Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill

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

September 2013

Prepared by Policy & Strategy of Inland Revenue and the Treasury

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Taxation of foreign superannuation

OVERVIEW

Clauses 2(14), 6, 7, 8, 9, 17, 18, 25, 30, 40, 41, 42, 43, 66, 67, 75, 103(9), (10), and (11), 106, 115, 116 and 117

People who migrate to New Zealand (or those who return to New Zealand after working overseas) frequently have contributed to superannuation schemes in their previous country of residence. The current rules for taxing New Zealand residents on their foreign superannuation are complex and can be difficult for taxpayers to understand. In some cases, superannuation interests are subject to tax on accrual under the foreign investment fund (FIF) rules. In other cases, a person may be taxed on receipt depending on the legal structure of the foreign scheme (such as whether the scheme is structured as a company or a trust). The tax treatment differs according to which set of rules applies. As a result, it is not always clear that the rules result in a fair outcome, particularly for lump-sum amounts.

An issues paper proposing reforms to simplify the tax treatment of foreign superannuation was released in July 2012. Fifty-nine submissions from a variety of interested parties – including individuals, professional advisory firms and pension transfer agents – were received. The proposals included in this bill took into account suggestions put forward in submissions and consultation.

The bill proposes a new cohesive set of rules to replace the current rules applying to interests in, and income from, foreign superannuation schemes from 1 April 2014. It is proposed that the FIF rules will generally cease to apply to foreign superannuation interests, unless they are "grandparented".

Instead lump-sum amounts received from 1 April 2014 would be taxed on receipt under one of two new calculation methods: the schedule method or the formula method.

The schedule method is the default method. It is designed to approximate the tax that would have been paid on accrual while the person was New Zealand-resident, in conjunction with an interest charge that recognises that the payment of tax has been deferred until receipt.

The formula method taxes the person based on the actual gains while they were resident in New Zealand, again in conjunction with an interest charge that recognises that the payment of tax has been deferred until receipt.

The new rules will also allow people who have transferred their funds to a KiwiSaver scheme to withdraw an amount to pay their tax liability arising from the transfer.

The bill also contains a concessionary "15% option" to assist taxpayers who have not previously complied with their tax obligations.

Fifteen submissions were received in relation to the foreign superannuation proposals included in the bill. Most of these proposals broadly supported the changes proposed by the bill. A number of submissions addressed the transitional measures and the concessionary "15% option" for taxpayers who have not previously complied.

This officials' report proposes several policy and technical changes to the foreign superannuation proposals in the bill.

Two changes relate to the proposed optional KiwiSaver withdrawal mechanism. Officials propose that KiwiSaver providers should inform Inland Revenue when a taxpayer has used the proposed optional withdrawal facility, and where the provider's systems allow it, pay the amount directly to Inland Revenue. Officials also propose that the facility should be able to be used if the person's student loan repayment obligation increases as a result of the transfer.

A third change relates to how transfers of a foreign superannuation interest from one person to another are taxed when the transfer occurs on death or relationship split. Officials propose making the bill more consistent with other parts of the Income Tax Act 2007 that deal with the transfer of assets in such situations.

A further proposal is to restrict the application of the proposed regime to foreign superannuation interests where the rights to the interest were first acquired while the taxpayer was non-resident. Officials note that this is consistent with the existing law for such taxpayers.

Several submitters noted that the proposed changes as introduced could potentially result in effective double taxation for taxpayers who are required to pay tax under the new rules and have not complied with their obligations under the FIF rules in the past. To ensure that the rules work as intended, officials propose that these taxpayers should not also be liable for their unpaid FIF tax obligations.

A number of minor changes and drafting clarifications are also proposed.

Issue: Support for the proposal

Submission

(Accountants and Tax Agents Institute of New Zealand, Arthur Jacobson, Baucher Consulting Limited, Chris Pearson, Corporate Taxpayers Group, Ernst & Young, Financial Services Council, Grey Power New Zealand Federation Incorporated, KPMG, New Zealand Institute of Chartered Accountants, New Zealand Law Society, PricewaterhouseCoopers)

A number of submitters have expressed their broad support for the proposed changes to the taxation of foreign superannuation interests *(Arthur Jacobsen, Chris Pearson, Corporate Taxpayers Group, Ernst & Young, Financial Services Council, Grey Power New Zealand Federation Incorporated, KPMG, New Zealand Institute of Chartered Accountants, New Zealand Law Society, PricewaterhouseCoopers).*

Two submitters supported the move to clarify the rules, and to exempt taxpayers during the first 48 months on residency *(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited).*

One submitter stated that the proposed changes contained in the bill represent an acceptable compromise between the proposals in the officials' issues paper and the submissions received in response to the issues paper *(Arthur Jacobsen).*

One submitter is pleased that the proposed rules provide options (schedule method and formula method) *(New Zealand Institute of Chartered Accountants).*

Another submitter expressed his support for the move to receipts-based taxation for foreign superannuation interests as the proposed changes would bring the New Zealand tax code in line with other countries *(Chris Pearson).*

Comment

Officials welcome the support for the bill.

Officials note that an issues paper proposing changes to the tax treatment of foreign superannuation was released in July 2012. Fifty-nine submissions from a variety of interested parties – including individuals, professional advisory firms, and pension transfer agents – were received.

A number of changes to the original proposals were made as a result of submissions, including the introduction of an alternative method of calculating actual gains (the "formula method").

Recommendation

That the submission be noted.

Issue: Receipts-based approach should be available only where the rights in the scheme were first acquired while non-resident

Clause 8

Submission
(Matter raised by officials)

The receipts-based approach contained in the bill should be available only where the rights in the foreign superannuation scheme were <u>first acquired when the person was a non-resident</u>. Where the person first acquired the rights in the foreign superannuation scheme while they were New Zealand resident, the FIF rules would generally apply.

Comment

Under current law, foreign superannuation schemes are taxed either under the FIF rules, or taxed upon receipt (or transfer) under the company, trust, or other tax rules. Broadly speaking, rights acquired while a person was resident in New Zealand are subject to the FIF rules.

The bill as introduced does not restrict the receipts-based approach to situations where the person was non-resident when they acquired the rights in the scheme, although persons who were New Zealand resident at the time of acquisition would not be eligible for the four-year exemption period (this means that they would instead apply the schedule or formula method based on the date that they acquired the rights in the scheme).

However, officials consider that the receipts-based approach is not appropriate for taxpayers who first acquire rights in a foreign superannuation scheme while they are already New Zealand resident. Under existing law, this is reflected in the fact that the FIF rules generally apply where the rights in the foreign superannuation scheme were acquired while resident in New Zealand.

The policy intention of the changes contained in the bill – in particular, moving to a receipts-based approach – is to make it easier for people who have migrated or returned from overseas with foreign superannuation to comply with their New Zealand tax obligations. While the receipts-based approach in the bill broadly approximates the FIF treatment in terms of the amount of tax actually payable, an important difference is that under the receipts-based approach, if a person leaves New Zealand before receiving the lump sum they will not be subject to any tax.

We consider that allowing taxpayers who acquire rights in a foreign superannuation scheme while they are New Zealand resident to use the receipts-based approach could undermine the existing rules that generally apply for portfolio investments.

For example, a New Zealand resident intends to retire overseas and wants to save for their retirement through a managed fund.

If they choose to save through a New Zealand-based managed fund, they will be subject to New Zealand tax on their investment gains as they are earned (paid by the managed fund). If they choose to save through a foreign managed fund, they will be subject to New Zealand tax under the FIF rules on the gains as they are earned.

If the receipts-based approach is available to them, it is possible that a taxpayer who intends to retire overseas may be able to invest into a foreign fund that is set up to provide retirement benefits, and choose to withdraw that lump sum when they move overseas. This would mean that they would not pay any tax on the gains they earned in that fund while they were New Zealand resident.

Officials consider that this is not consistent with the underlying policy intention of the rules.

Complexity can arise where rights in an employment-related scheme are acquired partly while non-resident and partly while resident. This could occur, for example, if the employer or employee continues to contribute to the scheme or where rights are vested while the person is a New Zealand resident.

Under the existing rules which determine whether the FIF rules or other receipts-based rules apply, in many cases, such as where rights in an employment-related scheme were acquired partly while non-resident and partly while resident, the rules must be apportioned. That is, the FIF rules apply to those rights that were acquired while New Zealand resident and other tax rules would apply to the remainder of the rights.

Officials do not favour such an apportionment approach, as it is highly complex and compliance-heavy.

Rather, officials consider that the receipts-based approach should be available only where the person first acquired the rights while they were non-resident. A non-resident means someone who was not New Zealand resident under YD 1 of the Income Tax Act 2007.

Where the person first acquired the rights in the foreign superannuation scheme while they were New Zealand resident, the FIF rules would generally apply.

As noted above, in general, this recommendation would mean that there is no change from the position under existing law for those taxpayers with a foreign superannuation scheme that they have acquired while New Zealand resident, because the FIF rules generally apply where the rights in the foreign superannuation scheme were acquired while the person was resident.

Recommendation

That the submission be accepted.

Issue: Lump sums should not be taxed

Clauses 8 and 18

Submission

(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited, Ernst & Young)

One submitter argued that unless the pre-New Zealand capital base was merely nominal at the time the person became resident in New Zealand, the entire value of a lump sum withdrawal should not be taxed *(Ernst & Young).*

Two submitters stated that the schedule and formula methods imply that capital gains of superannuation funds should be taxed. This appears to eliminate the capital/revenue distinction within the Act and runs counter to the intention of the changes introduced in the Portfolio Investment Entity regime in 2007. The schedule method unfairly penalises foreign superannuation schemes relative to other investments, such as residential property held on capital account *(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited).*

Comment

The rationale behind the changes is to apply accrual taxation to lump sums, but instead of this being payable annually under the FIF rules it would be accumulated and payable only on receipt. An interest factor would be incorporated into the calculations to account for the use-of-money benefit that a person receives by not paying tax annually.

The eventual tax liability would, therefore, be a function of the length of time that the person holds the interest (as a New Zealand resident) before the income is received. A longer duration implies a greater deferral benefit.

Officials consider that this will ensure that the quantum of tax paid is relatively similar as for other assets (such as interests in foreign investment funds or foreign bank accounts).

Recommendation

That the submission be declined.

Issue: New rules should apply to pensions

Clauses 8 and 18

Submission
(KPMG)

The proposed treatment for lump sums should also apply to pensions.

Comment

The submitter is concerned that, by taxing pensions in full, there is no acknowledgement that pensions comprise both income and capital. The submitter argues that the methodology underlying the schedule method could be applied to pensions as it should be possible to derive a taxable percentage based on the total value of the pension pot.

Officials disagree with this submission.

A key reason for changing the current rules is the complexity of the current rules in respect of lump sums. Officials are of the view that the complexity of the rules has been a factor in non-compliance.

The same non-compliance that exists in relation to lump sums does not exist with periodic pensions. This is partly due to the fact that the taxpayer is simply required to include the value of the pension in their income tax return. This is consistent with the expectation of taxpayers.

Requiring individuals to apply the schedule method or something similar to their pension would significantly increase complexity. In addition, it would require a boundary to be drawn between social security pensions (which would continue to be taxed in full) and other types of pensions, which would introduce further complexity.

Officials are of the view that an increase in complexity could adversely affect compliance.

Recommendation

That the submission be declined.

Issue: Eligible foreign superannuation funds

Clause 8

Submission
(Chris Pearson)

It should be clarified which schemes are included in the definition of a "foreign superannuation scheme".

Comment

The submitter notes that the proposed legislation does not make it clear what superannuation funds would be taxed under the proposed new rules. The submitter suggests that it should include a number of common United States superannuation products and retirement savings schemes.

Officials note that the definition of foreign superannuation scheme is an existing definition in the current law. It is reasonably broad, and would likely include the schemes the submitter has mentioned.

However, more specific clarification would be more appropriate in a guidance document rather than in the legislation.

Recommendation

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

Issue: Clarifying the definition of foreign "superannuation scheme"

Clause 8

Submission
(Matter raised by officials)

The definition of a foreign "superannuation scheme" in the current law should be clarified to ensure that it does not include overseas social security schemes. This will preserve the existing tax treatment of payments from such schemes. This should be made retrospective to 2004.

Comment

It has been generally accepted that overseas social security schemes that make payments similar to New Zealand Superannuation are not subject to the FIF rules. Rather, when pensions or lump sums are paid from such overseas social security schemes, they will be subject to tax under the ordinary tax rules.

In general, this means that pensions from overseas social security schemes are subject to full tax. The taxation of lump sums depends on the character of the lump sum, but they are generally not taxed.

We consider that continuing this current tax treatment is appropriate in the context of the proposed changes.

The proposed new rules will apply to interests in a foreign "superannuation scheme". They are not intended to apply to overseas social security schemes that make payments similar to New Zealand Superannuation.

The definition of a "superannuation scheme", when originally enacted in 1989, excluded the historical equivalent of New Zealand Superannuation. Inland Revenue's view is that the definition of a "superannuation scheme" also excluded overseas social security schemes that make payments similar to New Zealand Superannuation.

In 2004, as part of the rewrite of the Income Tax Act, the definition of "superannuation scheme" was restructured. It appears that, as a result of these drafting changes, it is not clear that the definition excludes overseas social security schemes that are similar to New Zealand Superannuation. This is not the intended policy outcome.

Officials consider that the definition of a "foreign superannuation scheme" should be clarified to ensure that it does not cover overseas social security schemes, consistent with the original intention under the 1976 and 1994 Income Tax Acts. This will preserve the existing tax treatment of payments from such schemes. This should be made retrospective to the enactment of the rewritten Income Tax Act in 2004.

Recommendation

That the submission be accepted.

Issue: Pensions from trusts and companies

Clauses 6 and 66

Submission
(Matter raised by officials)

It should be clarified that a pension derived from a foreign superannuation scheme that is a company should not be a dividend. Similarly, it should be clarified that pensions derived from a foreign superannuation scheme that is a trust should not be taxed under the trust rules.

Comment

In many cases, the foreign superannuation scheme will legally be a unit trust, and therefore subject to the company tax rules. In other cases, the foreign superannuation scheme will legally be a trust, and therefore subject to the trust tax rules.

The proposed legislation provides that, when the foreign superannuation scheme is a company, a lump sum withdrawal is not a dividend.

Similarly, the bill proposes that a lump sum withdrawal from a foreign trust that is a foreign superannuation scheme will not be a taxable distribution.

In both cases, it is instead intended that the lump sum will be subject to the new rules.

In current legislation, pensions are taxed under a separate charging provision. However, it appears that it may not be clear whether this provision takes precedence over the company and trust rules.

It should be clarified that a pension received from a foreign superannuation scheme that is a company should be taxed as a pension and not be treated as a dividend. Similarly, it should be clarified that a pension received from a foreign superannuation scheme that is a trust should be taxed as a pension and not be taxed under the trust rules.

Recommendation

That the submission be accepted.

Issue: Application of trust rules

Clauses 66 and 67

Submission
(Ernst & Young)

There should be a statutory provision that the trust rules do not apply to foreign superannuation schemes or to income or benefits from them.

Alternatively, distributions from superannuation schemes should be excluded from the definition of "taxable distribution" in relation to non-complying trusts. Distributions from foreign superannuation schemes should be excluded from the definition of beneficiary income.

Comment

The bill proposes that a lump-sum withdrawal from a foreign trust that is a foreign superannuation scheme will not be a taxable distribution. Instead, it is intended that the lump sum will be subject to the new rules.

A trust will only be a non-complying trust if it has a New Zealand-resident settlor and does not meet certain obligations.

The bill provides that a contribution made to a foreign superannuation scheme will not automatically mean that the person is a settlor. This means that contributions to a superannuation scheme from a person made while they are New Zealand resident will not result in the foreign trust becoming a non-complying trust.

We consider that this should largely meet the submitter's concern that such situations should not be taxed under the trust rules.

Recommendation

That the submission be noted.

Issue: Trust rules – contributor is not a settlor

Clauses 2 and 67

Submission
(Ernst & Young)

The amendment that a person who makes a contribution to a trust that is a foreign superannuation scheme is not a settlor of the trust should be retrospective, rather than applying from 1 April 2014.

Comment

As noted above, a provision in the rules provides that a contribution to a foreign superannuation withdrawal will not automatically mean that the person is a settlor.

Officials understand that this issue will rarely arise in practice, because most schemes to which a person contributes will be unit trusts, and, under current rules, will therefore be subject to the company rules rather than the trust rules.

Officials consider that a retrospective change of this nature may cause further uncertainty, and therefore do not favour this approach.

Recommendation

That the submission be declined.

Issue: Transfers following death and divorce

Clause 8

Submission
(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited, Ernst & Young, KPMG)

Submitters have requested clarification of the treatment of transfers that occur following a relationship split, or upon death of the transferor. In particular, clarification is sought on how the new rules interact with the existing death and divorce rollover provisions.

Comment

As currently drafted, the bill proposes that the transfer of a foreign superannuation interest to another person is a taxable event. This is the same position as existing law. The original policy intention when the bill was introduced was that this would also include situations where a transfer occurs as part of a relationship property agreement, for example upon divorce. The tax liability would be based on the transferor's years of residence.

Similarly, the bill also proposes that upon death, the transfer of a foreign superannuation interest from the deceased to another person would generally constitute a taxable event.

Again, this is the same position as existing law. This is roughly consistent with other parts of the Act which provide that there would be a market value disposal and acquisition upon death.

The bill proposes an exception to this where, upon death, the foreign superannuation interest is transferred from one New Zealand resident to another New Zealand resident. In this case, rollover relief would be provided so that the interest is not taxable at the time of the transfer, but rather when the transferee ultimately makes a withdrawal. When the transferee does make a lump-sum withdrawal, their assessable period would be deemed to have begun when the deceased's assessable period began.

Several submitters questioned how this proposal would relate to other parts of the Income Tax Act which deal with property transfers in the event of death or a relationship break-up.

In particular, other provisions in the Income Tax Act ensure that a transfer which occurs as part of a relationship agreement is, in certain circumstances, not a taxable event. Instead, the transferee takes on the cost base of the transferor and would need to account for this when they ultimately dispose of the asset.

Further, other provisions in the Act provide rollover relief only upon death in the situation where the interest is transferred to the surviving spouse, civil union partner, or de facto partner. (Again, in this situation, the surviving spouse, civil union partner, or de factor partner 'steps into the shoes' of the deceased and takes on their cost base).

Officials now consider that a better approach would be to broadly align the treatment of transfers upon death and relationship split with the treatment in other parts of the Act, with some minor modifications to ensure that the integrity of the proposed new rules is maintained.

Under this approach, a transfer of a foreign superannuation interest from one person to another would generally constitute a taxable event, as per the current drafting in the bill.

However, where the transfer occurs as a result of divorce, the end of a civil union, or the end of a de facto relationship and the transferee is a New Zealand resident, rollover relief would be provided. When a lump-sum withdrawal is ultimately made by the transferee, they would be taxed as though their assessable period had begun when their ex-partner's assessable period began.

We also propose that where the transfer occurs upon the death of the transferor, rollover relief would be provided only where the transferee is a New Zealand resident and is the surviving spouse, civil union partner, or de factor partner. The assessable period would similarly be calculated from the beginning of the deceased's assessable period. Transfers to any other person should be taxed when the transferor dies.

Officials consider that this would be broadly consistent with the existing approach for rollover relief in other parts of the Income Tax Act.

Recommendation

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

Issue: Drafting clarification – transfer to a non-resident upon death

Clause 8

Submission
(KPMG)

Under the current drafting, the transfer of an interest from a New Zealand resident to a non-resident upon death would not be taxable. There should be confirmation that there would be permanent rollover relief on death where the beneficial interest transfers to a non-resident (*KPMG*).

