zero-rating rules needs to be clearly set out. *(New Zealand Law Society, Russell McVeagh)*

Clarifications should be made to ensure that zero-rating applies to payments in respect of the assignment or surrender of a lease. *(Matter raised by officials)*

Comment

The clause is designed to ensure that taxpayers cannot circumvent the rules that zero-rate land transfers by making lump-sum payments under non-standard rental agreements. Broadly speaking, the intended effect of the provision is that if an up-front payment of more than 25 percent of the total rental is made in advance, the lease will be zero-rated. Officials and submitters agree that the policy behind the amendment is sound.

Officials agree with the New Zealand Law Society that the zero-rating rules should apply to the transfer of interests in leases, because these transactions have the potential to involve large lump-sum payments.

For the same reasons, officials submit that the zero-rating rules should be clarified to ensure that they apply to payments made for the assignment or surrender of leases. There is concern that, for example, a taxpayer could enter into a lease transaction and, almost immediately, receive a large payment to assign or surrender that lease. Such an arrangement, if standard-rated, could give rise to the type of arrangement that the zero-rating rules were designed to prevent.

Submitters are also concerned that the proposed drafting makes it difficult to be sure what quantum of up-front payment would trigger the zero-rating rules. In particular, there is concern that, under the current drafting, any upfront payment would result in zero-rating. The New Zealand Law Society also submits that the link to 25 percent of the total consideration specified in the lease is difficult to determine – particularly in the case of rolling or periodic leases when the "total consideration" can be unclear at the outset. Their preference is therefore to replace the "total consideration" test with one based on the lesser of a year or the agreed term of the lease.

Officials agree that only leases involving lump-sum payments that represent 25 percent or more of the lease payments should be zero-rated. The New Zealand Law Society submission that the threshold be set at 25 percent of annual lease payments (or the total lease if it is shorter than one year) is attractive for its simplicity. However, officials are concerned that such a rule might inadvertently affect commercial arrangements such as the payment of a deposit.

To clarify the effect of the provision, officials consider that the 25 percent should relate to the consideration that is the *greater* of one year's payments under the lease or the minimum term of the lease as entered into at the outset. For example, if the parties entered into a two-year lease, with an option to extend for a further two years, the "total consideration" should be the first two-year term. Alternatively, if the parties entered into a monthly lease with no fixed term, the lease should be standard rated unless there is an upfront payment of 25 percent or more of what would be the first year's rental payments.

In addition, officials consider that the provision should be clarified so that it only applies to payments that are not themselves regular payments under a lease. For example, if a one-year lease was entered into with quarterly payments, the payments should not be zero-rated, even though each one represents 25 percent of the total consideration. As mentioned above, the zero-rating rules are designed to cover non-standard rental payments that could be seen, at least in part, as the economic equivalent of freehold transfers.

Officials agree that the exclusion for lease payments could be moved out of the land definition to provide a distinction between interests in land and transactions involving land.

Recommendation

That the submission regarding moving the relevant paragraph to the "land" definition be accepted.

That the effect of the submissions regarding the clarity of the test be accepted, except the New Zealand Law Society's proposed annual lease payments test should be varied in the manner set out by officials.

Issue: Concurrent supplies

Clause 146

Submission
(New Zealand Institute of Chartered Accountants, KPMG)

The proposed drafting still does not clarify how the concurrent use of land rules would apply to, for example, land or common areas that are divided amongst taxable and non-taxable use.

Comment

Officials agree that there is potential confusion over the application of the concurrent use rules. The situations described in the submission are:

- common areas of an activity that is both taxable and exempt, such as communal areas in a residential rest home; and
- a building that is divided into taxable and exempt activities, such as a warehouse with an apartment on top.

The concurrent use of land rules are not designed to cater for these situations, which are more appropriately dealt with through the general apportionment rules. Instead, the concurrent use rules are in place to deal with a very specific fact situation.

Given the level of confusion, officials consider it would be preferable to spell out in the GST Act the scenario at which the provision is aimed: when the same piece of land is used both for the exempt purpose of residential rental while simultaneously being marketed for disposal as part of a taxable activity. Setting this scenario out in legislation should provide the clarity submitters are seeking, while also providing a clearer boundary between the concurrent use of land rules and the general apportionment rules.

Recommendation

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

Issue: Goods and services acquired before 1 April 2011

Clause 148

Submissions
(New Zealand Institute of Chartered Accountants, Matter raised by officials)

The old apportionment rules should apply to assets that were zero-rated before 1 April 2011 and not adjusted before that date. *(New Zealand Institute of Chartered Accountants)*

Clause 148 and section 21H of the GST Act should be redrafted to clarify when the old and new apportionment rules, respectively, apply to an asset. *(Matter raised by officials)*

Comment

Officials agree that supplies that were zero-rated prior to 1 April 2011 and not adjusted before that date should be subject to the old apportionment rules. As a matter of consistency, it can be argued that the new apportionment rules should apply, as the new rules would apply if the supply in question had not been zero-rated but had instead been fully taxable. However, allowing the use of the old apportionment rules is a pragmatic solution that should provide certainty and lower compliance costs for businesses.

As drafted, there is potential confusion over the application of section 21H, which is intended to clarify the application of the old and new apportionment rules. Section 21H(1) provides that the section only applies to an asset that has been adjusted under the old apportionment rules. Proposed section 21H(2B) then sets out the treatment for assets that have not been so adjusted. The assets affected by subsection (2B) are not a subset of those set out in subsection (1). As a result, it is possible to interpret subsection (2B) as having no effect. This is not the desired outcome and redrafting section 21H to clearly accommodate both situations is therefore recommended.

Recommendation

That the submissions be accepted.

Issue: GST groups and information obligations

Submission
(Russell McVeagh)

As currently drafted, it is not apparent how the obligations to provide information for land transactions apply to registered persons that are part of a GST group, but not the group's representative member. The legislation should specify that the provision or receipt of the necessary information by any group member should be treated as the provision or receipt by the representative member.

Comment

Officials agree that clarity in this area would be useful. Given that the taxable activity of each group member is treated for GST purposes as if it were carried on by the representative member, it makes sense that the required information should also be treated as being provided or received by the representative member. This will ensure the information is treated as being given and received by the person that is actually registered for GST and will be completing the requisite returns.

Recommendation

That the submission be accepted.

Issue: Agents and information obligations

Submission
(Russell McVeagh)

The requirement to provide information as part of the zero-rating for land provisions should apply to all agencies, not just undisclosed agencies.

Comment

From an administrative perspective, it is generally preferable for the information provided as part of a land transaction to relate directly to the parties who are the actual supplier and recipient of the goods and services. The rules that cater for purchases made by agents for undisclosed principals are a concession from this general position to reflect the commercial reality of these transactions.

Officials do not consider that these concessionary rules should be extended to all agency situations. In a "disclosed" agency, the parties should have no objection to the details of the principal, rather than the agent, being provided to the counterparty.

Recommendation

That the submission be declined.

Issue: Tax fraction for secondhand goods

Clause 145

Submission
(Matter raised by officials)

The secondhand goods input tax deduction available should be limited to the tax fraction that was in place at the time the goods were acquired.

Comment

Clause 145 clarifies that a person will be able to claim input tax deductions when they acquire the goods or services before becoming registered and later use those goods or services as part of their taxable activity. This deduction will be available when the person has paid GST on the goods and services under section 8(1) of the GST Act or on the import of goods under section 12(1). Both of these deductions are limited to "tax charged", being the tax actually paid by the person when they acquired the goods and services. If the goods and services were acquired when the rate of GST was 12.5%, GST at that rate will determine the maximum deduction they can claim.

When a secondhand good is brought into a taxable activity, officials consider that the input deduction available should similarly be limited to the tax fraction in place when the goods were acquired. To do otherwise would effectively afford secondhand goods favourable treatment over similar goods that were acquired on a plus GST basis.

Officials do not consider this amendment would place an undue compliance costs on businesses, because they already need to have documentary evidence to support any claim for a secondhand goods deduction. Under section 24(7), this evidence must include the date on which the goods were purchased. Given the GST rate has only changed twice since its introduction and on clearly defined dates, identifying the relevant tax fraction should be relatively simple.

Recommendation

That the submission be accepted.

Issue: Application of new apportionment rules

Submission
(New Zealand Institute of Chartered Accountants)

The GST Act should be amended to allow all registered persons to apportion GST for goods and services acquired after 1 April 2011 under the new apportionment rules. Amendments to clarify this should be retrospective. The Income Tax Act should allow small businesses to incorporate the GST apportionment ratio to adjust for private use, rather than having to account for fringe benefit tax.

Comment

Officials are aware that there is some potential confusion regarding the scope of the new apportionment rules – in particular, their application to non-individuals – and are looking at this as part of an existing item on the Tax Policy Work Programme. Given the timeframe for the current bill and the potential breadth of any changes in this area, officials will continue to review the scope of these rules with a view to including any changes considered necessary in the next available tax bill.

The potential for small businesses to use the GST apportionment rules to account for income tax in lieu of using the fringe benefit rules is not a matter being considered in the current bill, but is noted.

Recommendation

That the submission be noted.

Issue: GST treatment of land used for taxable and exempt purposes

Submission
(New Zealand Institute of Chartered Accountants)

Sections 5(15) and 20(3J) of the GST Act should be amended to confirm that the supply of a dwelling included in the supply of land is a separate supply and therefore treated as an exempt or non-taxable supply.

Comment

This is an interpretative issue that Inland Revenue has not reached a final view on. Once the position under the current provision has been clarified, Inland Revenue will communicate its position and recommend a legislative amendment if required. It is not necessarily the case that the current wording does not achieve the desired policy outcome.

Recommendation

That the submission be noted.

Issue: Drafting matters

Clauses 141, 145 and 152

Submissions
(Russell McVeagh, BDO)

The wording of clauses 141 and 152 should be amended to provide more clarity and consistency with other drafting in the GST Act. Consequential amendments to sections 78F(7), 73(3D) and 75(3E) of the GST Act would also aid clarity. *(Russell McVeagh)*

Clause 145 allows input tax claims for certain secondhand goods. However, section 21B(3) of the GST Act should also be updated to refer to the record-keeping requirements for secondhand goods. *(BDO)*

Recommendation

Officials agree that the drafting suggested in the submissions would be beneficial and recommend that the submissions be accepted.

Issue: Deductible output tax

Clause 88(3)

Submission
(New Zealand Institute of Chartered Accountants)

The amendment is supported but internal processes should be improved to prevent this sort of oversight from occurring. Alternatively a framework should be established to correct these errors more quickly.

Comment

The recent change to the GST apportionment rules prompted the introduction of a new defined term in the Income Tax Act 2007, "deductible output tax". As part of the creation of that definition, a type of GST output tax that was deductible under the old rules was not carried over into the new definition. The proposed amendment clarifies that the relevant output tax is deductible and makes the change retrospective to avoid any possible confusion about the correct position in the intervening period.

Recommendation

That the submission be noted.

Issue: GST – secondhand goods input tax credit

Submission
(New Zealand Institute of Chartered Accountants)

NZICA broadly supports the amendment but proposes a change to the drafting.

Comment

The provisions in new section 3A(2)(b) of the GST Act are intended to be read together as one provision, and therefore adding the word "not" to the second subparagraph as proposed by the submitter would change the intended outcome rather than correct it. Officials do agree, however, that the provision can be made clearer and will provide alternative wording.

Recommendation

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

Other matters

APPLICATIONS FOR OVERSEAS DONEE STATUS

Clause 91

Submission
(Deepavali Charitable Trust)

The overseas donee status of the four charitable entities to be added to Schedule 32 should be effective either from 1 April 2012 or from the date of Royal assent.

Comment

New Zealand organisations that support activities overseas and want their donors to be eligible for tax relief must be listed in Schedule 32 of the Income Tax Act 2007. The bill provides that four charitable organisations be added to Schedule 32, with donee status effective from 1 April 2013.

Officials consider that the application date of 1 April 2013 is appropriate. Additions to the list of overseas donee status have historically applied from the start of the income year. This is because the tax credit available for charitable donations is based on the donor's annual taxable income.

Officials do not support applying the changes from 1 April 2012 because donations made previously would qualify for donation tax credits, although donation receipts were not issued on that basis. Similarly, if a part-year application date applies, donors would have to identify whether donations were made after the date of Royal assent when claiming a donation tax credit at the end of the income tax year. This exposes donors to the risk of mistakenly claiming tax credits when no legal entitlement exists, and could be particularly problematic if a charitable organisation issues annual donation receipts.

Recommendation

That the submission be declined.

NON-RESIDENT FILM RENTERS' TAX

Clauses 5, 12, 19, 56, 68, 72, 84, 88, 91, 92 and 93

Submissions
(KPMG, New Zealand Institute of Chartered Accountants)

The proposal to repeal the non-resident film renters' tax regime is not remedial in nature and therefore should be deferred pending further consultation through the Generic Tax Policy Process (GTPP).

The ambit of the non-resident film renters' tax regime may be wider than the definition of "royalty" in the Income Tax Act 2007. *(New Zealand Institute of Chartered Accountants)*

Comment

This proposal replaces the effective tax rate of 2.8% on income derived by non-resident companies renting films in New Zealand with non-resident withholding tax (NRWT). The standard NRWT rate on royalties is 15%; however, the rate applying to most non-resident film renters would be 5% or 10% under New Zealand's double tax agreements.

The proposal was consulted through the GTPP as part of the Government discussion document, *New Zealand's International Tax Review: a direction for change,* released in December 2006. Officials have also recently been in contact with those who made submissions on the discussion document about the proposal.

The definition of "royalty" in section CC 9 of the Income Tax Act is widely drafted; for example, a payment for an outright sale of property is a royalty if the amount of the payment is based on the use of the property by the purchaser. Therefore, practically all amounts received by a non-resident that are currently subject to the non-resident film renters' tax regime will come within the "royalty" definition and be subject to NRWT. The treatment of a specific transaction, however, is dependent on its particular facts.

Recommendation

That the submissions be declined.

TIMING OF DETERMINING SERIOUS HARDSHIP

Clause 131

Submission
(New Zealand Institute of Chartered Accountants)

The amendment should be applied retrospectively to 1 December 2002.

Comment

The amendment ensures that when a taxpayer applies for serious hardship, the financial position considered by Inland Revenue is the financial position at the date the application for relief is made rather than at the time the tax became due. The debt rules in the Tax Administration Act 1994 apply from 1 December 2002. In the period from 1 December 2002 to the enactment of this bill, there may be cases when serious hardship was determined at the time the tax became due rather than at the time the taxpayer applied for relief. Therefore, officials recommended that the amendment apply from the date of enactment of this bill.

Recommendation

That the submission be declined.

RATE FOR EXTINGUISHING TAX LOSSES WHEN TAX IS WRITTEN OFF

Clause 132

Issue: Support for the amendment

Submission
(KPMG)

The submitter supports the proposal for Inland Revenue writing off tax losses at 28% (the company tax rate), when the taxpayer is a company. This matches the benefit a company would otherwise receive from use of such losses.

Recommendation

That the submission be noted.

RWT WITHHOLDING CERTIFICATES

Clause 105

Submission
(New Zealand Institute of Chartered Accountants)

The submitter supports the proposal to retrospectively clarify that interest payers can make RWT withholding certificates available on their websites, as long as the recipient agrees to receive the certificate in that way.

Recommendation

That the submission be noted.

RWT EXEMPTION CERTIFICATES

Submission
(New Zealand Institute of Chartered Accountants)

Taxpayers who have RWT exemption certificates should not be required to reapply every year. The period that the certificate applies for should be extended.

Comment

Taxpayers who have been issued with a certificate of exemption are not required to have RWT withheld on their interest or dividend income. Taxpayers can apply to Inland Revenue for a certificate of exemption if they meet certain criteria (for example, if they are a bank, or if they earned over $2 million in their last income year and complied with their filing obligations).

In most cases, Inland Revenue does not impose time limits on certificates of exemption. However, in certain limited circumstances Inland Revenue issues certificates of exemption for only one year. These circumstances are:

- The taxpayer expects that their income will be above $2 million.
- The taxpayer expects to have losses for a specific period of time.
- The taxpayer expects to get an RWT refund of over $500 for a specific period of time.

Taxpayers are required to provide certain information if they have been issued a certificate of exemption for one of these reasons.

If a taxpayer is granted a certificate of exemption on the basis that they expect their income to be above $2 million in the following year, it is reasonable that this is checked by Inland Revenue. (If the taxpayer did in fact earn above $2 million in that year, they would be issued with a certificate of exemption without a time limit.)

Inland Revenue can grant a certificate of exemption for a specific period of time if the taxpayer expects to have losses or to get an RWT refund of over $500 for that period. In these cases, the taxpayer is required to show budgeted accounts for the period. Taxpayers generally provide Inland Revenue with budgeted accounts for only a single year, which means that a certificate of exemption can be granted for only a single year.

Given the above, officials consider that the current administrative practice is reasonable.

Recommendation

That the submission be declined.

EMPLOYER SUPERANNUATION CONTRIBUTION TAX

Submissions

(Investment Savings and Insurance Association, KPMG)

Employers should have the option of applying progressive rates of employer superannuation contribution tax (ESCT) to employer superannuation contributions made on behalf of past employees.

Comment

Under the progressive ESCT rate structure, the contributing employer usually calculates the ESCT rate for each employee by reference to their salary or wages from that employment for the previous tax year. The aim is for employer superannuation contributions to be taxed at a proxy rate which is broadly equivalent to the employee's marginal tax rate on their salary and wage income. In establishing the ESCT rate, the contributing employer does not have to consider any income that is not from that employment – for example, investment income or income from any other employment the employee may have. This is largely for practical and compliance reasons, as it enables the contributing employer to use information it already has available to select the right rate.

In its current form, the progressive rate structure cannot be applied to past employees, for whom, by definition, the contributing employer does not have salary or wage information. So if the current method were applied, it would tend to lead to past employees being categorised within the lower ESCT rate bands, regardless of their actual current marginal tax rate.

Both submitters refer to employers who have often applied the progressive rates of ESCT to contributions made on behalf of past employees. Officials are aware of some recent approaches to Inland Revenue seeking to adopt a progressive rate approach, but are not aware that it has actually been used in practice.[2] Applying ESCT at a flat rate of 33% to contributions for past employees has been the generally accepted and long-standing practice of employers, practitioners and Inland Revenue.

Officials had considered the submitters' suggestion of linking the ESCT rate to a past employee's current total income instead. However, this would create a different basis on which to calculate the ESCT rate for contributions made on behalf of past employees vis-à-vis existing employees, for whom non-salary and wage income is ignored. It would require the past employee to provide his or her contributing employer with income information at the start of each tax year, which would impose a high compliance burden on employers and their past employees.

[2] To be certain that taxpayers are not disadvantaged by the retrospective nature of this amendment the bill contains a "savings" clause which protects the positions previously taken by taxpayers, in the event that any taxpayers have previously not applied ESCT at this flat rate, or have applied fringe benefit tax (FBT) instead.

Using an approach based on the past employee's total income to determine the ESCT rate creates difficulties when employer superannuation contributions are paid "for the benefit of a past employee", but under the terms of the superannuation scheme benefit payments are being made to a dependent, such as a surviving spouse. In this situation it would not be possible to take into account the past employee's income levels, but nor is it appropriate to calculate a progressive rate of ESCT in relation to the employer's superannuation contributions by reference to the spouse's current income.

The submission suggests involving the superannuation scheme in collecting income information from past employees. Although many schemes will contact members at least annually, this contact is not necessarily reciprocal. Further, ESCT obligations apply to employers not superannuation schemes, so it is not appropriate to involve fund managers or trustees in the collection of this income information.

Officials agree with the comment that superannuation contributions in respect of past employees occur almost entirely in the context of a defined benefit scheme. Using a flat ESCT rate will not usually affect the benefits received by scheme members from a defined benefit scheme, as the benefit levels are pre-set. The main reason the employer is required to pay employer superannuation cash contributions for past employees is because there is a scheme deficit in respect of these obligations. That is, insufficient contributions were made during the member's working life to pay the benefits now due. Officials therefore considered the option of linking an ESCT rate to the member's previous salary and wage levels, indexed, but this was considered likely to create a heavy compliance burden.