Comment

As noted in the section above, the original policy intention was that when an interest in a foreign superannuation scheme is transferred upon death from a New Zealand resident to a non-resident, the transfer would be taxable according to the deceased's assessable period.

The current drafting does not adequately reflect this policy intention and the provision will need to be adjusted.

Recommendation

That the submission be declined, but that the policy intention as outlined by officials should be clarified. .

Issue: Provisional tax

No clause

Submission
(Ernst & Young, Financial Services Council, New Zealand Institute of Chartered Accountants, New Zealand Law Society)

Foreign superannuation withdrawals should not be considered when determining a taxpayer's obligation under the provisional tax rules. The additional "withdrawal tax liability" should be excluded from the definition of "residual income tax". (*Financial Services Council, New Zealand Institute of Chartered Accountants*, *New Zealand Law Society*).

The withdrawal tax liability described in CZ 21B (the 15% option) should be expressly excluded from the definition of residual income tax in YA 1 (*Ernst & Young*).

Comment

When a taxpayer has a residual tax liability of $2,500, they are required to account for the provisional tax rules.

A concern raised by one submitter is that if the withdrawal was made late in their income year, use-of-money interest would be applicable to the first two provisional tax instalments that were missed, as the tax legislation assumes it was received evenly throughout the year *(New Zealand Institute of Chartered Accountants).*

Officials note that this is only the case if the taxpayer is already considered to be a provisional taxpayer. If they are not a provisional taxpayer before the lump-sum withdrawal, then they would not be subject to any use-of-money interest for the missed provisional tax instalments. They would however be required to account for provisional tax rules in the following income year. Officials note that there are a number of ways in which provisional tax may be managed.

One submitter notes that a tax liability arising from use of the 15% option in relation to past non-compliance should not be included as residual income tax. This is because the income actually arose in a past year, but for the purposes of the 15% option the income would be deemed to arise in the 2013–14 or 2014–15 income year *(Ernst & Young).*

Officials note that there are no current exemptions for certain types of income under the provisional tax rules. Introducing an exemption for foreign superannuation withdrawals could create an unintended precedent.

The issue raised by submitters also exists in relation to other lump-sum payments, for example lump-sum compensatory payments from ACC. No relief from the provisional tax rules is provided for such payments. As such, any decision here would set a precedent for other lump-sum payments.

Recommendation

That the submission be declined.

SCHEDULE METHOD

Clauses 8 and 106

Issue: 5% rate is too high

Submission
(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited, Ernst & Young, Financial Services Council, KPMG, New Zealand Institute of Chartered Accountants)

The underlying rate of return used for the purposes of the schedule method is too high and should be 3.5% or 4%.

Baucher Consulting Limited and the Accountants and Tax Agents Institute of New Zealand raised the issue in their written submission, and suggested an alternative underlying rate of return of 3.5% in their oral submission.

Comment

The proposals in the bill rely on an underlying rate of return of 5% to calculate the tax ultimately payable on a lump sum.

Submitters argued that the actual returns are likely to be less than the 5% rate of return used by the schedule method model for calculating tax, particularly following the global financial crisis. Managers' fees also have the effect of reducing the value of a person's interest, especially when the interest is low in value.

Officials note that while the schedule method assumes an underlying rate of return of 5%, we consider this assumption to be robust. Historically, average rates of return are more in line with the assumed 5%.

Submitters also argued that the fair dividend rate (FDR) method under the FIF rules should not be used as a precedent (FDR provides a rate of return of 5% of the opening value of the interest).

Under the FIF rules, the 5% FDR acts as a cap on taxable income from the foreign superannuation scheme. When the actual rate of return is greater than 5%, taxpayers are still able to use FDR. When the return is less than 5%, taxpayers who are individuals are taxed on that. When there is a loss, no tax is paid. Submitters argued that these factors mean that on average, the taxable rate of return for foreign superannuation under the FIF rules is about 3.5%.

Officials note that when the issues paper proposing changes to foreign superannuation was released in July 2012, some submitters suggested that the growth rate should be lowered.

Other submissions on the issues paper suggested that the growth rate should not begin until 4 years post-migration, rather than the first year of migration (as was in the original issues paper).

The proposals in the bill pick up the latter approach – that is, delaying the start of the growth rate until four years post-migration. Officials consider that this is a sensible approach as it prevents a cliff face after the four-year exemption. However, allowing both the four-year exemption and a lower growth rate would be too concessionary.

Officials also note that taxpayers would have the formula method available as an alternative to the schedule method. Using the formula method would prevent over-taxation when the average rate of return is lower.

Recommendation

That the submission be declined.

Issue: The schedule year fraction should not reach 100%

Submission
(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited, Ernst & Young)

The schedule year fraction should never reach 100% *(Ernst & Young).*

The schedule year fraction should be capped at 75% (*Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited*).

Comment

Officials note that the formula used to calculate the schedule method takes into account the deferral benefit received by a taxpayer from not paying tax on accrual.

In theory this means that the schedule year fractions could exceed 100% after year 26, but a decision was made to cap the rate at 100%.

Capping the schedule year fractions at a rate lower than 100% would have the effect of understating the deferral benefit for the taxpayers who gain the most from deferring the payment of tax – those who have held their interest for several decades.

Recommendation

That the submission be declined.

FORMULA METHOD

Clauses 8 and 103(10)

Issue: The "grow rate" should be removed

Submission
(Ernst & Young, PricewaterhouseCoopers)

The "grow rate" should be removed from the formula method.

Alternatively, the relevant rates could be provided by the Commissioner of Inland Revenue each year or else set out in a schedule (*Ernst & Young*).

Comment

The submitters note that the formula method, as an alternative to the schedule method, is too intensive, restrictive, and complex to be a viable option for taxpayers to apply. This is because people will struggle to understand and apply the concept of the interest component to account for the deferral of tax ("grow rate").

Officials note that accounting for the deferral benefit is a major component of the proposed new rules for taxing foreign superannuation interests, particularly when taxpayers may hold these interests for at least 20–30 years before bringing them into the New Zealand tax base.

Officials do not believe that calculating the "grow rate" is too intensive, restrictive, or complex. The "grow rate" formula utilises information that the taxpayer would have used in calculating other components of the formula method.

Recommendation

That the submission be declined.

Issue: Changing the tax rate in the "grow rate" calculation

Submission
(New Zealand Law Society)

The tax rate used to calculate the "grow rate" should be the taxpayer's actual marginal tax rate.

Where the actual rate has fluctuated during the relevant period, an averaging calculation should apply or the taxpayer should use the highest marginal rate applying over the period.

Comment

The term "grow rate" assumes that the person is on the highest marginal tax rate.

The submitter argues that when the taxpayer's actual marginal rate is less, this inappropriately inflates the benefit of the deferral and the actual marginal rate should be able to be used if it is less.

Officials are of the view that this would add unnecessary complexity to the proposed legislation. This would particularly be the case if the taxpayer were required to calculate their average marginal tax rate over a 20 or 30 year period, when tax rates may have fluctuated or they may not have access to the required information.

Recommendation

That the submission be declined.

Issue: Application to defined benefit schemes

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

The formula method should be available to taxpayers with defined benefit schemes. The submitters note that actuarial valuations are available and are considered to be a recognised means of valuing interests in defined benefit schemes.

There should be a separate option available to taxpayers with interests in defined benefit schemes *(New Zealand Institute of Chartered Accountants).*

Comment

In establishing the formula method, officials were concerned that reliable actuarial valuations of defined benefit schemes are not available.

While it is possible in theory to obtain actuarial valuations, these can vary greatly. This raises serious integrity issues.

Submitters did not provide further suggestions on how these integrity issues could be addressed in practice.

Recommendation

That the submission be declined.

RECOGNISED CONTRIBUTIONS

Clause 8

Issue: Voluntary contributions should be deductible

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

Voluntary contributions should be considered recognised contributions and therefore deductible *(Ernst & Young, New Zealand Institute of Chartered Accountants)*.

Comment

Under the new rules, tax is imposed when a lump sum is received or transferred under either the schedule or formula method.

The schedule method works backwards to presume, on the basis of the assumed interest rate, a particular value of the superannuation interest at the beginning of the person's assessable period. Any difference between the transferred amount and this 'deemed' original value is treated as gains. The deemed gains are taxable, while the deemed original value is not. The underlying result is that the schedule method treats contributions made while an individual is New Zealand-resident partly as investment gains and effectively taxes them as such.

There are different ways of relieving this potential over-taxation. The approach taken in the bill is to apply the schedule method to the amount of the lump sum after deducting the value of certain contributions made while New Zealand-resident, as long as those contributions have been subject to New Zealand tax. This reduces the amount of the lump sum on which the schedule year fraction is applied by the value of the contributions, thereby reducing the individual's taxable income.

While this has the advantage of being a very simple approach, it does have the result of being overly concessionary in most circumstances. This is because the deductions reduce the value of the lump sum on which the schedule year fraction is applied, but the schedule year fractions already implicitly divides the lump sum into capital amounts and gains. This effectively means that the individual would receive a double deduction for the contribution.

Because of this potential for under-taxation, contributions are subject to certain restrictions before they are "recognised" (that is, deductible under either the schedule or the formula method). In particular, voluntary contributions made to a foreign superannuation scheme after the individual becomes New Zealand resident would not be deductible. Only compulsory contributions required under the scheme's rules would be deductible.

Apart from the issue of under-taxation in respect of the schedule method, officials are also concerned about the potential for undermining the FIF rules – that is, a person who wishes to be subject to receipts-based taxation rather than the FIF rules could use the rules to route money through "voluntary contributions" into their foreign superannuation scheme and avoid being taxed annually.

This is also why officials also propose in this report to restrict the receipts-based approach to taxpayers who first acquired their foreign superannuation interest while non-resident.

Recommendation

That the submission be declined.

Issue: Voluntary contributions should be deducted under the formula method

Submission
(Financial Services Council)

Voluntary contributions should be considered recognised contributions under the formula method only (*Financial Services Council*).

Comment

One submitter acknowledged that allowing a deduction for voluntary contributions may be problematic for the schedule method, but submitted that voluntary contributions should be allowed only under the formula method, as the concern does not apply to the formula method.

Officials agree that allowing a deduction for voluntary contributions under the formula method does not present the same concerns of under-taxation as for the schedule method. This is because the formula method relies on *actual* information to divide a lump sum into a capital amount and gains.

However, as noted above, officials consider that there is a concern that a person who wishes to be subject to receipts-based taxation rather than the FIF rules could use the rules to route money through "voluntary contributions" into their foreign superannuation scheme and avoid being taxed annually.

This is also why officials also propose in this report to restrict the receipts-based approach to taxpayers who first acquired their foreign superannuation interest while non-resident.

Recommendation

That the submission be declined.

TRANSFERS TO NEW ZEALAND SCHEMES

Clause 8

Issue: Tax on transfers to locked-in New Zealand schemes

Submission

(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited, KPMG, New Zealand Institute of Chartered Accountants)

Transfers from foreign superannuation schemes to locked-in New Zealand superannuation schemes should be exempt from tax because the submitters do not consider such transfers to be income. They believe that no present entitlement to the funds arises at the point of transfer, so, the transfer should be treated as a capital transaction.
(*Accountants and Tax Agents Institute of New Zealand*, *Baucher Consulting Limited*).

Transfers to locked-in New Zealand superannuation schemes should not be taxed if they are locked in for 10 years (*New Zealand Institute of Chartered Accountants*) or if they are subject to anti-deferral measures, such as a minimum lock-in period (*KPMG*). These submitters argue that encouraging residents to repatriate their foreign superannuation schemes to New Zealand is beneficial not only for the New Zealand tax base, but also for New Zealand's funds management industry. However, they acknowledge officials' concerns regarding possible abuse and propose that an additional condition be attached to the transfer to mitigate this possible abuse – that the scheme must remain locked-in for a minimum period.

Comment

The intention behind the rules is to approximately tax the gains that the person made while they were resident in New Zealand. Exempting transfers into locked-in schemes would create a significant inequity between New Zealand residents with foreign superannuation schemes and those with other financial assets such as New Zealand superannuation schemes, shares, or bank deposits.

Officials also note that new residents will have four years to transfer their superannuation tax-free. Their tax liability gradually increases after that four-year period. This policy setting is expected to provide an incentive for taxpayers to transfer their superannuation to New Zealand sooner rather than later.

Officials consider that the submitters' proposals would instead encourage residents to keep their foreign superannuation interests offshore and only transfer their interest into a locked-in New Zealand scheme immediately before they are able (and wish) to use the funds. They would pay no New Zealand tax while their interest was offshore, which could potentially be several decades.

Recommendation

That the submission be declined.

Issue: Receiving superannuation scheme should inform individual of tax implications

Submission
(Charter Square Services)

The New Zealand schemes accepting transfers from overseas should be required to inform the individual making the transfer of the tax implications.

[Raised in the oral submission]

Comment

Under the new rules, people who transfer their funds to superannuation schemes may or may not have a tax liability in respect of that scheme (which will generally depend on their duration of residence in New Zealand).

Officials agree that it is important for individuals to understand their tax obligations before they decide to make a withdrawal or transfer.

A difficulty with this submission is that the superannuation scheme cannot provide specific advice to individuals that is tailored to their situation as the superannuation scheme is not a tax agent.

Officials will be working with the industry to ensure that appropriate general information can be communicated to individuals. At this point in time, officials do not consider that a legislative requirement is necessary.

Recommendation

That the submission to require schemes to inform the individual of the tax implications be declined, but that the issue be noted by the Committee.

Clause 115

Issue: Optional withdrawals from KiwiSaver could trigger UK QROPS rules

Submission
(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited, Charter Square Services, New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)

An agreement should exist between Inland Revenue and the United Kingdom's HM Revenue and Customs regarding the possible interaction between the United Kingdom's rules and the proposed KiwiSaver withdrawal mechanism *(Charter Square Services)*.

Three submitters suggest that Inland Revenue should clarify the interaction with the UK QROPS rules *(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited, New Zealand Institute of Chartered Accountants).*

Alternatively, transfers of foreign superannuation funds from the UK into QROPS should not be taxed *(PricewaterhouseCoopers).*

One submitter states that transfers into KiwiSaver should not be taxed *(KPMG)*

Another submitter has submitted that there should be a legislative solution to ensure that the QROPS rules are not triggered *(New Zealand Institute of Chartered Accountants).*

One submitter states that any tax leakage from exempting transfers into QROPS would be insignificant as any UK tax paid should ordinarily be available as a foreign tax credit *(PricewaterhouseCoopers).*

A submitter also states that in having the proposed rules apply to transfers from UK superannuation schemes to New Zealand QROPS would result in additional reporting responsibilities in the United Kingdom *(PricewaterhouseCoopers).*

Comment

The "qualifying recognised overseas pensions schemes" (QROPS) regime is administered by the UK's HM Revenue and Customs (HMRC). It allows individuals with interests in UK pension schemes to transfer their interests to certain overseas schemes (QROPS) without incurring any UK tax charges. The majority of New Zealand superannuation schemes that qualify as QROPS are KiwiSaver schemes.

Once a person has transferred from a UK scheme to a QROPS, there are specific provisions relating to how an individual may access their funds. If the individual makes a withdrawal from the QROPS and was a UK resident in any of the five preceding income years, the withdrawal may be classed as an unauthorised withdrawal and may be subject to an unauthorised payment charge and surcharge of up to 55%.

The new rules for taxing foreign superannuation contained in this bill propose a mechanism that would allow a person who transfers their foreign superannuation into a KiwiSaver scheme, and who has a resulting tax liability, to withdraw a portion of their superannuation to pay that tax liability (the "withdrawal mechanism"). This is an optional facility that is intended to make it easier for people to meet their tax obligations. Taxpayers do not have to use the facility and can choose to pay their tax liability from other funds if they prefer.

One submitter states that in making a withdrawal from their KiwiSaver using the proposed withdrawal mechanism, an individual may trigger this QROPS penalty charge and the scheme could be delisted as a QROPS.

Officials have confirmed with HMRC that the introduction of the withdrawal mechanism would not impact the ability of KiwiSaver schemes to qualify as QROPS.

Officials understand that the penalty charges exist to protect the integrity of the UK's tax system and pension regime, and that an exemption for the proposed withdrawal mechanism from the UK's unauthorised payment charge and surcharge is unlikely.

However, we believe that the risk of triggering the unauthorised payment charge is relatively low and does not require a policy response of exempting transfers into QROPS from New Zealand tax.

First, the penalty charge is only levied by HMRC if the individual was a UK resident in any of the five income years before the withdrawal. Under the proposed legislation, individuals who transfer within the first four years of becoming New Zealand resident would have no New Zealand tax to pay and would therefore not need to utilise the proposed withdrawal facility.

Second, while there may be some overlap for a new migrant in the fifth year of residence the proportion of the transfer that is assessed as income is only 4.76%. At the top marginal tax rate of 33%, the effective tax rate on the transfer would be approximately 1.57%. As this is a low effective tax rate, we expect that most individuals should be able to satisfy their tax liability out of other funds rather than using the KiwiSaver withdrawal facility. This means that they would be able to avoid the QROPS unauthorised payment charge.

One submitter states that any tax leakage from exempting transfers into QROPS would be insignificant as any UK tax paid should ordinarily be available as a foreign tax credit *(PricewaterhouseCoopers).*

Officials consider this to be incorrect. Under the double tax agreement (DTA) between New Zealand and the UK, New Zealand usually has the sole right to tax such lump sums. This means that New Zealand is not required to provide a foreign tax credit and the taxpayer should apply to HMRC for a refund of UK tax paid.

The submitter also states that in having the proposed rules apply to transfers from UK superannuation schemes to New Zealand QROPS would result in additional reporting responsibilities in the United Kingdom *(PricewaterhouseCoopers).*

This is also incorrect as the proposed rules do not change the reporting requirements of the QROPS regime.,

Recommendation

That the submission be declined.

Issue: KiwiSaver provider must be sufficiently satisfied before approving a withdrawal

Submission
(KPMG)

The requirement that the KiwiSaver provider must be sufficiently satisfied with the KiwiSaver member's application to withdraw the amount of the tax liability before releasing the funds should be removed.

Comment

Officials consider this requirement to be necessary to maintain the integrity of the KiwiSaver rules.

Officials do not believe that this will be overly onerous for the provider. Schemes would require a statutory declaration from the member, and may require other evidence (such as a tax assessment) as considered appropriate by the provider.

Officials note that similar requirements appear in other provisions governing permitted withdrawals in the KiwiSaver Act 2006.

Recommendation

That the submission be declined.

Issue: Notification of withdrawal and payment to Inland Revenue

Submission
(Matter raised by officials)

KiwiSaver providers should be required to notify Inland Revenue upon allowing a withdrawal from KiwiSaver to pay a person's tax liability and should also pay the amount directly to Inland Revenue if their systems allow them to do so.

Comment

The proposed withdrawal mechanism allows a KiwiSaver provider to approve a withdrawal from KiwiSaver to pay a person's tax liability, in limited circumstances.

At the moment there is no requirement for KiwiSaver providers to notify Inland Revenue about the request or pay the amount directly to Inland Revenue. We consider that this is inappropriate as Inland Revenue may not be aware of an individual withdrawing an amount and failing to pay their tax liability.

We consider that requiring KiwiSaver providers to notify Inland Revenue upon allowing a withdrawal, and requiring them to pay the amount direct to Inland Revenue (if their systems allow it) will support the integrity of the KiwiSaver rules and ensure that the withdrawal mechanism operates as intended.