Officials also note that, at the request of industry representatives, the Income Tax Act 2007 already has a provision to enable employer contributions made to defined benefit schemes to be taxed at a flat ESCT rate of 33%. This is because such contributions are not often easily allocable to any particular scheme member. Instead, they are generally based on an actuarial calculation of future liabilities to pay benefits to all members. Adopting the same flat rate for past employees assures consistency with this approach for defined benefit schemes.

Recommendation

That the submission be declined.

COMMISSIONER'S DISCRETION TO NOT RULE ON SECTION GA 1

Clause 118, new section 91E(3B)

Submissions

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

The Commissioner already has sufficient powers to decline to rule on any concerns that may arise. Sections 91E(3) and 91E(4) of the Tax Administration Act 1994 already give the Commissioner a discretion not to provide a ruling, or to preclude him from doing so, if doing so would require him to determine factual matters, or if insufficient information exists. If a ruling cannot be made without an investigation, the reason it is unable to be made is due to a lack of knowledge of factual matters.

If the Commissioner is able to determine that an arrangement is a tax avoidance arrangement, he should also be able to determine the tax advantage to be counteracted.

The proposed amendment would impose a blanket rule, effectively denying taxpayers the ability to require the Commissioner to rule on section GA 1 of the Income Tax Act 2007. Taxpayers who are prepared to use the rulings process are entitled to a full view of the risk they face if they decide to implement the arrangement. Allowing a discretion on whether to rule on section GA 1 may be detrimental to taxpayers who are denied a ruling and have no way of understanding the consequences of entering into an avoidance arrangement.

The status quo should be maintained as it ensures certainty for taxpayers. The proposed discretion is unjustifiable, unnecessary and should not proceed.

Comment

The purpose of the binding rulings regime is to allow taxpayers who apply for a ruling to obtain certainty on how taxation laws apply to an arrangement disclosed to the Commissioner. In most cases such arrangements will be prospective. However, the rulings regime is not intended be a full-scale audit or investigation of the arrangement and the parties to it. This is a separate process which can result in a tax adjustment by the Commissioner.

If the Commissioner rules that an arrangement is a tax avoidance arrangement, the Commissioner may currently be asked by the applicant to rule on how section GA 1 will apply. Section GA 1 is the reconstruction provision which allows the Commissioner to adjust the taxable income of a person affected by an arrangement in order to counteract a tax advantage obtained under the arrangement.

The proposed amendment would give the Commissioner a discretion to decide not to rule on the application of section GA 1. The proposed discretion is likely to be invoked in a minority of cases because it would require the Commissioner to take a position that an arrangement is avoidance and for a taxpayer (who is still determined to enter into such an arrangement) to seek a ruling on how the reconstruction power will apply. In order to rule on section GA 1, the Commissioner will need to undertake a thorough investigation of the arrangement, including the persons who may be affected by the arrangement, and other likely situations which might have arisen had the tax avoidance arrangement not been entered into. This can often be a lengthy process and rulings are not intended to be investigations or audits, nor is it appropriate or feasible for the Commissioner to handle rulings in that way. Often, because of timing issues, the tax advantage will not have fully crystallised or be able to be properly quantified until a full audit or investigation occurs.

A tax avoidance arrangement may affect more than one person. Accordingly, the Commissioner may need to adjust the taxable income of a number of people in order to appropriately counteract the tax advantages obtained. A taxpayer who is not a party to a tax avoidance arrangement can still be subject to the Commissioner's reconstruction power if they have obtained a tax advantage from the arrangement, even though they may not be aware that they have benefited from the arrangement. These matters can be difficult to determine using the binding rulings regime for complex arrangements involving multiple parties (who may not be applicants). This difficulty will be compounded if this involves prospective arrangements.

If an applicant for a ruling were able to require the Commissioner to rule on section GA 1, the Commissioner would have to rely on information (if obtainable) provided by the applicant about these other persons. The binding rulings regime is not the most appropriate place to determine what corrective adjustments may be required to be made to all taxpayers who have benefited, or would benefit, from a tax avoidance arrangement.

Requiring the Commissioner to make a ruling on section GA 1 may also give rise to a revenue risk should the Courts take a particular view on reconstruction that is less favourable than that obtained by ruling. The binding ruling would still be binding on the Commissioner if the arrangement was entered into, and could still be relied on by a taxpayer.

In addition, officials are concerned that a ruling on section GA 1 could be used to attempt to constrain the Commissioner’s ability to argue on the appropriate reconstruction (following an audit and proper investigation) in the context of the tax disputes process. Given the difficulty of arguments regarding counterfactuals and reconstruction, this may be undesirable.

Given these difficulties, officials do not consider that it will always be feasible or appropriate for the Commissioner to rule in a definitive and binding manner on the application of the reconstruction power. A discretion (rather than a requirement as submitted) is preferred by officials as, in straightforward cases, the Commissioner would be prepared to rule on the application of section GA 1.

The existing powers that the Commissioner has to decline to rule cannot readily be used in the reconstruction context given that the level of enquiry required will be tantamount to requiring an “audit or investigation”.

Recommendation

That the submissions be declined.

ADDITIONAL DECLARATION FOR ADVANCE PRICING AGREEMENTS

Clause 119, new section 91ED(1B)

Submissions
(KPMG, New Zealand Institute of Chartered Accountants)

The proposed amendment is not required and should not proceed. If Inland Revenue has concerns about the completeness of some advance pricing agreement applications and documentation packages, the Commissioner can ask an applicant for further relevant information, or ask an applicant to attend a meeting to answer questions and clarify any uncertainty.

If facts contained in the application are found to be incorrect or if material facts have been omitted, the advance pricing agreement is void, so taxpayers gain nothing from not fully disclosing the relevant background.

It is not clear how this provision will be applied in practice. What is the threshold for meeting the requirement that the information disclosed is comprehensive? This may result in applicants wanting to disclose every single aspect of the transaction, whether relevant to the advance pricing agreement or not.

Comment

The Tax Administration Act 1994 already requires an application for a private ruling to disclose all relevant facts, but in a number of applications the relevant facts are not outlined sufficiently for the purposes of providing a ruling.

The purpose of the proposed amendment is to reduce the number of inaccurate or factually incomplete applications. Advance pricing agreements are fact-intensive and tax agents are often as dependent on information received from the taxpayer as Inland Revenue is.

The amendment therefore requires the applicant, not the agent, to make the declaration as the person who is likely to have knowledge of the full and complete picture.

The applicant will be required to attest that to the best of their knowledge and belief the information which is disclosed for the application is comprehensive. The amendment does not require the applicant to know everything, but is aimed at ensuring the applicant examines the application before it is submitted.

Recommendation

That the submissions be declined.

CLASSIFICATION OF CHANGE TO FEES FOR BINDING RULINGS AND DEPRECIATION DETERMINATIONS AS REMEDIAL

Clauses 172 and 180

Submission
(KPMG)

KPMG supports changing the fee structure for binding rulings to a "plus GST" basis. It also notes that Inland Revenue should be able to set its fees for issuing depreciation determinations having regard to current conditions.

The classification of the changes to the fees charged for binding rulings and depreciation determinations as remedial items is misleading. It could have material financial consequences for taxpayers (as the cost of getting a depreciation determination will more than double) and may affect whether getting a depreciation determination is a viable option.

Comment

The binding ruling fees are being increased slightly, mainly to reflect the GST increase to 15% on 1 October 2010. The depreciation determination fees are being raised to reflect more accurately the costs currently associated with making determinations. The fees for depreciation determinations have not been changed since their introduction in 1993 although the costs of providing determinations have risen.

Recommendation

That the submission be noted.

Issue: Application of the foreign investor tax credit regime to foreign investment PIEs

Submissions
(*KPMG, Fonterra)*

The foreign investor tax credit (FITC) regime should be made available to investors in foreign investment PIEs. This would allow certain non-resident investors to receive similar treatment on imputed dividends earned through PIEs as they would have received if they had made the investment directly.

Comment

The FITC rules allow certain foreign portfolio investors that receive imputed dividends from New Zealand companies to claim credits for NRWT in their own country, while ensuring that New Zealand receives an appropriate amount of tax.

Officials agree that the FITC regime be made available to investors in foreign investment PIEs. Applying the FITC regime to foreign investment PIEs would align the tax treatment of non-resident portfolio investments made through foreign investment PIEs with that of portfolio investments made directly.

Key aspects of the proposal are that:

- the FITC mechanism applies at the level of the company paying the dividend to the foreign investment PIE, rather than the PIE;
- the foreign investment PIE must supply the company paying the dividend the necessary information in order for the company to appropriately apply the FITC rules;
- the FITC mechanism only applies to notified foreign investors that hold less than a 10 percent voting interest in the company paying the dividend and have a tax treaty rate of 15 percent or greater; and
- the mechanism is optional for foreign investment PIEs.

Recommendation

That the submissions be accepted and that this change apply from the 2013–14 income year.

Issue: Definition of the foreign PIE equivalent

Submission
(KPMG)

The foreign investment PIE equivalent definition should be amended to include an Australian managed investment trust (MIT) as a qualifying entity.

Comment

Officials agree that the definition of a foreign PIE equivalent should be amended to include a MIT, provided the MIT is not a New Zealand resident for tax purposes.

A foreign PIE equivalent is, broadly, a non-resident entity that would be eligible to be a PIE if it were resident in New Zealand. Foreign PIE equivalents are able to hold 100 percent of a New Zealand-resident PIE, and vice versa. This is subject to non-tax regulation, including the requirements of the Overseas Investment Office.

MITs are subject to similar or more stringent investment and investor restrictions as New Zealand PIEs and would therefore meet the definition of a foreign PIE equivalent. Further, including MITs within the definition of a foreign PIE equivalent would reduce the continued compliance costs of PIEs monitoring whether entities are foreign PIE equivalents.

Recommendation

That the submission be accepted.

Issue: Optional look-through rules for PIEs

Clause 41

Submissions
(KPMG, New Zealand Law Society)

Clause 41 should be amended to ensure that where a retail foreign investment variable rate PIE invests into a wholesale foreign investment PIE the flow-through rules work appropriately.

In particular, the drafting of the provision should be amended to refer to “amounts derived by the wholesale PIE” instead of “amounts paid to the wholesale PIE”. In addition, the proposed rule that would allow retail PIEs a deduction for expenditure incurred by the wholesale PIE should be clarified to ensure that it achieves what is intended.