Recommendation

That the submission be accepted.

Issue: Student loan repayment obligation arising from a transfer of a foreign superannuation scheme into KiwiSaver

Submission
(Matter raised by officials)

When a taxpayer applies to their KiwiSaver provider to withdraw the amount of the tax liability arising from the transfer into KiwiSaver, they should also be able to withdraw an additional amount to meet a student loan repayment obligation. This should be limited to the amount of the student loan repayment obligation that is attributable to the assessable income in relation to the foreign superannuation transfer.

Comment

Where a portion of the foreign superannuation transfer is taxable income, a corresponding student loan repayment obligation may arise for that income year.

Officials consider that this is an appropriate result as the portion included in the income tax return is income derived by the person, and so should be taken into account when calculating such obligations.

However, officials acknowledge that taxpayers who transfer their foreign superannuation interest into KiwiSaver may experience further cash flow difficulties in meeting their student loan repayment obligations that arise from that transfer.

Officials therefore consider that when a taxpayer applies to their KiwiSaver provider to use the proposed withdrawal mechanism to pay their transfer tax liability, they should also be permitted to withdraw an applicable amount to meet their student loan repayment obligations, but only to the extent that it arises as a result of the transfer.

Recommendation

That the submission be accepted.

Issue: Time limit for withdrawal mechanism

Submission
(Matter raised by officials)

The time limit applying to when an application for a KiwiSaver withdrawal may be made should be amended so that the application must be made within two years of the 'foreign superannuation withdrawal' being included in the appropriate income tax return. For this reason, it should also be made clearer that the withdrawal mechanism is only available when the lump sum has been assessed as income.

Comment

The proposed legislation currently provides that, in order to use the proposed KiwiSaver withdrawal mechanism, the application to the KiwiSaver provider needs to be made within two years of the transfer.

However, the tax liability is only confirmed when the taxpayer returns the appropriate portion of the transfer in their income tax return and it is assessed as income.

Therefore officials consider it more appropriate for the two-year limit to start from when the lump sum has been assessed as income.

Recommendation

That the submission be accepted.

Issue: Is the withdrawal option available for partial transfers into KiwiSaver?

Submission
(Charter Square Services)

A taxpayer who has transferred their foreign superannuation into a non-KiwiSaver New Zealand superannuation scheme, should be able to use the KiwiSaver withdrawal option by first transferring the amount of the tax liability from the non-KiwiSaver scheme into a KiwiSaver scheme then making the application for withdrawal.

[Raised in the oral submission]

Comment

The withdrawal option is only available to taxpayers who have transferred into KiwiSaver schemes. There are a number of New Zealand superannuation schemes that are not part of the KiwiSaver regime.

The reason behind creating a withdrawal option for KiwiSaver is due to the ease of making an amendment to the KiwiSaver Act 2006. Extending the withdrawal option to non-KiwiSaver schemes would require amending the trust deed for each scheme. Officials note that there is nothing preventing non-KiwiSaver schemes from providing such a withdrawal facility without government intervention.

Some – although not many – of these non-KiwiSaver schemes qualify as QROPS under the UK's 'qualified recognised overseas pension schemes' regime (for further information see 'Issue: Withdrawals from KiwiSaver could trigger UK QROPS rules'). This means that a number of UK migrants may transfer into these schemes but would not have access to the KiwiSaver withdrawal option to pay their tax liability.

However, a taxpayer who has transferred to a non-KiwiSaver superannuation scheme may know what their liability arising from the transfer is. They may then transfer this exact amount of the tax liability from a non-KiwiSaver scheme to a KiwiSaver scheme and then use the withdrawal facility to withdraw that full amount and pay Inland Revenue.

The submitter notes that the current drafting of the proposed legislation does not prevent this from occurring.

Officials do not think that this will be a significant issue as the majority of transfers made by UK migrants will be into KiwiSaver schemes. Inland Revenue will monitor the situation to see if any problems will arise.

Recommendation

That the submission be noted.

PAST WITHDRAWALS – 15% OPTION

Clauses 25, 116 and 117

Issue: Support for 15% option

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

Two submitters are supportive of the proposed concessionary option available to taxpayers who have previously not complied with their tax obligations *(Ernst & Young, New Zealand Institute of Chartered Accountants)*.

Comment

Officials note the support for the proposed concessionary option.

Recommendation

That the submission be noted.

Issue: Retrospectivity

Submission
(Elaine Hope, Leonie Walker)

One submitter stated that people who complied with the law previously should not have to pay 15% tax on a retrospective basis.

Another submitter stated that the changes should not be brought in retrospectively; the new rules should apply on a prospective basis.

Comment

The 15% option does not retrospectively impose a tax liability on any individuals.

Taxpayers who made a lump-sum withdrawal or transferred their foreign superannuation scheme before 1 April 2014 and complied with the law that existed at the time in relation to their scheme are not required to take further action. This includes people who have not paid any tax because an exemption applied to their situation under existing law (for example, because they were a transitional resident at the time). In these situations, the taxpayer will have no tax obligations as there was no liability under the existing law.

However, officials understand that a number of people who made a withdrawal or transfer may not have complied with their tax obligations.

These taxpayers can apply the law as it applied to their interest at the time that they made the withdrawal. They may be subject to use-of-money interest or penalties, although these may be reduced where the taxpayer voluntarily discloses their tax liability.

Alternatively, they can choose to use the 15% option proposed in the bill. The 15% option is a concessionary, low-cost alternative option for taxpayers who have made a lump-sum withdrawal or transfer before 1 April 2014, and who did *not* fulfil their tax obligations in relation to the foreign superannuation interest.

Under this option, the person can include 15% of their lump sum as income in their 2013–2014 or 2014–2015 tax return, and apply their marginal tax rate to that amount. For example, a person who transferred $100,000 would include $15,000 in their tax return. If their tax rate is 33%, they will have tax to pay of $5000.

It is important to note that taxpayers are not required to use the 15% option proposed in the bill and may instead choose to apply the law as it existed at the time.

Recommendation

That the submission be declined.

Issue: Past non-compliance should not be pursued

Submission
(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited)

Non-compliance should not be pursued and therefore the 15% option should not be available.

Comment

As noted above, a number of people have not complied with their tax obligations in relation to their foreign superannuation. The 15% option is intended as a low-cost concessionary measure for taxpayers to get their tax affairs in order.

However, it should be noted that although non-compliance has been high, a number of people have complied with their tax obligations.

The approach suggested by the submitter is likely to undermine voluntary compliance, which is a cornerstone principle of New Zealand's tax administration.

Recommendation

That the submission be declined.

Issue: Interest and penalties

Submission
(Ernst & Young, Financial Services Council)

The revised due date that applies in relation to the 15% option should also apply to non-compliant taxpayers who choose to apply the law that existed at the time.

Comment

Taxpayers have an obligation to comply with the tax rules governing their foreign superannuation interest at the time they are required to.

Officials are of the view that non-compliance should not be rewarded, but acknowledge that the existing rules are complex.

The 15% option is intended to be a low-cost option available to non-compliant taxpayers to help them get their tax affairs in order.

As it is an option, if a taxpayer chooses not to use, their liability under the existing law should remain.

Officials note that penalties are generally reduced for voluntary disclosures.

Recommendation

That the submission be declined.

Issue: Timeframe

Submission
(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited, New Zealand Institute of Chartered Accountants)

The window for the 15% option should be aligned with the period for which a taxpayer is required to keep tax records (i.e. seven income years) and non-compliance before that should not be audited (*New Zealand Institute of Chartered Accountants*).

The window for the 15% option should begin on 18 December 2006 or 1 April 2010. Non-compliance before this should not be audited. 18 December 2006 is proposed as this was the date of royal assent of the bill that excluded certain Australian superannuation schemes from the FIF regime. The rationale behind 1 April 2010 is that it is the beginning of the income year in which a number of articles highlighting the potential tax implications arising from lump-sum payments and transfers were published. (*Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited).*

Comment

The 15% option is a concessionary measure and officials therefore disagree with limiting its scope.

Officials note that the extent of audit activity relating to previous non-compliance will be determined according to how Inland Revenue's resources may be best utilised, as is normal tax administrative practice.

Recommendation

That the submission be declined.

Issue: Interests in foreign investment funds – clarification

Submission
(KPMG, New Zealand Institute of Chartered Accountants)

Taxpayers who did not comply with the FIF rules should be able to use the 15% option if they have made a lump-sum withdrawal before 1 April 2014 *(KPMG)*.

It should be clarified that taxpayers who have not complied with their obligations are able to choose between applying the law as it was at the time of withdrawal in each of the relevant income years, or paying tax on 15% of the withdrawal. If there were any applicable exemptions available to them at the time taxpayers should be able to utilise these *(New Zealand Institute of Chartered Accountants)*.

Comment

The policy intention is that taxpayers who have made a withdrawal and who have not complied with their obligations are able to choose between applying the law as it was at the time of withdrawal, or paying tax on 15% of the withdrawal. If there were any applicable exemptions available to them under the law that applied at the time, taxpayers should be able to utilise these.

Officials consider that this is, in general, sufficiently clear in the legislation.

However, one submitter noted that the current drafting does not seem to allow taxpayers who were non-compliant with the FIF rules and who made a withdrawal to use the 15% option in relation to past lump-sum withdrawals. Instead these people would only be able to use the law that existed at the time (i.e. recalculate their FIF liabilities).

Officials agree that the proposed legislation should be clarified so that non-compliant FIF taxpayers who made a lump-sum withdrawal before 1 April 2014 should have the 15% option available to them.

Recommendation

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

Issue: Withdrawals derived after 1 April 2014 should also be eligible for the 15% option

Submission
(Offen Advisors Limited, Owens Tax Advisors Limited)

The 15% option should be extended so that taxpayers who transfer their foreign superannuation scheme up to six months after 1 April 2014 are eligible to use the 15% option.

Comment

The policy intention is that taxpayers who derive a lump sum on or after 1 April 2014 would be subject to the proposed new regime.

Officials consider that it would be inappropriate to have the concessionary 15% option available for a longer period as it would undermine the proposed new regime.

Furthermore, officials consider that as part of the submission it would be necessary to amend the application date of the proposed regime, because it would be inappropriate to have the proposed new regime and the concessionary 15% option both applying at the same time.

Recommendation

That the submission be declined.

TRANSITIONAL ISSUES AND APPLICATION DATE

Clauses 2(14), 8 and 103(9)

Issue: Grandparenting under the FIF rules–support

Submission
(New Zealand Institute of Chartered Accountants)

One submitter welcomes the ability for taxpayers who have complied with the FIF rules to continue using the FIF rules.

Comment

Officials note the submission.

Recommendation

That the submission be noted.

Issue: Recognising FIF tax already paid for taxpayers who choose not to use the grandparenting option

Submission
(Corporate Taxpayers Group, Ernst & Young, Financial Services Council, KPMG, New Zealand Institute of Chartered Accountants)

Where the FIF rules have been applied in an income year, the assessable period should commence from the following income year, if the person changes to the new rules *(Ernst & Young, Financial Services Council, KPMG, New Zealand Institute of Chartered Accountants).*

This could be achieved by adding the number of FIF-compliant years to a person's exemption period to effectively extend the exemption period (*Corporate Taxpayers Group*).

Alternatively, a deduction should be allowed for tax on FIF income already paid with respect to that foreign superannuation interest. The amount of FIF income returned should be deducted from the value of the lump sum, or a tax credit should be allowed to offset tax already paid on attributed FIF income (*Financial Services Council, Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants, Ernst & Young*).

A third option should be provided for taxpayers wishing to transition from the FIF rules into the new rules:

- Taxpayers undertake a wash-up calculation to ensure that tax is not underpaid to the extent that the taxpayer has made lump-sum withdrawals during the time they were calculating income under the FIF rules

- The 15% option should be available to compliant taxpayers who wish to transition out of the FIF rules
- Taxpayers would then apply the proposed new rules to any lump sum withdrawals made going forward. (*Corporate Taxpayers Group*).

Comment

The issue relates to taxpayers who currently have an interest in a foreign superannuation scheme and have returned FIF income in the past. Under the proposed new rules, those taxpayers would be able to continue using the FIF rules, as long as they complied with the FIF rules prior to 20 May 2013 (the date of introduction of the bill). All other taxpayers must account for tax under the new rules (that is, upon receipt).

Taxpayers who choose not to use the grandparenting provision could be subject to double taxation of the same income when they move from accounting for income under the FIF rules to paying tax under the proposed new rules. The underlying issue is that the new rules do not account for FIF tax already paid.

Officials note that under the FIF rules, no tax is paid when a withdrawal is ultimately made. The new rules propose allowing this tax treatment to continue for taxpayers who have already returned income under the FIF rules. This means that taxpayers who continue to use the FIF rules will not be overtaxed.

Officials acknowledge that there is potential for effective over-taxation if a person chooses to be taxed under the new rules instead of continuing to be taxed under the FIF rules.

However, it is not clear why a taxpayer would generally wish to use the new rules if they have already paid tax under the FIF rules. Officials do not consider that this is an issue that will arise in practice.

Recommendation

That the submission be declined.

Issue: "Turning off" the FIF rules for non-compliance in the past

Submission
(KPMG, Offen Advisors Limited, Owens Tax Advisors Limited)

The submitters are concerned at the potential for double taxation if Inland Revenue pursues past non-compliance in the case of a person who did not comply with the FIF rules and is subject to the new rules on lump sums received after 1 April 2014.

This issue does not apply to people who have already made a withdrawal.

One submitter suggests that the FIF rules should not apply where lump-sum withdrawals are taxed from 1 April 2014 under the new rules *(KPMG)*.

Others submit that the legislation should be amended to ensure that only one regime – either the FIF regime or the proposed new regime – applies to withdrawals derived after 1 April 2014 *(Offen Advisors Limited, Owens Tax Advisors Limited).*

Comment

Officials expect that a large group of people have not accounted for income under the FIF rules in previous years.

The policy intention is that these taxpayers would be subject to the proposed new rules on any withdrawals made on or after 1 April 2014. It is not intended that these taxpayers would also be subject to audit activity on their unpaid FIF tax.

This is because the proposed rules for taxing lump sums would account for any tax that should have been paid on accrual, regardless of whether that tax was paid.

Officials agree that if these taxpayers were subject to the new rules on lump sums, but also remained liable for unpaid FIF tax in relation to that scheme, there would be an element of double taxation. This is undesirable.

It is also undesirable that taxpayers be subject to the FIF regime rather than the proposed new rules, if they do not meet the conditions for grandparenting.

Officials agree that, in these situations, the FIF rules should not apply to a person's interest for past years if their interest is subject to the new rules. This proposal would ensure that taxpayers are not over-taxed, and also has the advantage of simplicity, which is consistent with the intent of the proposed rules.

(It should be noted that an exception to this would be where the taxpayer acquired the interest in the foreign superannuation scheme while already New Zealand resident. As noted in this report, officials consider that the receipts-based approach should be available only where the rights in the scheme were first acquired while non-resident. This means that these taxpayers would still be subject to the FIF rules and so would remain liable for unpaid FIF tax.)

Recommendation

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

Issue: 15% option should be available in cases where a lump sum has not been derived

Submission
(Offen Advisors Limited and Owens Tax Advisors Limited)

Taxpayers who did not comply with the FIF rules, and have *not* made a withdrawal by 31 March 2014 should be permitted to use the 15% option in relation to their foreign superannuation interest as if they had made a withdrawal. That is, they should be able to return 15% of the value of the FIF interest in respect of their past FIF obligations.

Comment

Officials note that the underlying problem is that there is potential for effective double taxation, if the person is subject to tax under the new rules.

Officials note that the proposal to waive previous FIF obligations (Issue: "Turning off" the FIF rules for non-compliance in the past) would address this problem.

Recommendation

That the submission be declined.

Issue: Cut-off date for grandparenting is not adequate

Submission
(Ernst & Young, Offen Advisors Limited, Owens Tax Advisors Limited)

The submitters argue that 20 May 2013 is not an appropriate cut-off date for the grandparenting provision.

One submitter states that there may be a number of taxpayers whose interests in foreign superannuation schemes have only just become FIF interests since the beginning of their 2012–13 income year (generally from 1 April 2012). This may be because they were previously transitional residents. Generally, the standard filing deadline for these taxpayers would be 7 July 2013 so many may have not yet filed their tax return by 20 May 2013. As a result, such taxpayers would have no opportunity to be grandparented *(Ernst & Young)*.

The cut-off date for grandparenting under the FIF rules should instead be 7 July 2013 *(Ernst & Young)*.

Taxpayers who previously did not comply with the FIF rules, and who return 15% of the value of the FIF interest in order to remedy this non-compliance, should be able to continue using the FIF rules from 1 April 2014. *(Offen Advisors Limited, Owens Tax Advisors Limited)*.

Comment

The policy intention is to reduce complexity and minimise compliance costs, and to that end, all effected taxpayers should be brought into the new regime for taxing foreign superannuation interests.

However, some taxpayers have already complied with the FIF rules in the past in respect of their foreign superannuation interest.

To ensure that this group of taxpayers do not face increased compliance costs, the proposed legislation permits those taxpayers to continue using the FIF rules rather than requiring them to comply with the new regime.

This reasoning does not apply to taxpayers who have not yet returned any income under the FIF rules.

Officials are of the view that the date of introduction of the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill (that is, 20 May 2013) is an appropriate date for grandparenting and that grandparenting should not be extended to other taxpayers.

One submitter noted that there is a small group of taxpayers who have only just become subject to the FIF rules from the 2012–13 year because they ceased to be a transitional resident during the 2012–13 income year, and who may not have submitted their tax return by 20 May 2013 so would not have the opportunity to be grandparented *(Ernst & Young).*

Officials note that such taxpayers would generally have no FIF income as they would not have had an "opening market value" for their scheme at the beginning of the income year. This means that they would be unlikely to have FIF tax to pay for the 2012–13 income year. The FIF grandparenting provision is therefore not necessary for these taxpayers, and officials consider that the new rules should apply to them.

Recommendation

That the submission be declined.

Issue: Grandparenting under the FIF rules when no FIF income or a FIF loss

Submission
(Corporate Taxpayers Group, Ernst & Young)

The legislation should clarify that grandparenting under the FIF rules should be available to taxpayers with no FIF income or a FIF loss is reduced to zero when filing a return.

Comment

In a small number of circumstances, a taxpayer may have complied with the FIF rules in relation to a foreign superannuation interest, but have no FIF or may have a FIF loss. This would not be included in the person's tax return. It is not clear that they will be grandparented under the FIF rules, as the amount returned in these circumstances will be exactly zero.

Officials agree that taxpayers in this situation should be able to continue using the FIF rules.

Recommendation

That the submission be accepted.

Issue: Evidentiary standards for grandparenting under the FIF rules

Submission
(Corporate Taxpayers Group)

Further guidance needs to be provided on the evidentiary standards that must be satisfied for the purposes of grandparenting.

In particular, the submitter notes that Inland Revenue may not be aware that a taxpayer has complied with the FIF rules because where there is a double tax agreement in force, a FIF disclosure form is not required *(Corporate Taxpayers Group)*.

Comment

Officials do not consider that any special rules are needed. The person must be able to show that they were subject to the FIF rules and complied with their obligations under the FIF rules, including correctly returning FIF income (if there was any) in respect of the FIF interest. Officials will include a comment to this effect in a Tax Information Bulletin or similar guidance following enactment.

Recommendation

That the submission be noted.

Issue: Earlier application date of new rules for certain withdrawals

Submission
(New Zealand Law Society)

Taxpayers should be permitted to apply the proposed new rules for any foreign superannuation withdrawal derived in the 2012–13 or 2013–14 income year. This means that for withdrawals derived in the period 1 April 2012 to 31 March 2014, taxpayers would have the two originally proposed options (15% and existing law) as well as a third option of using the schedule or formula method.

Comment

Officials note that the 15% option is already a concessionary option. Further, this proposal would add complexity to the transitional period as taxpayers would then need to consider three different methods when complying with their tax obligations.

Officials therefore do not consider that a third option is warranted.

Recommendation

That the submission be declined.

Issue: Application date

Submission
(Ernst & Young)

References to 1 April 2014 may cause confusion for taxpayers with non-standard balance dates. The legislation should expressly provide that the rules will apply from taxpayers' 2014–15 income years.

Comment

The new rules apply for any withdrawals or transfers that are made on or after 1 April 2014. Officials consider that this is simple and easy for taxpayers to understand.

The submitter's suggestions would mean that some taxpayers with non-standard balance dates could start the rules at a different date to other taxpayers, which is likely to be confusing for taxpayers and more difficult to administer.

Recommendation

That the submission be declined.

EXEMPTION PERIOD

Clause 8

Issue: Pre-1 April 2014 migrants should receive an exemption period

Submission
(Ernst & Young, Financial Services Council, Offen Advisors Limited, Owens Tax Advisors Limited)

Submitters are concerned that under the current drafting, it is not clear that residents who arrived before 1 April 2014 would be eligible for an exemption period. They request clarification that once the new provisions apply, they would also be capable of applying to all persons who held foreign superannuation interests as at 1 April 2014.

Comment

Officials consider that the existing drafting is sufficiently clear that taxpayers who became New Zealand resident before 1 April 2014 would have the exemption period available to them.

The proposed legislation applies to foreign superannuation withdrawals derived on or after 1 April 2014. It then works backward to calculate a taxpayer's assessable period and thus, their exemption period. This means that for all withdrawals made on or after 1 April 2014, the taxpayer would have an exemption period available to them if they meet the other conditions.

Recommendation

That the submission be noted.

Issue: Parity between transitional residents and other residents

Submission
(Charter Square Services, Ernst & Young)

The same restrictions that apply to transitional residents should also apply to other residents in respect of the exemption period *(Charter Square Services).*

Alternatively, the proposals should not have specific rules for transitional residents. Rather, the exemption period should apply to all taxpayers *(Charter Square Services).*

The period of transitional residence may be slightly longer than 48 months in some cases, as the 48 months runs from the month in which an individual obtains a permanent place of abode or exceeds 183 days' presence in New Zealand within a 12-month period. This should also apply for other new residents who are not transitional residents to achieve parity of treatment *(Ernst & Young).*

Comment

The current law provides for a four-year exemption for new migrants who meet the criteria for being a transitional resident. However, migrants who have been away from New Zealand for less than 10 years are not eligible to be a transitional resident. In addition to this, migrants who receive Working for Families tax credits during their transitional residence period will generally cease to be transitional residents.

A design feature of the new rules is to extend the four-year exemption to all taxpayers with interests in foreign superannuation schemes that were acquired while they were overseas. This will simplify the rules and ensure that everyone will receive an exemption period regardless of whether they are in receipt of Working for Families tax credits or were non-resident for less than 10 years.

The four-year exemption period that is proposed for residents who do not meet the transitional migrant criteria is intended to broadly match the rules for transitional residents.

However, the current drafting may lead to differences in the timing of the exemption period.

In particular, one submitter states that when a transitional resident receives Working for Families tax credits, they then cease to be a transitional resident. This submitter states that the exemption period would then be cut short for such a taxpayer. There is no such restriction for non-transitional residents who receive Working for Families tax credits *(Charter Square Services).*

This is not the policy intention. Rather, when a transitional resident ceases to be transitional resident part-way during their transitional residence period, their exemption period should still continue for the full 48 months. This is discussed in further detail in "*Issue: Ceasing to be a transitional resident and the impact on the exemption period*".

Officials consider that the exemption period available to non-transitional residents should be aligned with the exemption period that applies to transitional residents.

As such, it is recommended that the provision in the transitional residents rules that may result in a transitional residence period of slightly longer than 48 months should also be available to non-transitional residents in relation to their exemption period.

Recommendation

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

Issue: When is a transfer “received”?

Clause 8

Submission
(Charter Square Services)

There can be a long time delay between when a foreign superannuation scheme releases the funds of an individual and when the receiving New Zealand fund cashes in the cheque. The time at which the transfer is received should be clarified as it could impact the individual’s tax liability.

Comment

Officials understand that when an individual transfers their foreign superannuation interest into a New Zealand or Australian scheme, it is “received” when the New Zealand or Australian scheme receives it.

Officials consider that this could be clarified in guidance.

We understand that the submitter is concerned that when a taxpayer makes an application to transfer their foreign superannuation scheme towards the end of an income year, the New Zealand scheme may not receive it until part–way through the next income year. This would have the result of pushing the taxpayer into a higher schedule year fraction.

Officials note that this timing of income is a standard feature of the Income Tax Act 2007 and that taxpayers have sufficient opportunity to plan when to transfer their scheme.

Recommendation

That the submission be noted.

Issue: Tax bracket creep

Clause 8

Submission
(KPMG)

The tax rate which applies to a lump-sum withdrawal should be calculated with reference to the taxpayer's average New Zealand income in the year of withdrawal and the previous four years, or else added to a taxpayer's income, and spread over the year of withdrawal and the following four years.

Comment

This would add unnecessary complexity, as the taxpayer would be required to obtain further information about previous income years or would be required to file IR 3 income tax returns for more years than required under the rules as currently proposed.

The issue raised by the submitter also exists in relation to other lump-sum payments, such as lump sum compensatory payments. No similar relief is provided other lump sums. As such, any decision here would set a precedent for other lump sum payments.

Recommendation

That the submission be declined.

Issue: De minimis threshold

Clause 8

Submission
(Accountants and Tax Agents Institute of New Zealand, Baucher Consulting Limited)

There should be an aggregate $50,000 de minimis exemption for transfers to QROPS or KiwiSaver. The submitters argue that this would encourage compliance as taxpayers would be able to transfer relatively small foreign superannuation scheme interests to New Zealand without penalty.

Comment

Officials note that the proposed rules do not penalise taxpayers who transfer their foreign superannuation interests to New Zealand. The tax imposed on the transfer would be the same as if the taxpayer had accounted for tax on accrual.

A de minimis exception from certain tax requirements is sometimes appropriate where the compliance costs outweigh the tax involved. Officials consider that the proposed rules are as simple as possible while still maintaining fairness, and therefore do not believe that a case can be made for a de minimis threshold.

Officials also note that no precedent for an exemption from tax for de minimis amounts exists under the current rules. There is a de minimis exception available under the FIF regime, but this does not meant the taxpayer is exempt from tax altogether. The taxpayer would instead be required to account for tax paid when the income is received, either as a lump sum or a pension.

Recommendation

That the submission be declined.

Issue: Past non-compliance should be given a full amnesty, but the schedule method should be more punitive

Clauses 25, 106, 116 and 117

Submission
(Charter Square Services)

The 15% option for past non-compliance should be reduced to 0%, but going forward the schedule method should be more punitive so that taxpayers are encouraged to transfer during the exemption period.

[Raised in the oral submission]

Comment

This submission consists of two points that are to be considered together.

The submitter argues that providing a full amnesty would reduce the number of resources Inland Revenue would otherwise divert into audit activity.

Furthermore, it would encourage migrants who have not transferred their retirement savings to New Zealand to do so before 31 March 2014, thereby bringing a large amount of money into the New Zealand tax base.

Officials do not agree that the submitter's arguments outweigh the consequences that would occur from rewarding non-compliance. As noted in the issue *"past non-compliance should not be pursued"* a 0% rate for past non-compliance would adversely affect voluntary compliance, which is a cornerstone principle of New Zealand's tax administration system.

The submitter provides that in conjunction with this full amnesty, the schedule method needs to be more punitive once a taxpayer's exemption period has expired. To achieve this, the submitter proposes that once the exemption period has ended, the assessable period would be calculated from their first day as a New Zealand resident. The effect of this is that in the fifth year of residence, the schedule year fraction would be 23.07% rather than the 4.76% as currently proposed.

The rationale is that by making the rate more punitive, it would encourage more migrants to transfer their retirement savings to New Zealand during the exemption

period. This would have the effect of bringing the funds into the New Zealand tax base sooner.

Officials disagree with this analysis as the tax implications of the transfer of a foreign superannuation interest are often an afterthought. We do not believe that making the schedule method more punitive would have a significant effect on the number of transfers made during the exemption period.

Officials are also opposed to this submission because it creates a cliff face in the schedule method. The schedule method is designed as a sliding scale. Under the submitter's approach, a difference of one day could see a taxpayer being assessed on 23.07% of a lump sum rather than 0%.

Recommendation

That the submission be declined.

Issue: Review section 70 of the Social Security Act 1964

No clause

Submission
(Grey Power New Zealand Federation Incorporated)

Section 70 of the Social Security Act 1964 should be objectively reviewed, with the objective being to devise a commensurate arrangement for existing immigrant retirees.

Comment

The submitter argues that the proposed changes heavily incentivise individuals to withdraw their foreign superannuation and transfer the proceeds to New Zealand. They argue that the proposed changes bestow a favourable option on new immigrants that was not available to existing retirees, because the only practical option available to existing immigrant retirees was to leave their contributions in foreign superannuation schemes until they matured in the form of an annuity or indexed periodic remittance.

Officials note that the proposals in the bill are aimed at ensuring that there is no disincentive for taxpayers to transfer their foreign superannuation to a New Zealand superannuation scheme compared to leaving their superannuation overseas (rather than providing an incentive). In broad terms, we do not consider that the proposals create a relative disadvantage for taxpayers who can only take their foreign superannuation in the form of an annuity or periodic remittance.

The submitter states that this perceived inequity may be resolved by arranging an objective review of section 70 of the Social Security Act 1964. Section 70 of the Social Security Act 1964 provides for the deduction of an individual's foreign social security pension from their New Zealand Superannuation entitlement. This deduction occurs when the foreign social security pension forms part of a programme of benefits and pensions that are paid for similar circumstances as New Zealand benefits and pensions;

and the overseas pension scheme is administered by the government of the country that pays the pension.

Officials note that this issue is not related to the contents of the bill.

In discussions between officials from Inland Revenue, Treasury, and Ministry of Social Development, it was noted that no review of section 70 of the Social Security Act 1964 is planned.

Recommendation

That the submission be declined.

Issue: Social security agreement between New Zealand and the United Kingdom

Submission
(Matter raised by Committee)

The Committee requested further information regarding whether there should be a social security agreement between the UK and New Zealand to account for social security pensions paid by the UK, which currently are not indexed for inflation.

Comment

Officials understand that a social security agreement currently exists between New Zealand and the UK.

Social security agreements are negotiated and administered by the Ministry of Social Development, and are not affected by the proposals in the Bill.

Officials have consulted with the Ministry of Social Development, who have provided the information set out below.

The Social Security Agreement between New Zealand and the UK

The text of the Social Security Agreement between New Zealand and the UK was last revised in 1983 and was specified in the Social Security (Reciprocity with the United Kingdom) Act 1983. This Act was revoked on 1 April 1990 and replaced by the 'Social Welfare (Reciprocity with the United Kingdom) Order 1990' (the Agreement) from that same date but the text remained unchanged.

The Agreement determines access to and treatment of social security payments between the countries and ensures that the two countries share the benefit and pension costs of mutual clients. In general, the Agreement provides the following benefits:

- people from the UK who move to New Zealand can use the Agreement to help them meet the residence criteria for New Zealand benefits that are covered by the Agreement

- New Zealanders who live in the UK can use their New Zealand residence to help them meet the residential/contribution criteria for UK benefits and pensions.

In 1983 when the Agreement was last revised, New Zealand had no ability to make payments to superannuitants who were residing in any overseas country. Consequently, the UK Agreement reflects that position. Under the Agreement, New Zealand benefits are not payable to residents of the United Kingdom, However, as the Agreement allows periods of residence in New Zealand to be treated as periods of contributions in the UK, former New Zealand residents, provided that they have not lived in a country other than New Zealand or the UK, are able to access the basic United Kingdom State Pension at the full standard rate.

New Zealand's ability to pay pensions overseas was introduced from 1 April 1990 and the social security agreements that New Zealand has entered into since that time, such as the Netherlands Agreement, allow for payment of New Zealand Superannuation to overseas residents.

Non-indexation of UK pensions paid to New Zealand residents and a revision of the Agreement

UK pensioners living overseas in certain countries, including New Zealand, Australia, Canada and South Africa, have their UK State Pension rates "frozen". In other words, their State Pension is paid at the same rate as it was when they first became entitled, or the date they left the UK if they were already pensioners then. The frozen rates do not apply to people living in countries where a reciprocal social security agreement with the UK allows for increases to be paid or where a person lives in a European Economic Area (EEA) country. The New Zealand/UK Agreement does not provide for UK pension increases.

Officials note that this issue is not related to the contents of the bill.

However, officials from the Ministry of Social Development have advised that they have discussed the frozen pension policy with UK officials. UK officials have advised that there are no plans to amend this policy for UK pensioners residing in New Zealand. New Zealand officials from the Ministry of Social Development will continue to discuss the subject with UK officials when the opportunity arises.

Recommendation

That the submission be noted.

Issue: Use of 15% option after the 2014–15 income year

Clause 25

Submission
(Matter raised by officials)

When a non-compliant taxpayer chooses to use the 15% option in proposed CZ 21B in an income year after 2014–15, they should have their 2014–15 income year reassessed.

Comment

Consider the situation where a non-compliant taxpayer chooses in, say, the 2018–19 income year to use the 15% option in relation a lump sum derived before 1 April 2014.

The current drafting allows the taxpayer to return the 15% in their 2018–19 income tax return. However, the drafting provides that the due date associated with the tax on that 15% would be that of the 2014–15 income year.

This would not be feasible for Inland Revenue's systems as it would require there to be a split due date for the person's terminal tax liability in 2018–19 income year.

The drafting should be amended so that in such a scenario, the taxpayer should have their 2014–15 income tax return reassessed by Inland Revenue in order to use the 15% option.

Recommendation

That the submission be accepted. .

Issue: DTA and Australian pension override

Clause 8

Submission
(Ernst & Young)

The legislation should expressly provide that the provisions of CF 3 are subject to applicable double tax agreements (DTAs) and the exemptions in CW29 and CW 29B.

Comment

Officials consider that the existing legislation is sufficiently clear that the applicable DTAs and the exemptions in CW29 and CW 29B apply to the proposed regime in CF 3.

The proposed legislation has been drafted so that CF 3(1) identifies which particular events are considered to be taxable.

Officials do not consider it necessary that the proposed legislation should expressly provide that proposed CF 3 is subject to the exemptions in CW 29 and CW 29B.

Subpart CW deals with exempt income. In particular, CW 29 and CW 29B exempt from income tax transfers between certain Australian superannuation schemes and transfers from Australian superannuation schemes into KiwiSaver. It follows that CF 3 would be subject to the provisions of CW.

Double tax agreements have an overriding effect under BH 1 of the Income Tax Act 2007.

However, officials will consider these points for the purposes of any future guidance to be released.

Recommendation

That the submission be noted.

Issue: Explicit legislative clarification that transfers to purchase an annuity are not income

Clause 8

Submission
(Ernst & Young)

The legislation should also expressly provide that withdrawals/transfers/commutations to purchase an annuity from a foreign provider are not income *(Ernst & Young).*

Comment
Under the proposed rules, the policy intention is that transfers from one foreign scheme to another foreign scheme will not be taxable. (This does not apply to transfers to Australian schemes, because subsequent withdrawals from Australian schemes are generally not taxable under New Zealand law).

The policy intention is that this would also apply where the transfer is made in order to purchase an annuity from another foreign superannuation scheme.

Officials consider that the drafting is sufficiently clear on this point.

Recommendation

That the submission be noted.

Issue: Explicit legislative clarification of events that are not taxable

Clause 8

Submission
(Ernst & Young, KPMG)

The legislation should expressly provide that transfers between foreign superannuation schemes outside Australia are not income *(Ernst & Young).*

The legislation should clarify that a person who ceases to be a resident of New Zealand does not automatically trigger a taxing event *(KPMG).*

Comment

The proposed legislation has been drafted so that CF 3(1) identifies which particular events are considered to be taxable.

It is implicit that the cessation of New Zealand residence is not a taxable event and no other part of the Income Tax Act 2007 would impose such an "exit tax". It is also implicit that transfers between non-Australian foreign superannuation schemes, or where the funds are used to purchase an annuity would not be taxable.

Officials acknowledge that these submitters wish to improve the clarity of the proposed legislation, but consider that adding a specific provision to proposed CF 3 detailing events that are specifically *not* taxable would add unnecessary complexity to the proposed legislation. It could also create confusion as certain events may not appear in legislation as either taxable or non-taxable.

Recommendation

That the submission be noted.

Issue: Multiple assessable periods

Clause 8

Submission
(Matter raised by officials)

The legislation needs to be amended so that multiple periods of residence are aggregated when calculating a taxpayer's assessable period, if a taxpayer has more than one period of residence for a given foreign superannuation interest.

Comment

The submission concerns someone who becomes resident with a foreign superannuation interest, ceases to be a resident, then becomes resident again.

The policy intention is at that all periods of residence during which the interest has been held will be aggregated for the purposes of calculating the assessable period.

Officials consider that the current drafting does not achieve this policy intention. If an individual held an interest in a foreign superannuation scheme during two different periods of residence, the current drafting would only calculate the assessable period in reference to the second period of residence. The current wording of the legislation would effectively ignore the first period of residence.

To ensure that the proposed legislation works as intended, a legislative amendment is required.

As the policy intention is that there would only be one assessable period for each foreign superannuation interest belonging to a person, further changes may be required to proposed CF 3(10) and CF 3(15)(d) which refer to "an assessable period".

Recommendation

That the submission be accepted. The matter has been referred to drafters.

Issue: Ceasing to be a transitional resident and the impact on the exemption period

Clause 8

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

Section CF3(3)(a) says "a person who is a transitional resident", but it should be "qualifies as a transitional resident" (*New Zealand Institute of Chartered Accountants*).

Someone who is a transitional resident but then ceases to be because they apply for a WINZ benefit will not benefit from a full four-year exemption period under the current drafting *(Charter Square Services).*

Section CF 3(4)(a) should refer to both HR 8(2) and (3) (*Ernst & Young*).

Comment

Proposed section CF 3(3)(a) refers to someone who is a transitional resident under HR 8(2) disregarding any choice under HR 8(4). HR 8(2) provides the conditions under which a person may qualify as a transitional resident. HR 8(4) provides that a person is no longer a transitional resident either by choice or if they receive Working for Families tax credits.

One submitter states that if an election to not be treated as a transitional resident is made under HR 8(4), then CF 3(3)(a) would not work in its current form. This is because the person is not a transitional resident*(New Zealand Institute of Chartered Accountants).*

The policy intention behind CF 3(3)(a) is that a person who otherwise qualifies as a transitional resident but is not a transitional resident because they receive working for families tax credits, should still receive a four-year exemption period. This is why proposed CF 3(3)(a) states "… disregarding any choice under section HR 8(4)".

Officials acknowledge that the current drafting may not achieve this result. The submitter's suggestion may solve this issue.