Comment

The rules are intended to allow retail PIEs to treat amounts that are derived by wholesale PIEs as if they had been derived by the retail PIE. Similarly, the rules are also intended to allow expenditure incurred by the wholesale PIE to be treated as if had been incurred by the retail PIE.

Officials agree that the wording of section HM 6B should be clarified to ensure that the rules achieve these results.

Recommendation

That the submissions be accepted and that this change apply from the 2012–13 income year – the start-date for foreign investment variable-rate PIEs.

Issue: Investments of foreign investment PIEs

Submission
(KPMG)

The current drafting of section HM 13(6) has greater application than was intended as it may also apply to non-land portfolio investment entities and PIEs.

Comment

Officials consider that it is clear from the legislation that a foreign investment PIE is able to hold a greater than 20 percent interest in another PIE. This ensures that foreign investment PIEs can invest in wholesale PIEs. Therefore, officials do not agree that an amendment to the legislation is necessary. This policy intention can be confirmed from a release of an item in a *Tax Information Bulletin*.

The submitter has also raised some useful comments in relation to the current rules that place restrictions on the level of ownership a foreign investment PIE can have in other widely held entities. These restrictions are in place as a result of concerns that foreign investment PIEs could find methods to transfer otherwise non-deductible expenditure to an entity it owns that is able to use the deduction. The submitter questions whether these restrictions are appropriate.

A comprehensive review of these restrictions is not possible as part of this tax bill, but could be considered as part of a future tax bill.

Recommendation

That the submission be noted.

Issue: Tax rebates on partial redemptions

Submission
(KPMG)

PIEs should be allowed to trigger a tax event when there is a partial redemption of a PIE interest. Currently PIEs are allowed to make voluntary payments towards their final tax when an investor makes a partial redemption. In these situations the PIE should also be allowed a rebate for any tax losses or excess credits crystallised by the partial redemption.

Comment

Officials agree. This clarification would ensure that the law reflects existing practice. However, also consistent with existing practice, this treatment should be allowed only if the PIE adopts a consistent approach to partial redemptions. That is, the PIE makes a voluntary payment when there is tax to pay and receives a rebate when there are losses or excess credits.

Recommendation

That the submission be accepted.

Issue: Exit rules for PIEs

Submission
(New Zealand Institute of Chartered Accountants)

It should be clarified that an entity ceases to be eligible to be a PIE if it fails to satisfy the entity-type requirements in section HM 9 and the rules in section HM 17 that prevent PIEs streaming different types of income to different investors to minimise tax.

Comment

Officials agree that the provisions should be amended to clarify that a PIE ceases to be a PIE immediately if it fails to meet the requirements in sections HM 9 and HM 17.

Recommendation

That the submission be accepted.

Issue: Technical drafting amendments

Submitters and officials have technical suggestions that fix a number of errors with the bill and the current PIE rules. Officials agree with these submissions unless otherwise stated. These are outlined below:

- Section HM 14(1) of the Income Tax Act 2007 should be amended to refer to a "listed PIE" instead of "a company listed on a recognised exchange in New Zealand". (*KPMG*)
- Section HM 19C(1) should be amended to replace the reference to "section HM 11(a) and (d)" with "section HM 11(1)(a) and (d)". (*KPMG*)
- Section HM 19C(2) should be amended to replace the reference to "section HM 12(a) and (b)(iv) and (v)" with " section HM 12(1)(a) and (b)(iv) and (v)". (*KPMG*)
- The restriction on availability of a tax credit for a foreign investment PIE in section HM 47(6) should be noted in section HM 55. *(KPMG)*

  Officials do not agree that this amendment is necessary. Section HM 47(6) restricts the ability of foreign investment PIEs to have a credit and it is not necessary to repeat this restriction in section HM 55.
- Paragraph (a) of the section YA 1 definition of "fixed-rate share" should be amended to clarify that the definition also applies for the purposes of section CX 55(4). (*New Zealand Institute of Chartered Accountants*)
- Schedule 6, table 1B, row 2 should also refer to row 7.
- Foreign investment PIEs are not allowed deductions for expenses or credits in relation to "notified foreign investors". This treatment should also apply to transitional residents who have elected a zero percent tax rate with the PIE. *(Matter raised by officials)*
- The definition of "foreign investment zero-rate PIE", paragraph (a): should read "… section HM 19B (Modified rules for foreign investment zero-rate PIEs)". *(Matter raised by officials)*
- The definition of "foreign investment variable rate PIE", para (a): should read "… section HM 19C (Modified rules for foreign investment variable rate PIEs)". *(Matter raised by officials)*
- Section 57B of the Tax Administration Act 1994 should be amended to ensure that foreign investment zero-rate PIEs are not required to file a return with Inland Revenue for exiting investors if the only exiting investors are notified foreign investors. Information relevant to exiting notified foreign investors would be included in the end-of-year return that the PIE is required to provide to Inland Revenue. *(Matter raised by officials)*

DEFINITION OF “HIRE PURCHASE AGREEMENT”

Issue: Fundamental change in GST policy

Clauses 88(9), (10) and 168

Submission
(Brent Gilchrist)

There is no drafting error in the definition of “hire purchase agreement” so far as the definition applies to GST land transactions. Generally, a person who buys and sells residential homes can claim GST on purchases and pay GST on sales. However, the proposed amendment will result in a fundamental change in GST policy – the person will be required to pay GST on sales upfront if a tenancy agreement includes an option to buy the property.

The issue is more than remedial in nature and should be withdrawn pending proper review of its effect on businesses.

Comment

Officials note that the proposed amendment to the definition of “hire purchase agreement” in the Income Tax Acts 2004 and 2007 is simply intended to correct a drafting error from the rewrite of the Income Tax Act 1994, so that the definition remains consistent with longstanding case law.

The matter raised by the submitter relates to a policy concern about whether the definition should apply to GST land transactions – the GST Act relies largely on the Income Tax Act definition of “hire purchase agreement”. Officials are aware that there are different views on this matter and are currently reviewing the GST policy in this area.

As the GST issue relates in part to the definition of “hire purchase agreement”, officials consider that the proposed amendments to that definition, contained in the bill, should be withdrawn so that the policy and drafting issues can be considered together.

Recommendation

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

Issue: Exclude real property for income tax and GST purposes

Clauses 88(9), (10) and 168

Submission

(New Zealand Institute of Chartered Accountants)

The definition of "hire purchase agreement" in the Income Tax Acts 2004 and 2007 should be further amended to clarify that it does not include real property for income tax and GST purposes.

Comment

The proposed amendments to correct a drafting error are being withdrawn by officials so that the policy issue of whether the definition should apply to GST land transactions and the drafting error can be considered together. Whether the definition should explicitly exclude real property for income tax purposes will also be considered as part of this review.

Recommendation

That the submission be noted.

LOOK-THROUGH COMPANIES

Overview of submissions

Seven submissions were received on the look-through company (LTC) amendments proposed in the bill and in Supplementary Order Paper 1. Some technical issues were raised on the drafting, particularly in the Supplementary Order Paper. A number of further amendments are recommended by officials to clarify the intent of the proposed legislation.

NZICA made two submissions. The first submission contained comments on the loss limitation rules which officials consider were largely addressed by the amendments proposed in Supplementary Order Paper 1, which was tabled on 8 February 2012. NZICA subsequently made a second submission on Supplementary Order Paper 1 which officials have treated as replacing the comments made on the loss limitation rules in their first submission.

Several of the submissions commented on the process by which the original LTC rules were introduced by the Taxation (GST and Remedial Matters) Act in late 2010. This followed the announcement in Budget 2010 that the existing qualifying company and loss-attributing qualifying company (LAQC) rules would be replaced by a full look-through tax treatment.

Issue: Approach to transparent taxation provisions generally

Submissions
(KPMG, New Zealand Law Society, New Zealand Institute of Chartered Accountants)

A single set of look-through provisions should apply, rather than a separate subpart for partnerships and for LTCs. Specific restrictions on entry qualifications could be included as needed, depending on the underlying common-law status of the entity involved.

The "separate capacity" approach that is used in both the LTC and the partnership legislation is unclear. The interaction between the different statuses of a partnership/partner, or LTC/shareholder, and the partner or shareholder in a personal capacity should be specifically addressed in the various tax provisions.

For example, clarification should be provided on the operation of the transparent taxation approach to:

- the resident mining companies and resident mining operator rules;
- local authority shareholders in LTCs;[3]
- transactions between a partnership/LTC and a partner/shareholder;

[3] Officials note that a local authority cannot be a shareholder in an LTC, as a local authority is neither a natural person nor a trustee (in its capacity as a local authority) so the status issue as set out in the submission could not arise in practice.

- the financial arrangement rules and the forgiveness of debt; and
- the disposal of interests in a transparent entity when deemed to be the disposal of the underlying assets.

The legislation should be more comprehensive on the extent of transparent taxation provisions in each circumstance.

More guidance should be provided by Inland Revenue on the application of a transparent taxation approach.

Comment

Officials understand the submissions to be seeking a complete review of the transparent tax rules for partnerships and LTCs. A review of all tax transparency rules would require considerable resources which are not currently provided for in the Government's Tax Policy Work Programme.

The submissions raise some very technical aspects about the interaction of a transparent approach with other specific tax provisions – for example, the issue raised on the application of the resident mining companies and resident mining operator rules concerns the specific loss ring-fencing rules that are applied to that particular industry, rather than the transparency provisions in general. Some of these issues arise only with LTCs, because of the underlying existence of a company, but some may apply to limited partnerships (LPs), which also have a separate legal existence, and general partnerships too.

At present, officials would not support a comprehensive rewrite of the overall legislative approach to the taxation of partnerships and LTCs. The "capacity" approach used in the Income Tax Act 2007 merely encapsulates key concepts of transparency that have been in place internationally for many decades, primarily in the form of partnerships. For the most part, the current legislation simply codifies or modifies aspects of this capacity approach as necessary. Officials accept there are discrete areas where the interaction of a transparent tax approach with other specific tax provisions could be further reviewed to ensure they operate together more seamlessly. However, outside of these specific technical areas, the general transparent tax approach used for LTCs works well for straightforward, small business enterprises.

Officials will consider the comments about providing more guidance by Inland Revenue on the practical aspects of transparent tax treatment for partnerships/partners and LTCs/shareholders.

Recommendation

That the submissions be noted.