Another submitter states that a person ceases to be a transitional resident when they apply for a benefit from Work and Income New Zealand. They are concerned that if this occurs partway through the four-year period, they would not get the benefit of the full exemption period *(Charter Square Services).*

Officials note that HR 8(4) and subsequently HR 8(5) do not prevent an individual from being a transitional resident if they are in receipt of a benefit. As such, it is not the benefit from Work and Income New Zealand that disqualifies the person from being a transitional resident. We do note, however, that Work and Income New Zealand may include certain Working for Families tax credits in the benefit that is provided to the individual.

In this scenario, it is intended that the taxpayer would still receive the full four-year exemption period. As stated above, this is why proposed CF 3(3)(a) states "… disregarding any choice under section HR 8(4)". The alternate wording provided by the New Zealand Institute of Chartered Accountants may also resolve the concern raised by Charter Square Services.

Officials agree that the proposed wording of CF 3(3)(a) may require amendment to reflect that a person who qualifies as a transitional resident but elects not to be one, should still receive a full exemption period.

Officials note that the HR 8(3) provides for the calculation of the period of transitional residence. The timing of the exemption period for taxpayers who qualify as transitional residents (regardless of any choice under HR 8(4)) is the period provided by the transitional residence rules Officials agree that proposed CF 3(4)(a) which provides this should refer to HR 8(3).

Recommendation

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

Issue: Definition of "exemption commencement" and "exemption period"

Clause 8

Submission
(New Zealand Institute of Chartered Accountants, New Zealand Law Society)

The timing of the "exemption commencement" should be made clearer.

The definitions of "exemption commencement" and "exemption period" should be made clearer as they are difficult to follow as presently drafted. The submitters acknowledge that the intention of the legislation is to have the exemption period begin when the person became resident (either under domestic legislation or for the purposes of a double tax agreement).

The submitters are of the view that the current drafting does not give a specific start date for the exemption period. It should be defined as the date upon which the relevant individual becomes a New Zealand resident who is not a non-resident for the purposes of a double tax agreement.

One submitter has provided possible alternative drafting that could clarify when the exemption period would start *(New Zealand Law Society)*.

Comment

Officials agree that this provision may be able to be made clearer.

Officials also note that the provision as it relates to the start date of exemption period for non-transitional residents could also be improved.

Currently, the bill provides that the start of the exemption period for a person who is not a transitional resident is either 1. when the person becomes a New Zealand resident, or 2. when they "tiebreak" to New Zealand under a DTA (if they are a non-resident under a double tax agreement).

The second part of the provision was included to deal with the situation of a person who is resident under New Zealand's domestic law, but who is treated as a non-resident of New Zealand under a double tax agreement. For example, they might own a house in New Zealand, then live and work in the UK for 7 years and acquire an interest in a UK scheme (while retaining ownership of their house in New Zealand), and then move back to New Zealand. Without the second part of the provision, it was unclear on which date their exemption period would start.

Officials now consider the concern originally identified would generally no longer arise, because Inland Revenue considers that a person will not retain their New Zealand residence under domestic law solely because they own a house in New Zealand.

As a result, the second part of the provision is no longer relevant.

This would also have the advantage of being more consistent with the exemption period start date for transitional residents.

Recommendation

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

Issue: Definition of "foreign superannuation withdrawal" and "super withdrawal"

Clause 8

Submission
(New Zealand Institute of Chartered Accountants)

The term "super withdrawal", which is used in sections CF 3(7) and (9) should be replaced with "foreign superannuation withdrawal", and CF 3(8)(a) and (10)(a) should be repealed.

Comment

The submitter notes that "foreign superannuation withdrawal" is defined in section CF 3(1). "Super withdrawal" is defined in section CF 3(8)(a) and (10)(a) as the amount of foreign superannuation withdrawal, for the purposes of CF 3(7) and (9), respectively.

The submitter appreciates that this drafting may try to improve the clarity of the legislation for readers, but argues that it is unnecessarily convoluted.

Officials note that where "super withdrawal" appears in proposed 3(7) and (9), it is as part of a formula. This means that it is necessary to subsequently state what the terms in each formula are.

Recommendation

That the submission be declined.

Issue: Use of "transit" as a term

Submission
(New Zealand Institute of Chartered Accountants)

In clause 8, section CF 3(11) and (15), the term "opening value" should be used rather than "transit".

Comment

The term "transit" means the opening value of the person's interest in the scheme at the beginning of their assessable period. This should be amended to "opening value" instead, which is a term used in other parts of the Income Tax Act 2007, and is more descriptive.

Officials agree with the submitter's analysis.

Recommendation

That the submission be accepted.

Issue: Definition of assessable period

Clause 8

Submission
(New Zealand Institute of Chartered Accountants)

Clause 8 Section CF 3(5)(a) currently reads "beginning from the last *of*". This should read "beginning from the last *day*".

Comment

Proposed section CF 3(5)(a) provides when a taxpayer's assessable period should begin. It takes into account a number of factors such as if a person receives an exemption period, and if not, when they became resident or when they first acquired an interest in a foreign superannuation scheme.

The policy intention is that the assessable period should begin when the last of the events listed in proposed CF 3(5)(a) occurs. Officials consider that wording proposed is appropriate and does not require amendment.

However, officials note that the proposed change to restrict the new rules to interests in foreign superannuation schemes that were first acquired while the taxpayer was non-resident would result in minor amendment to proposed CF 3(5)(a) to ensure that it operates correctly.

Recommendation

That the submission be noted.

Issue: Residence under a double tax agreement

Clause 8

Submission
(Ernst & Young)

The current drafting CF 3(16)(a) refers to a person who "is a New Zealand resident and is a non-resident under no double tax agreement". It does not read clearly or easily, so it should be amended. In contrast, CF 3(3) refers to "a New Zealand resident who is not a non-resident under a double tax agreement" which is much simpler to read.

Comment

Officials will consider whether the drafting could be improved.

Recommendation

That the submission be noted. The matter has been referred to drafters.

Issue: Definition of "distribution time"

Clause 8

Submission
(New Zealand Law Society)

There should be a general definition of "distribution time".

Comment

"Distribution time" is defined in the proposed section CF (8)(c)(iii) for the purposes of the formula in the proposed section CF 3(7). However, there is no corresponding definition for that term as it is used in sections CF 3(10) and CF 3(15).

Recommendation

That the submission be accepted. The matter has been referred to drafters.

Issue: Definition of "distributed gain" and "gains out"

Clause 8

Submission
(New Zealand Law Society)

The drafting in relation to the "gains out" definition (proposed section CF 3(10)(b)) is difficult to follow and is at risk of being circular, as "gains out" is a component of the "distributed gain" definition but uses the "distributed gain" definition itself.

Comment

Officials note that the intention of the "gains out" term is to capture what has previously been calculated as the "distributed gain" for withdrawals in previous income years in relation to this taxpayer and foreign superannuation scheme.

As "gains out" captures *past* calculations of "distributed gain", the drafting is not circular where lump-sum withdrawals have been in the past. If the taxpayer has not previously taken any lump-sum withdrawals, then the value of "gains out" is zero.

Recommendation

That the submission be declined.

Issue: Definition of "contributions" in CF 3(12)(d)

Clause 8

Submission
(New Zealand Law Society, Ernst & Young)

The definition of "contributions" in proposed section CF 3(12)(d) should refer to "recognised contributions under subsection (16)".

Comment

The current drafting of CF 3(12)(d) refers to "contributions to the interest in the scheme made before the distribution time". This is inappropriately broad as it would allow a taxpayer to take a deduction for contributions made before they were New Zealand resident. This would lead to under-taxation.

Officials intended that only contributions made during a person's assessable period should be deductible, subject to other conditions.

The drafting proposed by the submitter would be consistent with other sections where a deduction for certain contributions is allowed (CF 3(7), the corresponding definition in CF 3(8)(b), CF 3(14), and the corresponding definition in CF 3(15)(d)).

Recommendation

That the submission be accepted.

Issue: Definition of "withdrawals" in CF 3(12)(b)

Clause 8

Submission
(New Zealand Law Society)

Proposed section CF 3(12)(b) should be amended to ensure that only withdrawals in the "assessable period" are taken into account in that definition, for the purposes of calculating the "calculated gains fraction" in CF 3(11).

Comment

The definition of "calculated gains fraction" in proposed section CF 3(11) incorporates "withdrawals" and "contributions".

A taxpayer is only permitted a deduction for "contributions" where they have been made at a time when the taxpayer was New Zealand resident.

The submitter notes, however, that there is no such requirement for the purposes of the "withdrawals" definition. A corresponding requirement should apply for withdrawals, as any withdrawal made prior to a taxpayer becoming New Zealand resident should not be relevant for the purposes of determining gains accrued during the assessable period.

This would have the effect of overstating the gains that have accrued to the individual while they were New Zealand resident.

Officials agree that this is not the intended result. It was intended that only distributions made during a person's assessable period would be relevant for the calculated gains fraction.

Recommendation

That the submission be accepted.

Issue: Definition of "accrued total" in CF 3(15)(d)

Clause 8

Submission
(New Zealand Law Society)

Proposed section CF 3(15)(d) should be amended to ensure that only distributions in the "assessable period" are taken into account in that definition.

Comment

This issue is similar to that titled "Definition of "withdrawals" in CF 3(12)(b)"

For the purposes of the formula in CF 3(14), CF 3(15)(d) provides a definition of the term "accrued total". This term takes into account all previous distributions, but only recognised contributions to the extent that they were made during the person's assessable period.

This would have the effect of overstating the gains that have accrued to the individual while they were New Zealand resident. This is not an intended result.

Recommendation

That the submission be accepted.

Issue: "Gains out"

Clause 8

Submission
(Ernst & Young, New Zealand Law Society)

"Gains out" is used in two slightly different manners in CF 3(9) and CF 3(15)(a), which could cause confusion. The term in CF 3(15)(a) should instead be "distributed gain" as it refers directly to what was calculated in CF 3(9).

Comment

The dual use of "gains out" is unintended as they do not bear the same meaning. "Gains out" defined in proposed CF 3(15)(a) refers to the formula in CF 3(13).

As the formula method requires the calculation of more than one formula, multiple uses of a term with different meanings may unduly increase the complexity of the method.

Officials agree with the analysis provided by submitters.

Recommendation

That the submission be accepted.

Issue: Incorrect reference to “distributed gain”

Clause 18

Submission
(New Zealand Law Society)

Proposed section CW 28C(a) refers to the “distributed gain” given by section CF 3(7). It should instead refer to the “assessable withdrawal amount” which would be consistent with proposed section CW 28C(b).

Comment

The submission is correct as CW 28C(a) makes reference to CF 3(7), which contains the formula used to calculate the “assessable withdrawal amount”. “Distributed gain” has a different meaning and would be incorrect in this context.

Recommendation

That the submission be accepted..

FURTHER GUIDANCE

No clause

Issue: Formula method example in bill commentary

Submission

(New Zealand Law Society, PricewaterhouseCoopers)

The example in the bill commentary does not illustrate how the "grow rate" should operate. This should be provided in further guidance *(New Zealand Law Society).*

The example in the bill commentary incorrectly refers to the value of the interest at the time of migration, rather than at the beginning of the assessable period. The commentary should be clarified to prevent any mismatch *(PricewaterhouseCoopers).*

Comment

The example in the bill commentary relating to the formula method only covers the formulae in proposed CF 3(9)–(12). This can be found on page 15 of the bill commentary. The calculation of the "grow rate" found in proposed CF 3(13)–(15) were not provided due to the length of the example.

Officials agree with the submission that the remainder of the example should be published in a guidance document.

The example sets out a scenario for "Thomas". It states that "Thomas migrates to New Zealand with a foreign superannuation scheme worth NZ$100,000". Thomas would receive a four-year exemption period so to use the formula method, Thomas would need to know the value of the fund at the end of his exemption period (and beginning of his assessable period). The current drafting achieves this, but the example is incorrect. The example should state that the scheme was worth NZ$100,000 at the beginning of his assessable period once his exemption period had expired.

Officials agree that this error should be corrected in future guidance.

Recommendation

That the submission be accepted.

Issue: Publication of the proposed changes

Submission
(KPMG, PricewaterhouseCoopers)

The proposed changes, once enacted, should be publicised as widely as possible.
Comment

Inland Revenue is working on a communication strategy for the proposed changes, which will explain the changes to affected taxpayers. The messages will depend on what a person's circumstances are. The communications strategy will take into account Inland Revenue's range of communication methods, including working with relevant industries and practitioners.

Recommendation

That the submission be noted.

Mineral mining

Clause 13

Issue: Exploration expenditure and the claw-back rule

Submissions
(Straterra, OceanaGold, Ernst & Young, Solid Energy New Zealand Limited/New Zealand Coal & Carbon Limited, PricewaterhouseCoopers, Newmont Waihi Gold Limited)

1. The proposal to claw-back exploration expenditure that produces an asset used in the extraction of minerals should not go ahead.

2. Such a claw-back rule is contrary to the tax treatment of research and development (R&D) expenditure and feasibility expenditure, and general taxation principles.

3. The distinction between the exploration and development phases is clear (or at least not substantially worse than any other boundary issues in taxation), so the claw-back rule is redundant.

4. Australia does not have any claw-back rule in its regime.

5. Any issues can be dealt with through the usual audit and anti-avoidance measures.

Comment

Officials do not accept the analogy between mining exploration expenditure and R&D. R&D expenditure is designed to create a novel product or process. By contrast, mining exploration expenditure is more likely to be using existing techniques to uncover a new mineral deposit. This is not to say that a mining company cannot incur R&D expenditure if it is developing a new product or process.

Officials do accept the analogy between exploration expenditure and feasibility expenditure, but do not consider that this is a reason for dispensing with the proposed claw-back rule.

Submitters have pointed out that, in the ordinary course of events, a taxpayer is required to make a judgement as to whether or not a deduction is available. Once that decision is made then the taxpayer is locked into that decision. This reasoning ignores the fact that self-assessments can be amended at later times, either through the disputes procedure or by the agreement of the Commissioner. However, more fundamental is the apparent assumption by some submitters that feasibility expenditure is always deductible.

Submitters have referred to the Commissioner's interpretation statement on feasibility expenditure (IS 08/02: *Deductibility of Feasibility Expenditure*) to support the proposition that exploration expenditure should be subject to the normal tax rules that relate to feasibility. Officials note that the interpretation statement states, at paragraph 8:

…for feasibility expenditure to be deductible… there must be a sufficient relationship or nexus between the expenditure and the taxpayer's business or income-earning activity. Any expenditure incurred before the establishment of a business or an income-earning process will not fulfil this statutory nexus because the expenditure will have been incurred too soon.

Officials therefore consider that, for a newly-established mining operator, prospecting and exploration expenditure may never be deductible because there is no income-earning activity for the expenditure to relate to. In this respect, the automatic deduction for prospecting and exploration expenditure provided for in the bill is concessionary to such miners, and creates certainty to all miners in that they do not have to determine how their expenditure would be treated if it were subject to the general feasibility rules.

When a line is drawn in tax legislation between expenditure that is immediately deductible and expenditure that is required to be capitalised, this will generally create an incentive for affected taxpayers to reclassify expenditure in favour of the category for which immediate deductions are available. Officials accept that, by allowing a category of expenditure to always have immediate deductions (exploration expenditure), the proposed rules create this incentive. The claw-back rule is designed to address this tension. If expenditure is incorrectly classified, deductions will be added back as income and depreciated.

It also addresses the situation that a miner may face in circumstances where they are genuinely unsure as to whether expenditure will create a lasting asset or simply be unsuccessful exploration expenditure. If no lasting asset is created, the deduction will remain in place. If it transpires that the expenditure has created an asset that will be used during the extraction process, it is the economically correct result that the expenditure be added back and depreciated over the useful life of the asset created (in this case, a mine).

Submitters have commented that, in almost all cases, the claw-back rule will have no practical application. The submissions note that mining operators take the decision to move from an exploration phase to a development phase very seriously because committing to development is committing significant financial resources. Decisions of this nature will invariably be taken at board level and detailed records will be available to identify when one phase ends and the other begin.

Officials accept that this may be the case. However, this is not sufficient justification for removing the claw-back rule. The rule is designed largely to remove the incentive to reclassify expenditure. In many respects, if it never gets used, it will be a mark of its success, rather than of its inherent failure. In any event, even when the decision to move to development is clearly marked in time, this does not mean that some expenditure has not been inadvertently misclassified in the prospecting phase.

Submissions have also pointed out the difficulty that a mineral miner may have in apportioning expenditure that is subject to the claw-back rule. An example raised in oral submissions was that a miner might build five roads into a site during the exploration phase and only use one of those roads in the extraction process. Officials accept that, in circumstances such as these, some sort of apportionment will be necessary. However, the requirement to apportion expenditure is a regular feature of tax legislation and it is generally achieved by fair and reasonable methods. Officials do

not consider an apportionment exercise carried out to comply with the claw-back rule to be any different in this regard.

Officials note the situation in Australia but do not consider regimes operated in other jurisdictions to be determinative of what is appropriate for the New Zealand context.

However, an accurate apportionment does however hinge off having appropriate records on which to base it on. On this subject, officials have also considered a point that was raised by the technical advisor to the Select Committee. The advisor has pointed out that it would be difficult for a taxpayer to comply with the claw-back rule in any period where they were no longer required to keep records for tax purposes. Officials have sympathy with this view and therefore consider that the application of the claw-back rule should be limited to expenditure incurred in a period for which the miner is required to keep records for the purposes of the Tax Administration Act 1994. Although this arguably creates an incentive for a miner to extend their development phase to avoid the application of the claw-back rule, officials do not consider this will be a substantial issue in practice. It is not the aim of these rules to impose record-keeping requirements on mineral miners over and above those that apply to other taxpayers.

Recommendation

That the submissions be declined, except that the claw-back rule be limited in its application to the period for which a miner would be required to keep records for tax purposes.

Issue: Timing of the claw-back rule is uncertain

Clause 13

Submission
(Newmont Waihi Gold Limited)

The claw-back rule applies to expenditure incurred after the 2012-13 income years under DU 1(1)(b), but that provision does not apply until the 2014-15 income year.

Comment

Officials agree that the claw-back rule should only apply to expenditure incurred after the new rules take effect. This will avoid unnecessary retrospective application.

Recommendation

That the submission be accepted.

Issue: "Life of Mine" concept for depreciation purposes

Clause 35

Submission
(Solid Energy New Zealand Limited/New Zealand Coal & Carbon, Ernst & Young, Straterra, PricewaterhouseCoopers, OceanaGold, Newmont Waihi Gold Limited)

The proposed use of the assumed life of the mine as the basis of spreading mining development expenditure should not go ahead *(Oceana).* The straight line and diminishing value methods of depreciation provided for in the bill do not adequately reflect the realities of the industry. Income is 'lumpy' and depreciation should be allowed to follow this income pattern. The most effective way of achieving this would be to allow depreciation on a "unit of production" or "extraction" basis, or at least an option to deduct on that basis. This would more closely align the treatment with that of the coal and petroleum mining industries. Alternatively, miners who use IFRS or other generally accepted accounting practice for financial reporting purposes should have the option of applying their financial reporting method for income tax purposes, without any adjustments being required *(Ernst & Young, Oceana).*

The rules should allow for deductions when mines are "mothballed" (i.e., abandoned projects).

Comment

Officials accept that a unit of production basis for determining the life of a mine is an appropriate measure. However, it is important to establish an appropriate denominator for any depreciation calculation using this basis. Officials understand that some miners base their units of production used in their accounts on the units extracted over the "economically recoverable amount". We consider this would be an inappropriate measure for tax purposes because it would be subject to fluctuation in accordance with things like the prevailing commodity prices. It is for this reason that we also disagree with the proposition of final deductions being available if a mine is "mothballed".