Issue: Tax transparency and withholding provisions

Submission
(New Zealand Law Society)

The reference to withholding taxes as they apply to LTCs should be removed from the opening language of section HB 1 as it is unnecessary, confusing and potentially harmful.

Comment

The submission refers to the opening language of section HB 1(1), which ensures that withholding tax obligations are applied to LTCs – that is, it ignores tax transparency. These provisions are necessary to allow payers making payments to the LTC to consider only the status of the LTC. Without them, taxpayers would have to consider the status of each of the underlying shareholders in the LTC, which is not generally feasible. The same outcome is achieved for partnerships by way of specific provisions in the withholding tax rules. Similarly, the opening wording means that the obligation to withhold taxes from payments made falls on the LTC. This is primarily for administrative simplicity as the LTC handles all withholding and paying obligations under these rules.

Officials note that there is no risk of economic double taxation of income derived through an LTC and later distributed to shareholders, because the LTC is not treated as paying "dividends" when it makes a distribution.

Recommendation

That the submission be declined.

Issue: Look-through companies – elections and methods

Submissions
(KPMG, New Zealand Law Society)

The proposed amendment to clarify that elections and methods relating to an LTC are made by the company should not proceed, as the matter can be addressed through guidance.

"Methods" should be a specifically defined term. *(KPMG)*

Comment

The amendment clarifies the treatment of tax elections and valuations carried out for tax administration purposes in relation to the assets of an LTC. It is considered necessary to make a specific provision for LTCs because, although they are taxed as transparent entities, and so are akin to partnerships, legally LTCs are separate entities and as such hold legal title to the assets. This is in contrast to a general partnership, where title is held by each partner, usually on a joint and several basis.

The partners of a partnership generally have the right to be involved with all of the partnership's business. The shareholders of an LTC do not have this right in their capacity as a shareholder; the day-to-day operation of the LTC's business is the responsibility of the LTC's directors. In some cases a shareholder will also act as a director, but not in all cases. Thus, although the partnership and LTC rules have been deliberately written to mirror each other as far as possible, some variations are inevitable to deal with differences in their underlying legal structure and form.

The amendment applies in respect of elections and valuation and timing methods relating to LTC property and income. Although not defined in the Income Tax Act, the terms "election" or "method" are used directly in the relevant sections of the Act, and as such are defined by conventional usage. An example is the valuation of livestock, for which section EC 11 of the Income Tax Act 2007 provides three valuation methods. Under the current legislation, the shareholders must agree jointly which valuation method to apply, but then each shareholder is obliged to sign an election for this chosen method. In many cases the shareholder may not be directly involved in the day-to-day operations of the LTC; from an administrative perspective it would be the director or other relevant officer of the company who makes these elections for the LTC's livestock.

The amendment will also ensure that, under the depreciation rules, an election to treat the LTC's depreciable property as not being depreciable property is made by the LTC and applied by all shareholders, otherwise each shareholder could make a different election in relation to their portion of the same depreciable property. This would create huge compliance complexities and tax return discrepancies.

The amendment has deliberately been drafted to exclude "tax positions" that are neither elections nor valuations, because tax positions should be taken by a taxpayer. The LTC is not a taxpayer; the transparency rules mean that its shareholders are the taxpayers. Tax positions include provisions relating to whether an individual is a "cash basis" person (section EW 54(1)), and whether the cost of a person's attributing interests in a foreign investment fund (FIF) is more than $50,000 (sections CQ 5 and DN 6). Tax positions must take into account a shareholder's interests outside of the LTC – for example, any attributing interests in a FIF that are held by the shareholder in a personal capacity, as well as their attributed interests via the LTC.

Officials note that the full transparent approach applies to tax elections and valuations in relation to LPs. Like LTCs, but unlike general partnerships, LPs are separate legal entities, and limited partners cannot play any active role in the partnership's business. Officials consider that there may be some merit in reviewing this position to consider when an LTC-style approach might be more appropriate for an LP. This review will take some time to complete, and is subject to available resources. However, it could be carried out separately so as not to delay these LTC amendments, which are helpful to LTC shareholders.

Recommendation

That the submissions be declined. Guidance on the amendments will be released in Inland Revenue's *Tax Information Bulletin*.

Issue: Working owners and fringe benefit tax

Submission
(New Zealand Institute of Chartered Accountants)

A "working owner" of an LTC should have the option to be subject to either the fringe benefit tax (FBT) rules or to treat expenditure on the provision of a benefit as private expenditure and so non-deductible.

LTCs must comply with the reporting requirements in the Companies Act 1993 and the Financial Reporting Act 1993 to provide a "true and fair view" of the company's position. If benefits are treated as distributions for income tax purposes, and made non-deductible, the income tax consequences will differ from the position portrayed in the financial statements.

The proposed amendment should apply prospectively from the date of enactment and not retrospectively from 1 April 2011.

Comment

Although a company at general law, a look-through company is a creation of the Income Tax Act 2007 – that is, it "exists" as an LTC for income tax purposes only. It is therefore unavoidable that there will be some divergence between accounts it must prepare as a company under the Companies Act, and the income tax approach and consequences for it and its shareholders resulting from its transparent tax status.

An LTC cannot "employ" its shareholders for income tax purposes, because under the principles of transparency, each shareholder is effectively treated as self-employed; they receive the income and the deductions of the business personally. Any money or benefits the shareholder draws from the business are not generally relevant to their tax position. This is exactly the same for a general partner.

To simplify administration for an LTC, the Income Tax Act allows a shareholder to choose to be treated as a "working owner", so that regular payments made to that shareholder can be treated as salary or wages and the LTC can apply the PAYE rules. There is a similar long-standing provision for partnerships and "working partners".

The amendments in the bill do not change the FBT position for working owners. Officials consider that even under the current legislation for LTCs, the FBT rules do not apply. However, the LTC legislation for working owners is drafted differently from the “working partner” legislation. Although there is no particular reason for this difference, it has led practitioners to query the difference in style. The amendments simply ensure that the LTC legislation is written in the same style as the longer-standing partnership legislation, to aid readers’ understanding.

Recommendation

That the submission be declined.

Issue: Definition of “employer” and “employee”

Submission
(New Zealand Institute of Chartered Accountants)

The current definitions of “employer” and “employee” in the Income Tax Act 2007 are insufficient. The definitions aim to exclude certain taxpayers from the definition for FBT purposes, which is consistent with the policy of treating such benefits as distributions of profits – for example, it excludes partnerships in relation to their working partners and LTCs in relation to their working owners.

However, the current drafting of the definition of “employer” does not appear to exclude partnerships or LTCs if they make PAYE income payments to other employees (employees who are not working partners or working owners). The drafting of the definition of “employee” also does not appear to exclude working partners or working owners if they receive PAYE income payments from another source (other than the partnership or LTC).

Comment

The parts of the employer and employee definitions referred to in this submission are not being amended by this bill.

However, officials do not agree with the analysis of these definitions. Whether a benefit is provided to a person under the FBT rules is established by the relationship between each individual recipient and the provider of the benefit. The fact that a partnership/LTC may have employees who are not working partners/owners does not prevent subparagraph (c)(i) of the definition of employer applying when considering the position of that partnership/LTC and a working partner/owner for FBT purposes. The fact that a working partner/owner may have another employment relationship elsewhere is not an issue that the partnership/LTC has to consider.

Recommendation

That the submission be declined.

Issue: Benefits provided to employee's associates

Submission
(New Zealand Institute of Chartered Accountants)

Section GB 32 of the Income Tax Act 2007 should be amended to ensure that the provision does not unintentionally apply to fringe benefits provided to working owners who are associated with non-working owner-employees of an LTC, or working partners of a partnership who are associated with a non-working partner employees of a partnership.

Comment

Section GB 32 applies if a benefit is provided by an employer to a person who is associated with an employee, and would have been a fringe benefit if provided to the employee. This is an anti-avoidance provision.

Although this section is not being amended by this bill, officials agree with the points made in this submission and consider the opportunity could be taken to address this issue at the same time that other FBT-related legislation for transparent entities is being re-drafted.

The correct outcome should be that, if a benefit is provided to a working owner of an LTC, or a working partner of a partnership, who is associated with an employee (who is not themselves a working owner or partner) of that LTC or partnership, the benefit should not be treated as though it is provided by the LTC or partnership (as employer) to the employee. Instead it should be considered as a distribution to that working partner or working owner.

Recommendation

That the submission be accepted.

Issue: Aggregation of look-through counted owners

Submission
(nsaTax)

The changes to the definition of "relative" will mean that a number of LTCs will cease to qualify as a result of the look-through counted owner test no longer being satisfied, because under the revised relative definition trustee shareholders and their beneficiaries will count as two counted owners, not one.

Comment

Officials note that the current definition of "relative" does not connect trustees and beneficiaries directly. So under the current legislation, trustees and beneficiaries are not generally considered to be a single look-counted owner under the current rules. Further, all beneficiaries who derive as beneficiary income, income from the LTC will each be regarded as a look-through counted owner. Beneficiaries will only be aggregated and counted as one look-through counted owner to the extent that the beneficiaries themselves are relatives.

The LTC rules are intended for closely held businesses, so provide that an LTC must have five or fewer look-through counted owners. For the purposes of determining the number of look-through counted owners however, the shareholdings of relatives (for example, spouses, siblings, grandparents and grandchildren) are aggregated so that together they are treated as one look-through counted owner. An LTC can, therefore, have quite a large number of shareholders within these familial connections.

The amendment means that, for the purposes of the LTC rules, the interests of the trustees of a trust are not aggregated with another shareholder merely because that shareholder is a relative of a beneficiary of the trust. This inadvertent connection of trustees with relatives of beneficiaries greatly increases the complexity and scope of the look-through counted owners test.

Officials note that in practice there are usually other familial connections between trustee shareholders, trust beneficiaries and any other shareholder that will bring them within the "five or fewer" look-through counted owners requirements.

Recommendation

That the submission be declined.

Issue: Commencement date of amendments

Submission
(Ernst & Young)

The commencement date for the amendment to section HB 11(7)(a) of the LTC loss limitation rules should not be earlier than 1 April 2011.

The proposed 1 April 2011 commencement for any changes to the partnership loss limitation rules in section HG 11(12) needs to be clarified in relation to partners' prior and current income years and any unfiled returns of income. A savings provisions may be required to protect limited partner taxpayers.

Comment

The commencement dates referred to are both drafting errors.