For example, if a mineral price dropped significantly, a miner might determine that it was no longer economical to recover any more minerals. The mine would be 'mothballed' and all further development expenditure taken as a deduction. If, the following year, the commodity price rose again, the miner might make the decision that more minerals could be extracted at a profit. The miner would be utilising the original development expenditure to restart the mine but would have already claimed all deductions in respect of those assets. Such an outcome would fail to recognise that the development assets have a useful life that at least partly depends on the minerals still being *in situ* rather than simply the commodity price on any given day.

Officials therefore consider that any depreciation on a unit of production basis should take place as a function of the "proven and probable" mineral reserves. Such an outcome is consistent with the proposals in the original officials' issues paper that suggested these revised rules and would also be consistent with a depreciation method available to petroleum miners under the Income Tax Act 2007.

Officials accept that a unit of production method is probably only of value to miners that produce IFRS accounts. Requiring all miners to produce equivalent accounts just

to determine their depreciation calculations may impose significant compliance costs on smaller operators. Therefore, officials consider that the following rules should apply to determine which method is used:

- Miners can use the unit of production method, as set out above, if they produce IFRS accounts or otherwise keep appropriate records for this method to be verified; otherwise
- Miners can use the methods currently provided for in the bill, meaning they depreciate their costs over a period not shorter than the life of mine estimated in their accounts (or over the period they reasonably estimate the mine to operate if they are not required to perform any such calculations for the purposes of their accounts).

Officials consider this combination of methods can provide the maximum flexibility to miners without imposing significant compliance costs – while also providing appropriate outcomes from a policy perspective. However, to avoid additional complexity, officials recommend that, once a person has made their choice of deduction method (when commercial production commences), that method should be retained for the entire life of the mine.

Officials accept that any depreciation method has potential to create ‘trapped’ development expenditure at the end of a mine’s life. This issue is covered in the “refundable credit” section, below.

Recommendation

That the submissions be accepted and unit of production method, based on proven and probable reserves, be included as a depreciation method in the bill.

Issue: Drafting issues for “Life of mine”

Clause 35

Submission
(Ernst & Young)

The use of the terms “income year” and “spreading period” in proposed sections DU 6 and DU 7 that may cause uncertainty and potentially lead to disputes.

Comment

Officials agree that confusion in this regard is undesirable.

Recommendation

That the submission be accepted.

Issue: Unit of measure: "mine" or "permit area"

Clause 35

Submission
(OceanaGold, Newmont Waihi Gold Limited, Straterra)

Some miners have multiple mines in one permit area, whereas others have a single mine that covers multiple permit areas. Given some mines have shorter life-spans than others in the same permit area, it is penal to enforce depreciation of development expenditure on a permit area basis because some of this expenditure may relate to a relatively short-lived mine.

Comment

Officials accept that depreciation should generally be based on the estimated useful life of the actual income-producing asset. There are therefore good policy reasons for allowing depreciation deductions over the life of a particular mine if the expenditure is properly attributable to that mine. The concern would be if the rules allowed a miner to inappropriately allocate expenditure to a shorter-life mine in order to accelerate depreciation deductions.

Officials have contacted colleagues in the Resource Markets Policy Team of the Ministry of Business, Innovation and Employment (MBIE) to see if the differentiation between "permit area" and "mine" is likely to be significant in practice. MBIE is of the view that almost all mineral miners will only have one mine per permit area, and that the two terms will effectively be interchangeable in those cases. Those miners that do have a mine that covers several permit areas are likely to be large operators that are required to produce audited IFRS accounts. Officials have confidence in the fact that there is a high degree of rigour that goes into these accounts that should prevent costs being misallocated to shorter-life projects.

Officials therefore consider that a mineral miner should be able to use an individual mine as the measure for depreciation purposes. However, this option should only be available to miners that produce audited IFRS accounts and the allocation of expenses to individual mines should only be allowed if they are permitted for the purposes of those accounts. If expenses cannot be so allocated, the default position should be that the life of the permit area is the relevant depreciation measure. This approach would appear to provide a full market capture (on the understanding that only large mining operators will have more than one mine), while still preventing inappropriate allocation of expenses in such cases.

Recommendation

That the submission be accepted, subject to the "mine" option only being available to miners that produce audited IFRS accounts and the allocation of expenses to individual mines should only be allowed if they are permitted for the purposes of those accounts.

Issue: Refundable credit for development expenditure

Clause 88

Submission
(OceanaGold)

OceanaGold agree that there should be a tax credit for mineral miners, but are concerned about how it will work in practice and submit that it should have wider application. Depreciating development expenditure over the life of the mine creates the potential for "black-hole" expenditure to arise. This may occur if the depreciation deductions available in the final year of the mine's operation exceed any income derived from the mine in that year. The refundable credit mechanism should be extended to cater for this eventuality.

Comment

Officials accept that this is an issue. It is not the intention of these rules to create black-hole expenditure for miners in the circumstances described. However, officials would be reluctant to recommend a system whereby a mineral miner could obtain a refundable credit in advance of when it was appropriate. The refundable credit mechanism is designed to prevent a miner having deductions at the end of the life of the mine when there is no corresponding income to offset the expenditure.

In order to be consistent with this principle, a refundable credit for development expenditure should only be available after mining operations have ceased. To have otherwise may allow a miner to write development expenditure down to zero on the basis that their accounts show the mine has no residual life and, if they had insufficient income in that final year, claim a refundable credit. However, the mine may just be 'mothballed'. If the miner then started using the mine again (because the commodity price rose), they would still be using the same assets created by the original development expenditure, but would have claimed all that expenditure as a deduction.

To prevent this result, while still producing an appropriate policy outcome, officials consider that the refundable credit should be available for residual development expenditure, but only when it is certain that mining operations have ceased. The most effective way of achieving that result would be to provide that the credit was only available in the year that the miner relinquishes its rights under the relevant permit. "Relinquish" is a term that is already used for the purposes of the petroleum mining rules and there are legislative markers in the Crown Minerals Act that set out when a miner finally surrenders rights to mine an area. Tying the credit to these dates already provided for in relevant statutes will provide certainty to both miners and Inland Revenue in determining when the refundable credit is available in respect of development expenditure.

Recommendation

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

Issue: Extend the refundable credit to petroleum miners

Clause 88

Submission
(Corporate Taxpayers Group)

The proposed refundable credit rule should be extended to other regimes within the Income Tax Acts such as the petroleum mining sector. There is currently uncertainty as to whether the existing loss carry back rule that applies to petroleum miners can operate beyond the four-year statutory time-bar for amending assessments.

Alternatively, the loss offset and refund rules should be revised to ensure that their operation is consistent with the operative provisions in the Income Tax Acts, including the petroleum mining rules.

Comment

The refundable credit proposed for mineral miners is an economic equivalent to the loss carry back rule available to petroleum miners – in this respect, we consider there is an inherent consistency between the two. This is further demonstrated in the proposed changes to quantum of the tax credit for non-company miners (see "amount of tax credit" submission, below).

As the submitter notes, the petroleum loss carry back rule contains a provision that explicitly overrides the statutory time-bar. However, officials consider the policy intent of these provisions is clear. Further, officials are not aware of the argument used by submitters ever being adopted by Inland Revenue to disadvantage a petroleum miner in practice.

Officials also consider making the changes proposed in the submission would be inappropriate for the following reasons:

- The changes in the current bill are focussed on mineral mining, not petroleum. The petroleum rules are relatively complex and officials would be concerned that amending one part of them without adequate consideration of the rules in general may result in unintended consequences.
- Making changes to the petroleum mining rules at this stage in the bill's progress would preclude consultation with the wider industry. Officials are reluctant to recommend changes to such a significant sector without providing that industry with an opportunity to comment.

Recommendation

That the submission be declined.

Issue: Refundable credit should be based on tax paid by the mining company, not the particular permit area

Clause 88

Submission
(Newmont Waihi Gold Limited)

The refundable credit should be limited to tax paid by the mining company, not ring-fenced to the particular permit area.

Comment

The refundable credit is designed to ensure that the appropriate amount of tax is paid on a project by project basis. Allowing the refundable credit to operate on a company may allow a company to effectively cash-out a loss on any given mine. Cashing out losses is not a general feature of the New Zealand tax system.[1]

Recommendation

That the submission be declined.

Issue: Rehabilitation expenditure

Clause 35

Submission
(PricewaterhouseCoopers, Ernst & Young, Solid Energy New Zealand Limited/New Zealand Coal & Carbon Limited, OceanaGold, Straterra, New Zealand Law Society, Newmont Waihi Gold Limited)

Allowing a deduction for rehabilitation expenditure only when it is paid is penal when compared to the general rules. A deduction should be available when:

- The expenditure is incurred;
- A provision is able to be made in the miner's audited accounts for rehabilitation costs.

The provision that allows a deduction for rehabilitation expenditure should be stated to supplement the general permission because such deductions may only be available after income-earning activity has ceased. *(Ernst & Young)*

Mining companies will have agreements with agencies such as the Department of Conservation and local authorities to undertake the rehabilitation work. This provides assurance that the work will be carried out. The quantum of the provision is capable of reasonable estimation *(PricewaterhouseCoopers).*

The definition of rehabilitation expenditure is too narrow as it does not refer to all legislation that may require rehabilitation work to be carried out. *(OceanaGold)*

[1] Officials do note the recent issues paper related to the cashing-out of certain types of R&D expenditure, but consider this to be a carefully defined initiative to assist start-up companies, and not something that has application in the context suggested here.

Some submitters noted their support for the proposal to allow a tax credit for rehabilitation expenditure where there is insufficient current year income to offset the expenditure *(OceanaGold)*, given the restrictions on the ability to group losses, and the existence of a similar rule for petroleum miners *(New Zealand Law Society).*

Comment

The bill provides that a deduction for rehabilitation expenditure is available when the amount is paid. Officials considered this approach provided certainty to the parties concerned and also aligned the deduction to what is understood to be the practice in the petroleum mining sector.

Allowing a deduction on the basis of amounts paid is also not unprecedented in the Income Tax Act.[2] However, officials accept that the general rule for deductibility for tax purposes is to allow the deduction when it is incurred.

In saying that, officials are concerned that submitters are collapsing the two possible alternative positions into one. Officials consider there are fundamental differences between the legal test of when expenditure is "incurred" and the tests used for accounting purposes to determine whether a provision should be made. This is rightfully so given the two sets of rules ultimately serve slightly different purposes. Accounting rules can be incorporated into tax rules when they produce appropriate policy outcomes. However, there will be circumstances where accounting tests are inappropriate for tax purposes, and officials consider this is such a case.

Officials consider that allowing a deduction based on the provisioning in accounts would allow inappropriately large deductions to be taken upfront, when there is insufficient certainty that such expenditure will be incurred for tax purposes. Although it is accepted that provisions in audited accounts are valued and estimated to the best of the person's ability, there is considerable uncertainty as to whether the expenditure is accurate, whether the timing of the expenditure is accurate or even if the relevant person will ever incur the expenditure. For example, the legal obligation to carry out rehabilitation expenditure rests with the permit holder. However, a permit is transferable personal property – it is possible for a miner to sell their permit and with it the obligation to perform the rehabilitation work. A provision in the miner's accounts is justified because this future obligation will impair the value of the company (and presumably result in a lower purchase price for the permit as the purchaser will also inherit the rehabilitation obligations), but it is not considered to be a reasonable basis on which to allow a tax deduction.

Equally, other Government agencies will require undertakings from miners to ensure that the land cannot simply be abandoned after mining has concluded. These arrangements are appropriate to achieve those policy objectives. However, they also are not considered as a suitable measure to quantify tax deductions. Officials have previously mooted the idea of a special account that a miner could contribute to in order to access tax deductions for rehabilitation expenditure[3] but, in responses to the officials' issues paper, industry were firmly opposed to this approach.

[2] See for example, section EA 4 of the Income Tax Act 2007, which relates to the deferred payment of employment income

[3] *Taxation of specified mineral mining: An Officials' Issues Paper* – 31 October 2012, at page 22

In summary, officials accept that, for the purpose of consistency, there are good reasons for rehabilitation expenditure to be deductible when it is "incurred". In saying this, it is not anticipated that the change will result in a significant difference in practice from the "paid" test currently in the bill – the legal test for "incurred" (as set out in case law) will still need to be satisfied before a deduction can be taken.

For the submissions regarding:

- the general permission, officials agree that this change is justified, given expenditure may be incurred after the miner's income earning activities have ceased;
- definition of rehabilitation expenditure being too narrow, officials accept that the definition should cover other legislation to the extent necessary.

Finally, officials consider the changes proposed here will also address an Ernst & Young submission regarding the use of the word "incurred" in proposed section LU 1.

Recommendation

That the submission that rehabilitation expenditure be deductible when it is incurred be accepted.

That the submissions that rehabilitation expenditure be deductible based on provisions in the person's accounts be declined.

That the submission suggesting that the rehabilitation deduction provision should supplement the general permission be accepted.

The submission suggesting that the rehabilitation expenditure definition cover other applicable legislation that may require rehabilitation work to be carried out be accepted.

Issue: Definition of "development expenditure"

Clause 35

Submissions

(Straterra, OceanaGold, Solid Energy New Zealand Limited/New Zealand Coal & Carbon Limited, Ernst & Young, PricewaterhouseCoopers, Newmont Waihi Gold Limited)

The definition of development expenditure in the bill:

- is too broad and may capture expenditure that is better described as "operational";
- is incomplete and may result in black-hole expenditure being incurred;
- should draw a distinction between immovable and movable property;
- should distinguish between depreciable property and other property (the latter being depreciated over the life of the mine)
- should be expanded to include vessels to accommodate the fact that mining can take place offshore (*PricewaterhouseCoopers*);

- operational mining expenditure should be deductible in the year incurred rather than spread over the life of the mine *(Ernst & Young, Straterra).*

Comment

The definition of "development expenditure" is essentially designed to capture the costs of developing the mine to the point when commercial extraction can begin and any expenditure after that point that has an enduring benefit to the mining operations. In this respect, the rules attempt to mimic the general tax rules – in that expenditure on creating a capital asset is capitalised into the cost of that asset and any 'capital improvements' that are made after the asset is in operation is similarly capitalised into the cost-base and depreciated over the remaining life of the asset.

It is not the intention of the rules to capitalise expenditure that is only related to the day-to-day operation of the mine after commercial production has commenced. Officials consider this can best be addressed by creating a new definition of "operational expenditure" and specifically carving that type of expenditure out of "development expenditure". If this is done, the expenditure that is left will be capital in nature and appropriate to deduct over the life of the mine.

With regard to the completeness of the definition, officials consider that the creation of a defined "operational expenditure" term should address this concern. Expenditure incurred after commercial extraction begins will be either "operational" or not. Under officials' suggestion, operational expenditure would be subject to the normal tax rules. So if, for example, a miner purchased a piece of plant that was only going to be used for operational expenditure, it would be deductible in accordance with its estimated useful life as a stand-alone piece of plant. Similarly, revenue expenditure for operation matters would be immediately deductible. Assets that are used for multiple purposes should be apportioned in an appropriate manner.

Officials do not agree that a distinction should be drawn between movable and immovable property, or that there should be types of property that is always depreciable according to set rules. Immovable property will generally have an estimated useful life that is contingent on the life of the mine, so it is appropriate that it is depreciated over that timeframe. However, that does not mean that movable property cannot be used to create assets of enduring benefit. Take, for example, a digger that is exhausted in the development phase of the mine. From a tax policy perspective, the 'right' outcome is that the cost of that digger is depreciated over the life of the asset it has created; in this case the mine itself. The benefit from the expenditure on that digger lasts for the length of the mine. This can be compared with a similar digger that is only used for extracting minerals – the benefit from its work is only derived while it is still operational so it should be depreciated over its useful life as a stand-alone asset.

Officials agree that the addition of "vessels" would add clarity to the definition.

Recommendation

That a new definition of "operational expenditure" be added to the bill and that operational expenditure should be carved out of the development expenditure definition. The definition of "development expenditure" should include vessels.

That the submissions that assets be distinguished by whether they are movable or immovable, or always be classified in a particular way, be declined.

Issue: Land expenditure

Clause 13 and 35

Submission
(Ernst & Young)

It is not clear why all land should be treated as revenue account property simply because it may have been acquired in connection with mining operations but are not directly part of those activities.

The legislation should clarify how the proposed land rules are intended to interact with the general tax rules for revenue account property.

Comment

The submission is of the view that because proposed section CU 2 treats land as being on revenue account when it is "acquired for the purposes of... mining activities..." this will capture an inappropriately large amount of land, such as land acquired in other locations for office or administrative purposes.

Officials agree that there is no good policy reason for capturing such land within the mining land rules. The policy intent behind the land provisions was only to capture land that includes, or is intended to include, all or part of a permit area. Officials had considered that the use of the term "mining operations", which is itself a defined term in proposed section CU 7, limited the scope of the land rules to such land. However, we accept that the wording in this regard is not as clear as it could be.

Officials also agree that it would be useful to clarify the inter-relationship between the proposed rules and the general revenue account property rules so that the specific land rules applied in preference to the general rules.

Recommendation

That the submission be accepted so that:

- proposed section CU 2 be clarified to only applying to land that contains all or part of a permit area; and
- the specific land rules override the general revenue account property rules.

Issue: Premium on land

No clause

Submission

(OceanaGold, Straterra)

Any premium paid by a mineral miner for land should be included as "development expenditure" and depreciated over the life of the mine.

Comment

Officials accept that mineral miners can pay a premium for land, on the basis that the existing landowner will inflate their sale price once they are aware their land may contain mineral deposits. In theory, any overpayment will be for the minerals within that land, so that portion of the expenditure will devalue as those minerals are extracted.

However, there are genuine valuation issues associated with attempting to calculate any premium paid. Valuations for land can differ significantly even before mineral deposits are added to the equation. Although officials are aware that there are tax rules for forestry that allow the cost of the trees to be separated from the cost of the land. However, forestry assets are inherently easier to value because they are above land and readily quantifiable. Although a mineral miner will not buy land unless they are relatively certain it will contain commercially viable deposits, officials do not consider that valuing those deposits with sufficient certainty to allow a tax deduction (even over time) is possible.

There are also compliance costs issues associated with obtaining such valuations. Officials consider that motivating miners to obtain valuations may result in dead-weight costs being incurred. In officials'' view, the only time that any premium can effectively be valued is at the time the land is disposed of (when the difference between the cost price and the resulting land value is crystallised). The refundable credit for losses made on land sales is designed to address this premium issue. If a mineral miner has actually paid a premium for land and is forced to take a loss when the land is ultimately sold, the credit may be available to ensure that no capital loss is suffered.

Recommendation

That the submission be declined.

Issue: Grouping

No clause

Submission

Mining companies should be allowed to group with non-mining companies. Allowing grouping with any company is consistent with the tax rules that apply to other taxpayers. *(KPMG, Straterra, OceanaGold)*

Grouping should at least be available until a continuity breach (*PricewaterhouseCoopers).*

The general loss rules that apply to all taxpayers should apply to mineral mining. *(Solid Energy New Zealand Limited/New Zealand Coal & Carbon Limited, Straterra)*

Comment

Under existing tax rules, which the bill does not propose to significantly alter, a mineral mining company can only form a tax group with other mineral mining companies. This restriction on grouping for miners is seen by officials as inter-related with the existing concession that allows mineral miners' losses to survive a continuity breach (in other words, a change in majority shareholding). Under this continuity rule, if a mineral mining company suffers a breach in continuity, any losses in existence at the time of that breach are able to be carried forward to future years.[4] This differs from the general tax rules, under which losses that exist at the time of a continuity breach are permanently forfeited.

Officials are concerned that if these losses are allowed to survive a continuity breach, but mining companies were also allowed to group with any other company, opportunities for inappropriate loss trading may arise. The concession around continuity breaches is designed to recognise that mineral mining is a risky, but capital intensive industry. It may be that equity finance is the only way that a start-up miner can raise sufficient funds to make a viable operation. The flip-side of retaining this concession is that losses should only be used to offset mining income. Officials consider the best way to ensure this result is to limit the ability for mining companies to group with non-mining companies that may derive income from other sources.

Allowing grouping only up until the point of continuity breach, would solve some of these issues, but would be complicated to administer as it would involve a mining company having different treatment to another mining company. Officials consider it is preferable to treat the industry as a whole and have one set of rules applying to it.

Recommendation

That the submission be declined.

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[4] Such losses are only able to be offset by income earned from the relevant permit area.

Issue: Loss continuity rules

No clause

Submission

The proposal not to change the rule that allows losses to survive a continuity breach are welcomed. *(Straterra, OceanaGold, PricewaterhouseCoopers)*

The loss continuity rule should be clarified so that it covers all of the new types of expenditure covered in clause 35. *(Straterra, OceanaGold)*

The existing loss continuity rules do not work as intended *(OceanaGold*)

Comment

Officials agree that the loss continuity rules should apply to all types of expenditure. This would align them with the current treatment, which is intended to be retained.

With regard to possible flaws in the existing rules, officials consider the solution proposed would effective require each mining permit to be treated as a silo so that loss-offset could be maximised. The logical extension of this would be that, in the converse situation when a particular permit area was in profit, a company could not use losses in another permit area to shelter those losses. We do not consider this would be an acceptable solution for the industry.

Ultimately, officials consider the loss continuity rules work for the situation they are designed for – when a company is required to breach continuity to raise funds to carry on its operations.

Recommendations

The submission regarding the types of expenditure that can survive a continuity breach be accepted.

The submission regarding possible existing flaws in the continuity rules be declined.

Issue: International competiveness

No clause

Submission
(Straterra)

The proposed changes demonstrate a lack of understanding of the nature of investment in minerals in New Zealand. It is not about whether or not to allocate a New Zealand investment dollar in minerals or other sectors; it is about being competitive for attracting global minerals investment into New Zealand, as opposed to elsewhere in the world

Comment

Officials continue to hold the view set out in the Regulatory Impact Statement outlining the proposed changes (http://taxpolicy.ird.govt.nz/sites/default/files/2013-ris-arfsrm-bill-2.pdf). Of particular relevance to addressing the submitter's concerns are paragraphs 15-17 of that statement:

> 15) *Tax concessions that favour one particular industry distort investment decisions and the productivity of capital. Distortions arise in this context if a tax concession induces people to invest in a particular sector that, in the absence of the tax, they would not invest in. If businesses are effectively subsidised through the tax system, it also has the potential to distort the domestic labour market through that industry being in a position to offer remuneration that a non-subsidised business could not match.*
>
> 16) *New Zealand's framework for taxing inbound capital is based around applying broadly the same tax rules no matter which area of the economy the capital is invested. This is consistent with our broad-base, low rate tax framework. This is why, for example, the same company tax rate applies to companies across the New Zealand economy. The logical extension of option 1* [maintaining the existing concessionary regime] *would be to abandon this framework and apply lower effective tax rates on foreign investment into certain areas of the economy. Not only would such an approach put the company tax base at extreme risk, it would likely result in unfair and inefficient outcomes. In addition, it would strongly encourage industries to lobby Government for industry-specific tax concessions.*
>
> 17) *Further, we consider that, even if tax settings are a consideration when investing into a certain jurisdiction, they will - provided the rules are not actively discriminatory - be relatively insignificant compared to other factors, such as a country's infrastructure, the skill of its labour force and the market price of the mineral in question.*

Recommendation

That the submission be noted.

Issue: Offsetting losses

No clause

Submission
(New Zealand Institute of Chartered Accountants)

Miners should be able to offset losses from one permit area against income derived in respect of another permit.

Comment

Apart from the restriction on grouping and ring-fencing of losses that survive a continuity breach, mentioned above, officials consider that losses from one permit area will be able to be used to offset income from another.

Recommendation

That the submission be noted.

Issue: Changing structures

No clause

Submission
(New Zealand Institute of Chartered Accountants)

Mining companies should be allowed to change business structures (to, for example, a partnership). A mechanism should be in place to allow this to happen without tax impost.

Comment

Officials do not consider a mechanism that allows a mineral miner to change business structures is appropriate in this instance. Very often there are sound tax policy reasons for crystallising gains and losses at the time a business structure is changed.

The only recent precedent for allowing such a tax free transfer was when loss-attributing qualifying companies (LAQCs) were removed from tax legislation. That was a special case because the LAQC structure was being disbanded. In this instance, there is no impediment to a miner carrying on business in a company structure – in fact officials consider that the vast majority of miners would wish to carry on in that way. Introducing extremely complex rules (the LAQC rules cover approximately 4 pages of legislation) to address a theoretical problem would appear to be unnecessarily complex.

Recommendation

That the submission be declined.

Issue: Amount of tax credit

Clause 88

Submission
(New Zealand Institute of Chartered Accountants)

That the rate of tax that applies to refundable credits for specified mineral miners who are neither companies nor trustees should be clarified.

Comment

Officials agree that the amount of the tax credit should be clarified in cases where the credit is available to non-companies. Officials suggest that the credit should be based on the previous year's income of the person, subject to the proposed cap on the credit. This would mean that, for an individual, the credit would be limited to the tax paid in the previous year from their mining activities. If that income is insufficient to absorb all of the losses, it would be carried back to the previous year (where the same treatment should apply) and so on. Mining income should be treated as the first income such a person derives.

Reimbursing trustees at the trustee rate may overcompensate the trust – particularly if the income from previous years has been distributed to low-income beneficiaries. Officials therefore consider that, in the hands of a trustee, the credit should be limited to the total tax paid by the trustee and its beneficiaries in the previous year. This should be limited to income derived from mining activities in the previous year and based on an assumption that all of the trust's income was mining income and was the first to be distributed to beneficiaries.

Such rules would be consistent with the policy that the tax credit is the economic equivalent of the loss-carry back rule that applies to petroleum miners.

Example: Individual

Sam is a "mineral miner" who also has a part-time job. In each of years 1 and 2, Sam earned taxable income of $80,000 in total from is mining activities and $20,000 from his job. At the end of year 2, Sam's mining activity ceases and in year 3 Sam incurs $150,000 of rehabilitation expenditure and derives no other income.

Sam is entitled to a tax credit. The amount of the credit is calculated by looking back at the total tax paid in the previous years. The first year to consider is year 2. Sam derived $80,000 in taxable income from mining that year. Sam's tax liability on that $80,000 was $17,320.

Sam still has $70,000 of rehabilitation expenditure that has not been offset, so that is carried back to year 1. Sam's $80,000 of taxable mining income from that year exceeds the $70,000 still to be offset, so Sam is required to calculate the credit based on the first $70,000 of income. The tax on $70,0000 is $14,020.

Sam's total tax credit on his $150,000 rehabilitation expenditure is $17,320 + $14,020 = $31,340.

Example: Trust

The trustee of the Mining Trust is a "mineral miner". The trust has three beneficiaries: Amy, Ben and Charlie. In year 1, the trust earned $100,000 taxable income. It distributed $20,000 to each of the beneficiaries as beneficiary income and retained $40,000 as trustee income. The beneficiaries are in the following situations for the year:

- Amy has carried forward losses of $50,000;
- Ben has no income other than that received from the trust;
- Charlie is employed on an annual salary of $100,000.

At the end of year 1, the trust's mining activity ceases and in year 2 it incurs $80,000 of rehabilitation expenditure and derives no other income.

The trust is entitled to a tax credit. The beneficiary income from year 1 is required to be counted first. For each $20,000 distribution, the tax liability was as follows:

- Amy paid no tax because the distribution simply absorbed some of her losses;
- Ben paid tax on $20,000 at $2,520;
- Charlie earned a total of $120,000 but his distribution is treated as his first income, meaning his tax liability on the $20,000 is also treated as being $2,520.

This makes a total credit from the $60,000 distributed of $5,040. There is still $20,000 of rehabilitation expenditure required to be offset at the trustee tax rate, making an additional credit of $6,600.

The trustee's total tax credit is therefore $5,040 + 6,600 = $11,640.

Recommendation

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

Issue: Application date for changes

Clauses 10−12, 13, 19−24, 27, 28, 34, 35, 37, 39, 56−60, 64 76−85, 88 and 103(2), (3), (5) – (7), (12), (14), (15), (17) – (36), (40) –(43), (47−(51)

Submission

(Newmont Waihi Gold Limited, Ernst & Young)

The proposed timing of the changes will give miners with an early balance date insufficient time to change systems to accommodate them. Information needs to be recorded in real-time in order to achieve compliance.

The proposed changes are currently expressed as coming into force on 1 April 2014. This should be amended so that they apply from the 2014-15 income years an later.

Comment

Officials agree that legislation with retrospective effect is not ideal, even if it is only for a very small number of taxpayers. However, although any new rules would alter the tax treatment of various types of expenditure, it does not mean that it will impose increased information-capture responsibilities on miners. Expenditure would need to be recorded whether a deduction was being claimed under the existing rules or the new rules – the difference is how that expenditure is accounted for in tax returns. There is not expected to be filing obligations before these rules take effect.

The legislation already provides that the revised rules would apply from the 2014-15 income years, so officials do not consider any changes are required in this regard.

Recommendation

That the submissions be declined.

Issue: Review of existing depreciation rules

No clause

Submission
(PricewaterhouseCoopers, OceanaGold, Newmont Waihi Gold Limited)

The depreciation rates for mining should be reviewed with a view to adding additional assets to the relevant depreciation determination and consulting with the industry to determine appropriate useful lives.

Comment

From a policy perspective, plant and machinery used in mineral mining should be able to be depreciated over its estimated useful life (or, in the case of plant and machinery used to develop the mine, over the life of that mine).

Policy officials understand that Inland Revenue's depreciation rates have been recently audited by a third party (including those rates applicable to the mining sector). That audit found the current rates to be appropriate. However, officials encourage submitters to contact Inland Revenue if there are items that should be on these tables of rates but are not currently listed. Equally, if there are genuine concerns over the rates that are listed, submitters are welcome to contact the Department to discuss those concerns.

Recommendation

That the submission be noted.

Issue: Depreciation of low-value items

No clause

Submission
(Waihi Gold Limited)

The current thresholds under which low-value items can be immediately deducted should be reviewed, and – in the mining context – should be lifted to $5,000 for individual items and $10,000 for a pool of items.

Comment

Officials note the concerns, but consider this is an issue of application to more than simply mining. There are many capital intensive industries where higher-value items are used more frequently. Any review of these thresholds should be carried out as part of a broader initiative and not be industry specific.

Recommendation

That the submission be declined.

Issue: Farm-out rules

Clauses 19 and 35

Submission

Uncertainty in those rules can currently be mitigated by agreeing an approach with Inland Revenue. *(PricewaterhouseCoopers, Straterra)*

It is appropriate to align the farm-out rules with those of petroleum miners. This is an area that could be reviewed at a later date if Inland Revenue agrees there are issues with the application of the rules. *(PricewaterhouseCoopers)*

Recommendation

That the submission be noted.

Canterbury earthquake tax measures

Issue: Comments on general earthquake-related provisions

SOP 257 – clauses 25B, 25C, 37B, 52B, 52C, 52D, 55B and 59B

Submission
(Corporate Taxpayer's Group, Deloitte, KPMG, NZICA)

These submitters expressed their support for the broad direction of the earthquake-related relief measures, and the amendments that took into account the current state of play with the recovery and rebuild of the Canterbury region.

Recommendation

That the submissions be noted.

Issue: The bill extends the time limit for Canterbury Earthquake tax measures from 2015-16 to 2018-19.

SOP 257 – clauses 25C, 37B, 52B, 52C, 52D, 55B and 59B

Submission
(Deloitte, NZICA, KPMG)

The proposal to extend the time limit for the Canterbury Earthquake tax measures to 2018-19 is welcome. However, the Government should commit to reviewing the time limit again in 2017.

Comment

The bill does not preclude a review of the time limit in 2017. Nevertheless, the Government has not signalled an intention to review the time limit unless there is a compelling reason to do so. The progress of the rebuild of Canterbury will clearly have a bearing on this.

Recommendation

That the submission be declined.

Issue: The bill requires that a new property must be "acquired" by 2018-19 in order to qualify for the depreciation recovery income roll-over relief.

SOP 257 – clauses 52B and 52C

Submission
(Deloitte, NZICA)

To qualify for the roll-over relief a taxpayer must have either purchased or built a new property in the Canterbury area before 2018-19. This timeframe is unrealistic given the current pace of rebuilding in Canterbury. Obstacles to rebuilding in this timeframe include the time required for Christchurch council to grant occupancy certificates for new buildings or resource consent for the build. Submitters propose that "acquired" by 2018-19 refer to when construction of a new property has commenced. The test for when construction has commenced could be, for example, based on evidence of a binding contract and expenses already incurred in relation to the new building (similar to the provisions in EE 31 of the Income Tax Act).

Comment

The key concern of submitters is that the deadline for taxpayers to have purchased or built a new building by 2018-19 is too soon. Rather than introducing a lower threshold to qualify for the relief from depreciation recovery income (e.g. a commitment to rebuild rather than a new build itself), officials consider reviewing the deadline in 2017 if it becomes clear that there are some real obstacles to rebuilding that is preventing taxpayers from acquiring a new building within the 2018-19 timeframe. If taxpayers became eligible for relief from depreciation recovery income before the purchase or construction of a new building, this would require an estimate of the cost of the new building before the real cost has been finalised. The cost of the new building is critical to calculating the amount of depreciation recovery income relief. Officials consider this approach would add complexity (namely a new rule on how to estimate the cost of a building before it has been built and a reconciliation with the actual costs of the new building once the building has been finished) and uncertainty.

Recommendation

That the submission be declined.

Issue: To qualify for the roll-over relief for a replacement building a taxpayer is required to have applied to the appropriate authority for consent to build.

SOP 257 – clauses 52B and 52C

Submission
(Deloitte, Ernst & Young, NZICA)

The requirement for taxpayers to have applied for building consent by the end of the 2015-16 income year in order to access roll-over relief for the 2016-17 to 2018-19 income years is unduly onerous.

While it is preferable to have no “checkpoint” in the 2015-16 income year, if one is necessary, we suggest that it should involve the taxpayer having completed concept designs and plans by the end of the 2015-16 income year. Alternatively, the reference to consent should be clarified to mean resource consent as opposed to building consent. *(Deloitte)*

Comment

Officials agree that it is preferable to remove the requirement for taxpayers to have applied for building consent by the end of the 2015-16 income year in order to access roll-over relief for the 2016-17 to 2018-19 income years. This is because of the on-going uncertainty around current planning and rebuilding activities in Canterbury.

While, as noted above, there is no intention at this stage to review the 2018-19 time limit unless there is a compelling reason to do so, officials consider that any such review should consider whether it is appropriate to tighten the requirements for accessing roll-over relief. This would be to ensure that relief is targeted at taxpayers who can demonstrate a genuine commitment to rebuilding in Canterbury.

Recommendation

That the submission be accepted.

Issue: Making roll-over relief available to taxpayers who reinvest other than through a company.

SOP 257 – clause 52C

Submission
(Deloitte, Ernst & Young, NZICA)

Currently the proposed amendment only allows for the reinvestment into a replacement property in Canterbury through a company. The bill should be amended to allow for a replacement property to be constructed or purchased through other investment entities, such as a partnership, trust or look-through company.

Comment

The extension of the rollover relief provisions aims to ensure affected taxpayers continue to qualify for the relief in situations where they do not invest directly themselves but they invest through a company. The provisions strike a balance between catering for the situations where taxpayers may choose to invest with other investors rather than directly and keeping the rules as simple as possible. Companies are the most common vehicle for investment. As at June 2012 there were 548,000 registered companies in New Zealand compared to only 1,300 limited partnerships. Extending the eligibility of rollover relief to look-through companies and limited partnerships would require additional rules for these investment vehicles. Joint investment entities such as look-through companies and limited partnerships could easily establish a company to

acquire a new property and the investors (look-through company shareholders and limited partners) could still remain eligible for the rollover relief.

Officials note that the rules cater for trustee shareholders; trusts themselves are unlikely to be used as joint investment entities.

Recommendation

That the submission be declined.

Issue: When tax liability is triggered at the end of the roll-over relief period, the liability should be spread over a ten year period following the end of the relief period.

SOP 257 – clauses 52B and 52C

Submission
(NZICA)

Taxpayers may not know whether roll-over relief applies until close to the 2018-19 income year deadline. If a taxpayer discovers in 2019 that the roll-over relief is not available to them, the tax liability may affect their business. Spreading any depreciation recovery income that might be triggered close to the time limit over ten years would lessen this impact. Further, a ten-year spreading provision would reduce uncertainty to taxpayers and minimise the impact on their investment decisions close to the 2018-19 time limit.

Comment

If by 2018/19 a taxpayer has not met the criteria for rollover relief, they will not have built or purchased a new building in the Canterbury region. Nevertheless, the taxpayer will still have benefited from a deferral of their tax liability from 2011. Providing further relief for taxpayers that are not rebuilding in the Canterbury region is not consistent with the intent of the relief policy and a ten-year spreading rule adds complexity to the existing rules.

Recommendation

That the submission be declined.

Issue: Amendment to s EE 23BB to allow for owners who are planning to acquire an interest in a reinvestment entity

SOP 257 – clause 52C

Submission

(Deloitte)

New section EZ 23BB should be expanded to allow for owners who are planning to, but have not yet, acquired an interest in the entity undertaking reinvestment (analogous to the requirement in s EZ 23B that a taxpayer must plan to acquire replacement property). Alternatively, if it is intended that taxpayers initially elect into roll-over relief through existing s EZ 23B and then elect into s EZ 23BB once they have acquired an interest in a reinvestment entity, s EZ 23B's requirement for the original owner to plan to acquire replacement property should be expanded to include acquisition of replacement property through another entity.

Comment

Section EZ 23BB applies where a person receives insurance proceeds for earthquake-damaged depreciable property, would have depreciation recovery income and has an interest in an entity that will acquire replacement property. By contrast, existing s EZ 23B applies where a person receives insurance proceeds for earthquake-damaged depreciable property, would have depreciation recovery income and plans in the current year to acquire depreciable property.

Officials agree that some form of transitional rule is required for taxpayers who have initially elected into roll-over relief under existing s EZ 23B because they plan in the current year to acquire replacement property but will now be acquiring replacement property through a joint investment entity (and so meet the criteria for electing into new s EZ 23BB). This is discussed further below in relation to the submission "Clarifying the transition between ss EZ 23B and EZ 23BB".

Recommendation

That the submission be noted subject to officials' comments.

Issue: Rename "suspended recovery income" in s EZ 23BB

SOP 257 – clause 52C

Submission

(Deloitte)

Under s EZ 23BB, both the short-term deferral of depreciation recovery income (which exists until the replacement asset is acquired) and the long-term deferral (which exists until the interest in the replacement asset is sold) are called "suspended recovery income". The long-term deferral of depreciation recovery income under the section should be named something other than "suspended recovery income" for clarity.

Comment

The term "suspended recovery income" is used in s EZ 23BB to refer to the amount of depreciation recovery income that can be deferred until or unless specific events occur. Officials consider that the use of the term is sufficiently clear.

Recommendation

That the submission be declined.