Officials agree that the commencement date for the amendment to the LTC rules should be 1 April 2011.

The commencement date for the majority of changes to the partnership rules was intended to be 1 April 2012, to avoid difficulties with partnership returns already filed using the existing calculations. There are two exceptions when the proposed amendments apply from 1 April 2008, being the start of the limited partnership rules.

The first exception is the clarification to the definition of "capital contribution", which officials consider simply states the existing position more explicitly, for taxpayer ease of use. The second exception is the clarification of the inclusion of excess FIF dividends within the "income" item of the loss limitation formula. This corrects a legislative drafting error to ensure that this provision operates as intended, and delivers the outcome that, in practice, it had been understood to achieve. Both are taxpayer positive.

Recommendation

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

Issue: Look-through company elections and revocations

Submission
(Ernst & Young)

Taxpayers' decisions on whether to use the LTC rules may have been influenced by the definition of "secured amounts". These taxpayers should be able to make a late election or revocation of LTC status.

Comment

Officials do not agree that late elections or revocations should be permitted as it would be impossible to confine these only to the circumstances when the "secured amounts" calculation was the prime motivating factor in a taxpayer's decision-making process.

The majority of the proposed changes to the "secured amounts" definition are to simplify and broaden the application of the rules in line with the original policy intention, and are in the taxpayer's favour. Officials do not consider that taxpayers would have based their decision to use the LTC rules solely on the basis of the extent of the owner's basis they could establish by virtue of guarantees provided in respect of the company's debt.

Recommendation

That the submission be declined.

Issue: Inclusion of dividends from a foreign investment fund as income in the loss limitation formula

Submissions

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

The inclusion of the "difference" between FIF distributions and attributed FIF income does not adequately address situations when there is a FIF loss. Also, when the FIF dividends received are less than FIF income, the inclusion of the "difference" could reflect some double counting.

Comment

This amendment corrects an error in the original legislation to ensure that this provision operates as intended and delivers the outcome that, in practice, it had been understood to achieve.

The policy intention has always been that when a shareholder or partner's proportionate share of the dividend actually distributed by a FIF is higher than their amount of FIF income as calculated using the shareholder/partner's chosen FIF calculation method, the difference should be added to their "income" for the purposes of the loss limitation formula, because they are at economic risk for these dividends. In the case of a FIF loss being calculated under the FIF rules but FIF dividends being received, the actual dividend amount should be counted.

Officials agree that the drafting should be clarified to confirm that the section applies only when there is an "excess" of FIF dividends received over FIF income, and that when there is a FIF loss only, the positive dividend amount is counted.

Recommendation

That the submissions be accepted.

Issue: Inclusion of capital improvement costs as income in the loss limitation formula

Submission

(New Zealand Institute of Chartered Accountants)

Capital improvement costs should be reflected in the loss limitation formula because they represent an increase in the asset base of the LTC, and so are an amount for which a shareholder is at risk.

Comment

The policy objective for the loss limitation formula is to measure an individual's economic risk exposure – that is, the amount they have personally put in to the LTC (or stand liable for in the case of a guarantee or indemnity for the LTCs debt). Extending this to include capital improvements that are funded by the company would not be consistent with this policy, as these improvements have not increased the economic investment made by, or risk exposure of, the shareholder.

The submission draws an analogy with realised capital gains. Realised gains are included in the formula because the shareholder could draw these down as dividends; if the gains remain in the company the individual has foregone access to this money. That is not the case with internal revaluations or expenditure reflected in capital improvements.

Officials note that to the extent that capital improvements are funded by the company directly from retained profit, the income that produced that profit will previously have been counted in the loss limitation formula. The realised capital gain/loss items in the formula effectively take into account, at point of realisation, expenditure on capital improvements that would not previously have been recognised for income purposes.

Recommendation

That the submission be declined.

Issue: Secured amounts and loans made by a shareholder

Submission
(New Zealand Institute of Chartered Accountants)

An LTC shareholder can only include a guarantee within their "secured amounts" items if those secured amounts are not accounted for by another person that is another shareholder. It is unclear how a shareholder would know how another shareholder has treated this secured amount for tax purposes.

Comment

The "secured amounts" definition concerns guarantees made by a shareholder in relation to an LTC's debt. It excludes a guarantee made by one shareholder (the guarantor shareholder) in relation to a loan given by another shareholder (the creditor shareholder) to the LTC, because that loan amount will be counted by the creditor shareholder directly in determining their owner's basis. If the guaranteed amount were also included by the guarantor shareholder as a secured amount it would result in the same amount being double counted. It also opens up avoidance opportunities by "reciprocal" loans and guarantees being made by shareholders of the same LTC.

Officials do not consider there will be any difficulty with either shareholder knowing about the existence of the loan or guarantee in this circumstance, because the guarantor shareholder will have provided the guarantee to the creditor shareholder.

Recommendation

That the submission be declined.

Issue: Definition of "guarantor" – LTCs

Submissions
(nsaTax, PricewaterhouseCoopers)

The definition of "guarantor" should aggregate the shareholder, and all their associates who have provided a guarantee for the same debt, as one single guarantor. *(PricewaterhouseCoopers)*

A guarantor means a person who has an effective look-through interest for the LTC. *(nsaTax)*

Comment

The new definition of "guarantor" does provide for the aggregation of a shareholder, and all their associates who have provided a guarantee for the same debt, as one single guarantor.

Although in most cases this means that a guarantor will be a shareholder, the second part of the definition covers circumstances when there is a guarantee provided by a third party who is neither a shareholder nor an associate of a shareholder. In this situation the denominator figure for "guarantors" by which the amount of debt secured by guarantee is divided recognises this third-party guarantee. The policy rationale is that the presence of this third-party guarantor reduces the economic risk exposure of the shareholders who have provided a guarantee.

Recommendation

That the submissions be noted.

Issue: Definition of "guarantor" – partner's associate

Submissions
(Ernst & Young, Meridian Energy)

Where a limited partner is a company and all guarantors are members of the same wholly owned group of companies as the limited partner, the limited partner and all guarantors should be collectively treated as one guarantor. *(Meridian Energy)*

Companies that are not limited partners but are partly owned by the same group as a company that is a limited partner should also be counted with the single guarantor. *(Ernst & Young)*

Comment

The definition of "partner's associate" as it relates to companies in the same wholly owned group as the partner is not changed by the bill. These will be collectively treated as one guarantor with the relevant limited partner(s).

Members of partly owned groups are not currently included in the definition of "partner's associate". The definition applies only to companies in the same wholly owned group. Part-ownership means others outside of the company's economic group are sharing the risk exposure from the guarantee, and so are reducing the economic exposure/risk of the limited partners (and their associates) who have also provided a guarantee. As such, it is consistent with the policy approach to third-party guarantors that these partially owned companies should be reflected as separate guarantors.

Recommendation

That the submissions be declined.

Issue: Definition of "recourse property"

Submissions
(Ernst & Young, Meridian Energy, New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

"Recourse property" means property to which a creditor has recourse to enforce a guarantee or indemnity for a debt, if the guarantee or indemnity expressly provides recourse to "only" that property. The word "only" should be removed as it implies that the provision will not apply if the creditor has limited surety over two or more properties. *(New Zealand Institute of Chartered Accountants)*

The “secured amounts” definition uses a “lesser of (a) or (b) approach; it is unclear how this approach operates when there is no comparator in (b) – that is, there is no recourse property. It should be clarified whether the amount is “zero” or whether this part of the definition does not apply.

Comment

The inclusion of the word “only” is pivotal to the definition of “recourse property”. It ensures that the guaranteed amount is restricted in situations when the creditor’s recourse is restricted to identified assets – for example, the terms of a guarantee may be restricted to allow a creditor recourse against the guarantor’s share portfolio and rental bach, but not his family house. If the combined values of that share portfolio and bach are less than the amount of debt guaranteed, the guarantor is only “at risk” up to the value of the share portfolio and bach and so only the value of the share portfolio and bach should be included in the owner’s basis.

Officials consider that the word “applicable” in the proposed amendment is sufficiently clear to provide that when there is no recourse property the paragraph of the definition dealing with recourse property is “not applicable”.

Recommendation

That the submissions be declined.

Issue: Attribution of secured amounts when there is no recourse property – pro rating

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

The “secured amounts” definition should pro-rate the amount of the guarantee based on the particular LTC shareholder’s share of the guarantee or indemnity, rather than averaging, as this better reflects their proportion of economic risk.

This definition should use the same proportional attribution method used for “recourse property” in situations when more than one shareholder has provided a guarantee for the same debt.

Comment

In some situations more than one shareholder may provide a guarantee for the same amount of a debt. The amount of the debt that both shareholders have guaranteed is apportioned between each guarantor on an equal split basis. Any debt amounts that are not covered by more than one shareholder’s guarantee will not be apportioned.

The total economic risk is only the amount of the debt guaranteed. The policy rationale for an equal split basis is that each shareholder has full and equal exposure under the guarantee to the extent they have guaranteed the same debt amount. Averaging the guaranteed debt amount to each shareholder is the equitable way to account for this shared risk. The shareholders' respective level of shareholding in the LTC is not relevant to the risk exposure under a separate guarantee.

There is no recourse property so the "proportion of ownership interests in the recourse property approach" is not a suitable apportionment mechanism.

Recommendation

That the submissions be declined.

Issue: Attribution of secured amounts when there is recourse property – clarification

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

The definition of "secured amounts" should set out how the value of recourse property should be "attributed" to a shareholder. It should particularly set out the position in situations when the recourse property is offered under a guarantee or indemnity provided by an associate so that the shareholder himself or herself has no ownership interest in the recourse property.

Comment

If the same recourse property is used as security by more than one guarantor making a limited recourse guarantee, then it is their proportional interests in the recourse property that should be attributed to them. For example, a guarantor may provide a guarantee limiting recourse to a piece of land held as tenant-in-common. The guarantor's economic exposure under the guarantee is reflected by their percentage ownership interest in the land (recourse property), so this should also carry through to be their secured amount. If the ownership interest is on a joint tenancy basis, the "proportion" of a person's interests in that recourse property will be divided equally by the number of joint tenants who have an interest in that same property. Officials agree that the proportional attribution could be more clearly set out in the legislation.

The term "recourse property" is defined by reference to the "relevant debt", which therefore includes debts for which an associate provides a guarantee or indemnity. These are aggregated together as a single guarantor in the new definition of "guarantor". The interests of the associate in the recourse property are therefore treated as the shareholder's interests for these purposes. In the case of more than one association, the interests will be equally shared among all shareholders who have an association with the person providing the guarantee. Officials consider the current drafting achieves this first outcome, but on the second, officials agree that it could be improved to address more explicitly the approach to proportional attribution where an associate of more than one shareholder provides a guarantee or indemnity, if this will help taxpayer understanding.

Recommendation

That the submissions be accepted.

Issue: Application of initial basis provisions

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

There is uncertainty between the interaction of section HZ 4C(1), which provides that the section applies in the "transitional year", and section HZ 4C(2) which is to be used when applying sections HB 11 and HB 12 not only in the transitional income year, but also in later years. *(New Zealand Institute of Chartered Accountants)*

The amendments should be made in section HB 11 – for example, section HB 11(5)(a) should be amended to refer to either the transitional value as determined under subpart HZ or the market value of a person's shares in the LTC at the time when the person purchases or subscribes for them.

Comment

Officials do not agree that there is any divergence between subsections (1) and (2) of section HZ 4C. "When" may be used to convey the section's application "if" there is a situation in which a qualifying company has first become an LTC for the transitional year. Therefore it does not affect the application of section HZ 4C(2) to both the transitional income year and later years, as necessary. In any case, section HZ 4C(2) is specific about when it applies, so there is no doubt about its application

Section HB 11 contains the primary loss limitation formula, which applies to all look-through companies, not just those that have transitioned from being a qualifying company. Therefore, the amendments are made not in section HB 11, but to subpart HZ because that specifically deals with these transitioning qualifying companies.

Recommendation

That the submissions be declined.

Issue: Calculation of initial basis for a qualifying company using the market value or the accounting book value method

Submission
(Ernst & Young)

Section HZ 4C should not preclude the addition of any further investment amount arising from transactions or events occurring after the start of the transitional year, so that the year-end balance date amounts may be truly representative of a taxpayer's investment. It should also be clear that year-end amounts are included for items referred to in paragraphs (b) and (c) of section HB 11(5).

The proposed amendments relating to capital gain amounts and capital loss amounts which require any calculations of those amounts to be changed to account for the opening valuation of the "investments" are complex and will lead to uncertainty.

Comment

The amendments to section HZ 4C relates to investment amounts in section HB 11(5)(a) only in terms of valuing shares on the last day of the income year before the transitional year. Further investment amounts arising from transactions or events occurring after during the transitional year, or any later year, will be included in the formula under the primary provision at section HB 11(5)(a). The amendments mean that section HZ 4C no longer includes items referred to section HB 11(5) (b) or (c) because these are valued when applying the formula on the last day of the transitional income year, and each later year in which the company is an LTC, not before.

It is necessary to adjust for the inclusion of values in the initial basis that relate to internal revaluation reserves (both increases and decreases) when these eventually are realised as capital gain or loss amounts, otherwise there would be double counting or under-valuation of an owner's basis in later years. This does require detailed calculations, but the rules already require a shareholder to calculate and apportion a capital gain or loss on assets when realised, for the purposes of applying the loss limitation formula. Shareholders will also have access to the company records detailing the revaluation of assets before the company transitioned into the LTC rules. This will enable the necessary adjustment to be made to reflect the revaluation adopted in their "initial basis".

Recommendation

That the submission be declined.

Issue: Drafting amendments

Submissions

(nsaTax, New Zealand Institute of Chartered Accountants)

The drafting of section HB 11(8)(a) should be clarified, to remove the repetition of the expression "by virtue of section HB 1" which serves no useful purpose. *(New Zealand Institute of Chartered Accountants)*

The phrase "net of higher ranking calls" is not defined. *(nsaTax)*

Comment

Officials do not consider that these provisions as currently drafted are unclear. The current wording meets the policy intent and no amendment is necessary. Although not a defined term, officials consider that the phrase "net of higher ranking calls" is sufficiently defined by conventional and commercial use; the proposed alternative does not enhance the current drafting.

Recommendation

That the submissions be declined.

THE TAX SYSTEM

Submission
(Andrew Sheldon Crooks)

The submitter disagrees with the current system of government in New Zealand and the basis on which tax is levied.

Comment

The matter raised in the submission is not in the bill.

Recommendation

That the submission be noted.

HARDCOPY RETURNS

Clause 110

Submissions
(KPMG, New Zealand Institute of Chartered Accountants)

The change is supported. *(KPMG)*

The provision should not specify who should sign the return, as this would be more consistent with the rules that apply to paper-based returns. *(New Zealand Institute of Chartered Accountants)*

Comments

The amendment is to clarify that an agent or a taxpayer can sign the hardcopy of a return filed electronically. Officials agree that there should be symmetry between paper returns and electronic returns whenever possible and are therefore comfortable with the NZICA submission that the signatory need not be specified.

Recommendation

That the KPMG submission be noted and the NZICA submission be accepted.

TECHNICAL CHANGES TO THE LIFE INSURANCE TRANSITIONAL RULES

Clauses 2(16), 26 and 27

Issue: Support for proposed changes

Submissions
(KPMG, New Zealand Institute of Chartered Accountants)

The changes to the transitional rules for life insurance are supported, including backdating the changes to the start of the new life insurance taxation rules.

Recommendation

That the submissions be noted.

Issue: Scope of proposed change

Submission
(KPMG)

The scope of the proposed change should also include the transitional rule that provides that premium increases on pre-1 July 2009 participating policies to meet increases in the Consumer Price Index (CPI) do not affect the grandparented status of the policy.

Comment

The transitional rules for profit participation life insurance policies provide for a simpler calculation of taxable income. The simplified calculation applies to participating life policies sold on or before 30 June 2009 – known as “old life policies”. Profit participating life policies sold after that date are taxed using a more comprehensive measure of income as a tax base integrity measure.

The proposed change to section EY 28 of the Income Tax Act 2007 clarifies that the transfer or sale of old life policies (after the start date of the new rules) does not result in those policies being taxed under the more comprehensive taxation formula applicable for participating business sold after 30 June 2009. Life insurers are concerned that any consolidation or rationalisation of the life industry could create additional tax compliance costs if old life policies are not appropriately grandparented. The concern arises because the life insurer who acquires the old life policies will often issue “new” life insurance policies on the same terms and conditions, including bonus entitlements. Increases to premiums that reflect increases in the amount of life cover may also feature as part of the issue of the “new” policies.

Provided that the premium increase is no greater than the higher of the CPI rate or 10 percent (as currently provided for in section EY 28), the life policy should continue to be treated as a continuation of existing business.

Recommendation

That the submission be accepted.

TREATMENT OF THE OUTSTANDING CLAIMS RESERVE WHEN GENERAL AND NON-LIFE INSURANCE IS TRANSFERRED TO ANOTHER INSURER

Clause 21B

Submissions
(KPMG, Matter raised by officials)

Technical changes are required to the Income Tax Act 2007 to clarify the tax position of insurance companies when there is a transfer of business partway through an income year. *(Matter raised by officials)*

KPMG supports the suggested legislative change and submits that it should have retrospective effect to facilitate the transfer of general and non-life business if the transfer is made to ensure the insurer meets the new licensing requirements under the Insurance (Prudential Supervision) Act 2010. *(KPMG)*

Comment

Under the Income Tax Act, a deduction connected with movements in an insurer's outstanding claims reserve (OCR) (or income depending on the nature of the actual movement) is calculated on an income year basis. This means that the legislation does not provide an appropriate closing value if the OCR for a particular line of general or non-life insurance business is transferred at a point of time other than at the end of an income year. As a result, a selling insurer can lose its entitlement to deduct the closing value of its OCR.

Instead, the tax deduction that would otherwise be available is effectively transferred under the Income Tax Act to the insurer that acquires the business. If the transfer occurs within New Zealand, the tax difference can be resolved by the parties agreeing to adjust the transaction value of the transfer to ensure a tax-neutral outcome. If, however, the transfer involves relocating New Zealand-based insurance business offshore, a permanent tax can be created against the taxpayer.

Officials recommend a technical amendment to the Income Tax Act that sets an appropriate closing and opening balance for the OCR when it is transferred from one insurer to another.

Application date

KPMG, on behalf of Cigna Taiwan Limited, notes that the application date of the amendment is important for their client and submits that the change should be backdated.

To meet the regulatory requirements of the Insurance (Prudential Supervision) Act 2010, Cigna Taiwan is restructuring its business. This restructure is likely to be completed before the bill is enacted. As such, the application of current law to Cigna Taiwan would result in it losing its entitlement to a deduction for any movements in its OCR up to the date of transfer. Cigna Taiwan advises that this will create a one-off tax liability of $3 million.

Reasons for backdating the suggested amendment are:

- The current law creates an outcome that is inconsistent with the policy intent to allow insurers a deduction when they are reasonably expected to be liable for a claim.
- The Income Tax Act, in this particular instance, should not create a tax liability in respect of actions to ensure compliance with the Insurance (Prudential Supervision) Act 2010.

In terms of the case against backdating, officials have undertaken limited consultation with two insurance representative groups about the suggested amendment. Both groups supported the change, subject to it applying prospectively and noting that a number of transfers have already been completed on the basis of the current legislation. Backdating the change could disturb these transactions. One group, however, supported the change applying retrospectively on an elective basis if the current legislation has the effect of denying an insurer a deduction.

In balancing these competing arguments, officials agree with KPMG's suggestion that the amendment apply to transfers occurring on and after 1 October 2012, but allow the option for the change to apply retrospectively in following limited circumstances:

- The taxpayer elects to apply the rule from a date no earlier than 7 September 2010, being the date the Insurance (Prudential Supervision) Act 2010 was enacted.
- The transfer of the general insurance contracts are to a transferee who is non–resident and does not carry on a business in New Zealand through a fixed establishment.
- The transfer is made by the seller for the purposes of complying with the Insurance (Prudential Supervision) Act.

Recommendation

That the submissions be accepted. The Income Tax Act should be amended to set an appropriate closing and opening balance for the OCR when it is transferred from one insurer to another. The amendment should apply to transfers made on and after 1 October 2012, or at the election of the taxpayer from a date no earlier than 7 September 2010 if:

- the transfer is to a non-resident who does not carry on a business in New Zealand through a fixed establishment; and
- the transfer is made for the purposes of complying with the Insurance (Prudential Supervision) Act 2010.

REWRITE AMENDMENTS

Issue: Valuation of livestock

Clauses 20 and 165

Submissions
(New Zealand Institute of Chartered Accountants, Matter raised by officials)

The proposed amendments to section EC 1(1) should clarify that, as is currently the case, the livestock valuation rules under sub-part EC will continue to not apply where livestock is used in a dealing business. *(New Zealand Institute of Chartered Accountants)*

That the proposed amendments to section EC 1(1) should clarify that, as is currently the case, the livestock valuation rules under sub-part EC will continue to not apply where livestock is used in a dealing business. Clause 165 of the bill proposes an amendment to section EC 1(1) of the Income Tax Act 2004, mirroring the amendment proposed in clause 20 for section EC 1(1) of the Income Tax Act 2007. *(Matter raised by officials)*

Comment

Officials agree that the valuation rules in subpart EC should not apply to livestock that is trading stock of a dealing business. This is contemplated by the definition of trading stock in section EB 2, which includes livestock that used in a dealing business.

Recommendation

That the submissions be accepted.

Issue: Trustee income

Clause 38

Submission
(New Zealand Institute of Chartered Accountants)

NZICA (although not considering a legislative amendment necessary) broadly supports a clarification amendment to section HC 25(1).

Comment

Section HC 25 is a key component of the settlor trust regime. This section ensures that a non-resident trustee of a trust, which has a New Zealand resident settlor (and certain other trusts), is taxable on undistributed income derived from sources outside New Zealand.

The Rewrite Advisory Panel noted that section HC 25(1) of the Income Tax Act 2007 contains an ambiguity. The ambiguity could result in the provision applying to income distributed as beneficiary income. This is not the policy intention, and we agree with the Panel that the drafting should be improved.

Recommendation

That the submission be noted.

Matters raised by officials

DEFINITION OF "DOCUMENT"

Submission
(Matter raised by officials)

Schedule 2 of the Tax Administration (Form of Warrant) Regulations 2003 (which is the prescribed form for a warrant under section 16C of the Tax Administration Act 1994) should be updated to refer to "documents".

Comment

A new definition of "document" was inserted into the Tax Administration Act by the Taxation (Taxation Administration and Remedial Matters) Act 2011 replacing the old defined phrase "book and document". The new definition removed references to redundant technology. The words "book and document" throughout the Inland Revenue Acts were replaced with the new term "document".

However, Schedule 2 of the Tax Administration (Form of Warrant) Regulations has not been updated with the new terminology.

Schedule 2 of the Tax Administration (Form of Warrant) Regulations should be amended to refer to "documents".

Recommendation

That the submission be accepted.

AUCKLAND COUNCIL – INDEPENDENT MĀORI STATUTORY BOARD

Submission
(Matter raised by officials)

The Income Tax Act 2007 and the Goods and Services Tax Act 1985 should be amended to deem the Auckland Council Independent Māori Statutory Board to be a "local authority" for the purpose of those Acts. These amendments will mean that the Board is treated in the same way as other advisory-type boards of the Auckland Council.

Comment

Section 81 of the Local Government (Auckland Council) Act 2009 establishes the Board and sets out its purposes. The purpose of the Board is to assist the Auckland Council to make decisions concerning the promotion of cultural, economic, environmental, and social issues of significance to Māori, and to ensure that the Council acts in accordance with statutory provisions referring to the Treaty of Waitangi.

The Board is established as "a body corporate", separate from the Auckland Council. Consequently, the Board is a separate legal entity that can, and does, act in its own name, including in relation to the acquisition of supplies of goods and services required for its purpose and incurring expenditure in relation to such supplies. In contrast, the Pacific Peoples Advisory Panel and the Ethnic Peoples Advisory Panel established by the Mayor of Auckland Council are not separate legal entities. Their functions are carried out under the Auckland Council umbrella.

Under current income tax law, the Board would be taxed as a normal company. Therefore, there is a possibility that the funding that it receives from the Auckland Council could be viewed as income and, therefore, taxable. Officials note that, had the Board's functions been carried out by the Auckland Council, as are the functions of other similar Boards, there would have been no question about the tax treatment of the funding stream – the funding would not have been subject to tax.

Under current GST law, the Board would not be able to register for GST purposes. This is because the funding provided by Auckland Council under the Funding Agreement to carry out its functions does not constitute "consideration" for any "taxable supply" by the Board. It is a grant-type funding that enables the Board to fulfil its statutory role, and does not have the requisite link to any reciprocal supply by the Board to Auckland Council. Therefore, the Board is not carrying on a "taxable activity". Without any form of taxable activity, the Board cannot register for GST purposes and it cannot claim back the GST content of its expenses (such as fees paid to consultants providing advice to the Board).

The question of the tax status of the Board did not arise during policy development on the Local Government (Auckland Council) Act. The general approach adopted for the restructuring was for general tax law to apply to the entities of the Auckland Council restructuring, unless there was significant policy justification for departing from that approach.

Officials consider that a departure from the general restructuring approach in relation to the Board is justified. This support is given on the basis that:

- the Board is a non-profit body and is carrying out functions similar to other advisory boards of the Auckland Council;
- the deemed status is consistent with the current tax treatment that applies to other advisory boards of the Auckland Council. The functions of these boards are carried out within the structure of the Council and, therefore, attract the local authority tax treatment; and
- the deemed status would provide certainty of tax treatment and help to minimise tax compliance costs for the Board and funding costs for the Auckland Council.

The amendments will ensure that:

- the funding provided by Auckland Council to the Board will not be subject to income tax because local authorities are generally exempt from income tax under section CW 38 of the Income Tax Act; and
- the Board is able to register for GST purposes and then can claim back the GST content of expenses that it incurs in carrying out its functions. Local authorities are deemed to be carrying on a "taxable activity" under section 6(1)(b) of the GST Act.

Officials also consider that the proposed amendments should be retrospective in application and apply from 1 November 2010, the date on which the Board was established. The proposed amendments are taxpayer-friendly, and we do not expect there to be any adverse consequences associated with retrospective application of the proposed amendments for the Board or Inland Revenue.

The Auckland Council and the Board support the proposed amendments.

Recommendation

That the submission be accepted.

UPDATE TO CROSS-REFERENCE IN DEFINITION OF "SUPERANNUATION SCHEME"

Submission
(Matter raised by officials)

There is an out-dated reference to the repealed Social Security Act 1964 in the superannuation scheme definition in the Income Tax Act 2007. This should be replaced with a reference to the New Zealand Superannuation and Retirement Income Act 2001.

Comment

This cross-reference was overlooked when the New Zealand Superannuation and Retirement Income Act was enacted. The reference should be updated.

Recommendation

That the submission be accepted.

EMISSIONS TRADING

Issue: Definition of "forestry business"

Submission
(Matter raised by officials)

The definition of "forestry business" should be extended to include forestry activities that exist solely for the purpose of receiving emissions units, rather than the production of timber.

Comment

A person who carries on a "forestry business" is allowed an income tax deduction for expenditure they incur on forest establishment and maintenance costs. This overrides the general rule denying deduction for capital expenditure.

"Forestry business" was previously undefined, and there was some uncertainty over whether a forest grown purely with the objective of creating an entitlement to receive emissions units would fall within it. A new definition of forestry business was inserted in 2009, to ensure that foresters who received emissions units under the Permanent Forest Sink Initiative, a scheme under which harvest was restricted, would be entitled to receive deductions.

Some instances have recently emerged of foresters who are registered to receive emissions units under the Emissions Trading Scheme (ETS), but who are unlikely to harvest. These foresters ought to be entitled to the same deductions as any forester whose objective is to harvest timber.

It is consistent with the earlier amendment and the appropriate treatment to extend the definition of "forestry business" to foresters registered to receive emissions units under the ETS.

The proposed change should apply retrospectively from 1 April 2008.

Recommendation

That the submission be accepted.

Issue: Tax treatment of allocations of emissions units for removal activities

Submission

(Matter raised by officials)

The accrual accounting rules which apply to industrial allocations of emissions units should be extended to allocation of emissions units for removal activities.

Comment

The ETS includes a number of categories under which those who carry on economic activity in New Zealand might be allocated emissions units by government. The tax rules for the main categories of allocation are well established.

Detailed legislative provisions exist to ensure that income is correctly recognised when businesses have an entitlement to receive industrial allocations of emissions units. These rules deal with two timing issues:

- Emissions units are allocated on a calendar year basis, and most businesses have income years which are not calendar years.
- Emissions units are allocated sometimes in advance of, and sometimes subsequent to, the additional cost arising for which the allocation is intended to compensate.

Similar timing issues arise for allocations for removal activities. However, there are no specific tax rules for allocations to businesses for "removal activities" outside the forestry sector. "Removal activities" are activities which result in greenhouse gases being removed from the atmosphere, including by incorporation into products or export.

These timing issues can readily be addressed by extending the existing accrual accounting rules developed for industrial allocations to removal allocations.

The proposed change should apply retrospectively from 1 July 2010, which is the date that businesses first became entitled to removal allocations.

Recommendation

That the submission be accepted.

TRUSTEES QUALIFYING AS A CASH BASIS PERSON

Submission
(Matter raised by officials)

Section HC 24(2)(b) of the Income Tax Act 2007 should be removed to ensure the legislation better reflects the policy objective that trustees should be able to return income tax in relation to financial arrangements on a cash accounting basis, subject to meeting certain thresholds.

Comment

Prior to changes made in 2009, only an individual or a trustee of a deceased estate meeting the criteria under section EW 60 could return income tax in relation to financial arrangements on a cash accounting basis (section EW 60 specifies when a trustee of a deceased's estate is treated as a "cash basis person" for the purposes of the financial arrangement rules).

In the Taxation (Business Tax Measures) Act 2009, amendments were made to the financial arrangement rules to allow non-individuals, subject to certain thresholds, to return income tax on a cash accounting basis. These changes included broadening the definition of "cash basis person" to include trustees other than trustees meeting the criteria in section EW 60.

However, the requirement in section HC 24(2), that in determining a trustee's income tax liability, the trustee is not entitled to be a "cash basis person" unless section EW 60 applies, was not removed as part of these amendments.

Recommendation

That the submission be accepted.