Issue: Expansion of s EZ 23BB to cater for rebuilding occurring by an entity in the same group

SOP 257 – clause 52C

Submission
(Deloitte)

New s EZ 23BB should be expanded to cater for the situation where reinvestment occurs through a company which is in the same group of companies as the company that owns the destroyed property that is being replaced.

Comment

While officials recognise that investment to acquire replacement property may occur through a company that is in the same group as the company that owns the destroyed property being replaced, it is considered that expanding depreciation roll-over relief to group company situations would add significant complexity to the rules. This is because the rules would need to be modified to fit with the tax rules that apply to groups of companies e.g. loss grouping. This complexity is undesirable as it is at odds with the policy intent of ensuring that depreciation roll-over relief is clear and straightforward to apply.

Recommendation

That the submission be declined.

Issue: Clarification of timing of amendment to s EE 52

SOP 257 – clause 55B

Submission
(NZICA)

The amendment to s EE 52 should be drafted so that it is clear that it will not result in a taxpayer incurring a tax liability in a period earlier than the period in which the Bill is enacted.

Comment

Section EE 52 specifies the amount of depreciation recovery income that a person has when they receive insurance proceeds for damage to a depreciable asset. The amendment to s EE 52 contained in the bill seeks to clarify that if damaged property is disposed of before the insurance proceeds are received, the proceeds will be treated as being derived immediately before the disposal. This is in order to remedy a gap in the legislation. If a person receives insurance proceeds for a damaged building and the building is then sold, the owner is taxed on the insurance proceeds. However, if the damaged building is sold before the insurance proceeds are received by the owner, the proceeds are not taxable.

The amendment applies from 25 June 2013, which is the date that the Supplementary Order Paper on further Canterbury earthquake tax measures was released. The reason for this application date is that applying the amendment from the beginning of the 2014-15 income year may give taxpayers a window of opportunity to prevent their insurance proceeds from being taxable (by selling their buildings to associates before 1 April 2014, for example). Also, this approach is consistent with the approach taken in the past to the application date for generic (albeit Canterbury earthquake-related) amendments clarifying the treatment of insurance proceeds.

Recommendation

That the submission be declined.

Issue: Clarifying the transition between ss EZ 23B and EZ 23BB

SOP 257 – clauses 52B and 52C

Submission
(NZICA, Ernst & Young)

Many taxpayers who will wish to use new EZ 23BB to claim depreciation roll-over relief will have already relied on s EZ 23B in earlier income years to suspend recognition of depreciation recovery income. Accordingly, the legislation should explicitly provide for a transition for taxpayers from s EZ 23B to s EZ 23BB.

Alternatively, section EZ 23BB should apply from a future date and a transitional provision should be introduced for taxpayers who have elected under section EZ 23B *(NZICA).*

Comment

New s EZ 23BB applies from 4 September 2010, which is the date of the first Canterbury earthquake. However, many taxpayers seeking to claim relief from depreciation recovery income will have already done so under existing s EZ 23B. Officials agree that a transitional rule should be included to allow taxpayers who have claimed relief under s EZ 23B to claim relief under s EZ 23BB going forward.

Recommendation

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

Issue: Clarify maintenance of suspension of income beyond 2018-19 income year

SOP 257 – clause 52C

Submission
(Ernst & Young)

It should be clarified that there will be no claw-back of depreciation recovery income under the proposed s EZ 23BB after the 2018-19 income year, where taxpayers retain their interests in the company acquiring replacement property and the latter retains the replacement property.

Comment

The policy intent is that there will be no claw-back of depreciation recovery income unless:

i. no replacement property has been acquired by the end of the 2018-19 income year; or
ii. the taxpayer exits the company holding the replacement property;
iii. the taxpayer goes into liquidation or bankruptcy; or
ii. the replacement asset is disposed of.

Officials consider this is achieved by the current drafting of s EZ 23BB. Guidance on the application of the section will be provided through the *Taxation Information Bulletin,* once the bill is enacted.

Recommendation

That the submission be declined.

Issue: Ensure clear initial suspension of depreciation recovery income

SOP 257 – clause 52C

Submission
(Ernst & Young)

It is submitted that s EZ 23B(2) and new s EZ 23BB(2) should be amended to ensure there is a clear initial suspension of a taxpayer's depreciation recovery income. The concern is that as each of these provisions currently refers to amounts which may be depreciation recovery income in or after the current year, describing them by reference to the excess recovery amounts "that remain at the beginning of the current year" after earlier adjustments and attributions, may mean that there is no clear initial suspension of the amount that would otherwise be depreciation recovery income.

Comment

Officials consider that the drafting of s EZ 23B(2) and new s EZ 23BB(2) ensures that there is an initial suspension of a taxpayer's depreciation recovery income. This is achieved through the reference to an "amount that may be depreciation recovery income of the person *in* or after *the current year*". However, guidance on the application of the sections will be provided in the *Taxation Information Bulletin*, once the bill is enacted.

Recommendation

That the submission be declined.

Issue: Calculation of suspended amounts under new s EZ 23BB

SOP 257 – clause 52C

Submission
(Ernst & Young)

The submitter states that the various calculation provisions in new s EZ 23BB need revising to ensure taxpayers have effective suspension of the full amount of their depreciation recovery income until the replacement property is fully acquired, which may occur over several years.

Comment

Officials consider that the various calculation provisions in new s EZ 23BB work as intended, which is to ensure taxpayers have effective suspension of the full amount of their depreciation recovery income until replacement property is fully acquired by the end of the 2018-19 income year. Further guidance on the application of the calculation provisions will be provided in the *Taxation Information Bulletin*, after the bill is enacted.

Recommendation

That the submission be declined.

Issue: Clarify meaning of "settlor" and quantification of settlements and trust corpus for the purposes of s EZ 23BB

SOP 257 – clause 52C

Submission
(Ernst & Young)

The submitter suggests clarifying the meaning of "settlor" as it is used in s EZ 23BB. Section EZ 23BB deals with taxpayers suspending recognition of their depreciation recovery income if they are the settlors of trusts of which the trustee(s) hold voting interests in an "owning company". The submitter also suggests clarifying the quantification of settlements and trust corpus for the purposes of s EZ 23BB.

Comment

Officials agree that the meanings of "settlor", "corpus" and "settlement" should be clarified in the context of s EZ 23BB. At present, these terms are defined only in relation to specific sections (which do not include ss EZ 23B or EZ 23BB). Officials consider that these definitions should instead be made generic – this will ensure that they apply in the context of s EZ 23BB.

Recommendation

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

Issue: Replacement of revenue account property

SOP No 257 – clause 25B

Submission
(NZICA)

Revenue account property (RAP) rollover relief should allow the taxpayer to claim the relief even if the replacement property is not revenue account property.

The issue arises where the original property only became RAP by virtue of a disposal within ten years of acquisition.

This is because the original property may be deemed to be held on revenue account because of associations or building development activities that the owner was involved with at the time of, or shortly following, the acquisition of the property.

If such a property is disposed of within ten years of its acquisition, or within ten years of the development activity, it will be treated as revenue account property, rather than a capital asset.

If the disposal is triggered or brought forward by the Canterbury earthquakes, this means the owner cannot retain the property for longer than the ten years – and so avoid the tax liability on the proceeds from disposal of revenue account property.

If these associations or activities no longer exist at the time the new property is acquired, they will not "taint" any replacement building. So it may not be possible for the replacement property to be treated as a revenue account property, and so the RAP roll-over relief at section CZ 25 of the Income Tax Act 2007 cannot be used.

Comment

The RAP roll-over relief has always required both the original and the replacement property to be held on revenue account. This is because the purpose of the roll-over relief is merely to delay the tax that would arise on the eventual sale of the replacement property; it does not remove the tax obligation altogether. However, this tax liability will only arise if the replacement property is RAP. If the replacement property is not or does not become RAP, there will be no "RAP income" arising in the future from the replacement's disposal.

Officials note that the issue raised could theoretically, prevent an owner of property that was deemed to be RAP from accessing the RAP rollover relief going forward. However, in order to apply the RAP roll-over relief to property that is not, in and of itself, RAP at time of acquisition, would require some complex and potentially onerous tracing provisions. One possible option is to deem replacement property to be RAP if the roll-over relief is claimed, but this creates difficulties when the property is eventually sold, in determining how much of the profit from that sale should be subject to tax. That is, the question arises of how to restrict the liability to the profit that would have arisen on the original property, allowing also for interest value over time.

Officials note that there is no evidence that this issue is actually causing any difficulties for Canterbury taxpayers in practice, which would justify adding further complex rules and tracing provisions to this rollover relief option.

Further, section CZ 26 of the Income Tax Act 2007 contains an exemption for income from certain property disposals within 10 years of acquisition, so this not an issue for taxpayers whose RAP is acquired by the Crown, which would include many of the worst affected RAP owners in the Christchurch CBD area.

Recommendation

That the submission be declined.

Issue: Application of revenue account property rollover relief

SOP No 257 – clause 25B

Submission
(NZICA)

The revenue account property (RAP) rollover relief at section CZ 25 should apply to an amount of income arising from the disposal of RAP under the following provisions, because the earthquakes will have triggered the provision:

- Section CB 6 – disposal: land acquired for purpose or with intention of disposal
- Section CB 7 – disposal: land acquired for purposes of business relating to land
- section CB 9 – disposal within 10 years: land dealing business
- section CB10 – disposal within 10 years: land development or subdivision business
- section CB 11 – disposal within 10 years of improvement: building business
- section CB 12 – disposal: schemes for development or division begun within 10 years
- section CB 14 – disposal: amount from land affected by change and not already in income

Comment

RAP roll-over relief was introduced in 2011, and initially applied only to income arising from the disposal of buildings held on revenue account, if the building was rendered useless or destroyed by the earthquake.

This income arises under section CG 6, which applies when a person receives an amount for the loss or destruction of, or damage to, trading stock. As noted in the submission, buildings are defined as 'trading stock' for the purposes of section CG 6 if their disposal creates income under section CB 6 to CB 15.

The RAP relief was extended in 2012 to apply to land. It was also extended to apply to buildings which were not necessarily rendered useless or destroyed, but were being purchased by the Government under its compensation package, under the recovery/rebuild plan. However when the section was extended, it still only applied to income that was considered to arise under section CG 6. For some of the buildings, because they had not actually been destroyed, the income could arise not under section CG 6, but under the provisions at sections CB 6 to CB 14.

The amendments proposed in the supplementary order paper 257 already amend section CZ 25 to include sections CB 6 and CB 7.

Income arising under sections CB 9 to CB 11 and CB 14 from the disposal of buildings which are not necessarily rendered useless or destroyed, but are purchased by the Government under a compensation package, are addressed by the exemption at section CZ 26. So these sections should not be included in the RAP rollover relief rule at section CZ 25.

Recommendation

That the submission be declined.

Issue: Revenue account property rollover relief formula

SOP No 257 – clause 25B

Submission
(NZICA, Ernst and Young)

The formula for calculating the amount of the revenue account property (RAP) roll-over relief is circular, because section CZ 25(3)(a)(i) is based on the result of section CZ 25(3)(a)(ii), and vice versa.

The formula leads to unexpected results in circumstances where the cost of the replacement property exceeds the costs of the previous property (worked examples provided).

More guidance should be provided on how the formula should be applied.

Comment

The purpose of the RAP roll-over relief is to delay the tax that would arise on the disposal of the original RAP, until the eventual sale of the replacement property; it does not remove the tax obligation altogether. When the replacement RAP is eventually sold on, the "profit" will be taxed at that later stage.

RAP rollover relief allows for an equivalently valued RAP to be purchased with the receipts from the original RAP by deferring the payment of the associated tax. If The formula provides for the RAP income amount derived to be pro-rata If not all of the receipts from disposal of the original RAP are used to purchase replacement RAP, there is no deferral of tax on the unused remainder, that is, there is a pro rata approach, which is achieved through the formula. The three main situations and outcomes can be summarised as:

i. The cost of replacement RAP is *less than* the insurance proceeds and *less than* the cost of the original RAP.

In this situation no rollover relief will be due, because the tax liability arising on the sale of the original RAP can be met without affecting the taxpayers' ability to purchase the new RAP.

ii. The cost of replacement RAP is *less than* the insurance proceeds but *more than* the cost of the original RAP.

In this situation a portion of the insurance proceeds received is taxable as income (under either section CB 6, CB 7, CB 12, CB 13 or CG 6) immediately in the year of receipt, because it is not all needed to purchase the replacement RAP.

The formula in section CZ 25(3) requires a pro-rata approach.

The remainder of the income that is not taxed immediately is still rolled-over to reduce the cost price (for the purposes of section EA 2) of the replacement property.

iii. The cost of replacement RAP is *equal to or more than* the insurance proceeds, and *more than* the cost of the original RAP.

In this situation all the proceeds are put towards the replacement RAP. There is no pro-rata, and the full amount of taxable income will be rolled over.

The previous drafting in section CZ 25(3) meant that the formula simply did not apply in the third situation. The proposed amendments re-draft this formula to cover all three scenarios.

No change in outcome was intended; however officials agree that the calculation of one of the elements ('excess recovery') is unclear. This term "excess recovery" was intended to mean the excess (difference) between the amount received for the disposal of the original property and the cost of the replacement property. Officials agree that the derivation of this element of the calculation should be clarified in the drafting, and the drafting of the formula could be simplified to avoid any apparent circularity.

Officials will consider the comments about the provision of more guidance by Inland Revenue on the application of this formula, including a worked example.

Recommendation

That the submission be accepted.

On enactment of the bill guidance on the amendments and the formula will be released in Inland Revenue's Tax Information Bulletin, as usual.

Issue: Section CZ 26 exemption where income arises under section CB 12

SOP No 257 – clause 25C

Submission
(NZICA)

The exemption at section CZ 26 applies to income arising for the disposal of land and buildings purchased by the Government under its compensation. It should also apply to income arising under section CB 12.

Some taxpayers will be required to commence development or division work within ten years, as a result of the earthquakes, and should have access to the RAP rollover relief and/or the exemption provision.

Comment

The section CZ 26 exemption was designed for situations where the owner wished to take up the Government offer of purchase following the damage caused by the earthquake. However, taking up the offer would mean they could not retain the land for the requisite 10-year period, and so could not prevent income arising under sections CB 9 to CB 11.

It is not intended to provide extended relief for decisions around development and division which took place after the earthquake.

Section CB 12 taxes income from land in situations where work is commenced within ten years of acquisition. The time of disposal of the land is irrelevant.

Section CB 12 does not have an 'end date' – that is to say, if the person entered into non-minor developments within 10 years of acquisition they should always have known they were liable for income tax on disposal. Therefore the owner has not lost the ability to retain the land for a requisite period as there is no requisite period linked with disposal under section CB 12.

Recommendation

That the submission be declined.

Issue: Cross-reference in s EE 1(3)(d)

SOP 257

Submission
(Ernst & Young)

Section EE 1(3)(d) should be amended to include a reference to depreciation recovery income under the proposed new s EZ 23BB.

Comment

Officials agree that s EE 1(3)(d) should be consequentially amended to refer to depreciation recovery income calculated under s EZ 23BB.

Recommendation

That the submission be accepted.

Issue: Replacing "affected property" with "affected class" in s EZ 23B(4)(a)

SOP 257, clause 52B

Submission
(Deloitte)

There are only two instances in s EZ 23B(4)(a) where "property" should be changed to "class". The second instance of the word which refers to "other replacement property" should not be changed to "other replacement class".

Comment

Officials agree that there are only two instances in s EZ 23B(4)(a) where "property" should be changed to "class". The existing reference to "other replacement property" should remain.

Recommendation

That the submission be accepted.

Issue: Unnecessary colon in s EZ 23B(5)(a)(i)

SOP 257, clause 52B

Submission
(Ernst & Young)

The amendment to s EZ 23B(5)(a)(i) appears to include an unnecessary colon.

Comment

Officials agree that there is an unnecessary colon in the amendment to s EZ 23B(5)(a)(i) – this should be corrected so that "cost of the affected property" is replaced with "cost of the affected class".

Recommendation

That the submission be accepted.

Issue: Drafting amendments to s CZ 25

SOP No 257 – clause 25B

Submission
(NZICA, Deloitte)

1. The title of section CZ 25(5) should be updated to refer to the new 2018/19 income year deadline.

2. In section CZ 25(3)(a)(i) it should be clarified that the "total amount of deductions under sections DB 23 and DB 27" are referring to the original (affected) RAP and not the cost of acquiring the replacement RAP.

3. Section CZ 25(3)(a) and section CZ 26 should expressly override section CG 6, to ensure that income from the disposal of land and buildings held on revenue account, to which the RAP rollover relief applies, cannot also be considered to still arise under section CG 6.

Comment

1. Section CZ 25(5)(a) is being amended so that a taxpayer is liable to tax on amount of income equal to the amount of any remaining suspended recovery income at the end of the 2018-19 income year, not the 21015-16 year as currently. The title should be updated to reflect this extension.

2. Section CZ 25(3)(a)(i) should refer to total amount of deductions under sections DB 23 and DB 27 for the affected RAP.

3. Section CZ 25(3) already provides relief from section CG 6, if the taxpayer elects to use the RAP rollover provision under section CZ 25(1). Section CZ 26 prevents sections CB 9 to CB 11 from applying to a person, land or building. This means that section CG 6 cannot apply, as the land or building cannot become trading stock through the definition of trading stock at section YA 1 – which relies on income arising under sections CB 6 to CB 15.

Recommendation

That submissions 1 and 2 be accepted and submission 3 be declined.

Policy matters

Issue: Complexity of Working for Families tax credit rules

Clauses 89-98

Submission
(NZICA)

The Working for Families tax credit (WFF) rules in subpart MA to MK should be reviewed and simplified and made more coherent. Continual redrafting of the legislation has made it difficult to determine a person's entitlement.

Comment

There are trade-offs to consider when making a payment system more coherent and/or simple. Significant changes generally result either in families receiving less, or Governments spending more. Improving coherence may lead to systems becoming more complex. There are also concerns about accuracy and integrity.

For example, a review in 2001 recommended simplifying the family scheme rules, to reduce compliance costs and complexity by moving away from a welfare-based definition of income and aligning rules with a tax-based definition of income. However, a tax-based definition of income does not always provide a good estimate of the resources available to a family as the tax system can ignore payments received by families where it has been taxed elsewhere (such as distributions from trusts or fringe benefits).

The broadening of the definition of family scheme income from 2011 was in response to concerns about the fairness and integrity of the family scheme income rules. There had been an increase in the level of the tax credits over 2004-2007 and changes in how businesses were being structured (for example, as family trust-owned companies). The 2011 broadening reforms sought to recognise the resources available to some families and to better identify those families in genuine need of additional government assistance. The trade-off is an increase in complexity and for some families an increase in compliance costs and reduction in payments.

It is possible to align the wording and formulae in section MB 4 (relating to close companies) and section MB 7 (relating to trusts and trust-owned companies). In particular, the terminology on voting interests and shareholding in a company could be rationalised; the references to a company's accounting year in section MB 4 could be aligned with references to the company's income year in section MB 7; and the attribution of net company income to a shareholding trustee less dividends in section MB 7 could be aligned with the proposed formula in section MB 4 on the attribution of net company income less dividends to a major shareholder. It makes sense to rationalise the provisions that employ a similar concept, such as the attribution of company income in sections MB 4 and MB 7. These minor changes would reduce compliance costs with minimal impact on Government spending.

Officials will be reviewing the IR215 form and supporting information to see if we can provide better guidance on the income information that is required from families. In

some cases it may be appropriate for a person to seek assistance from their accountant or tax advisor to complete parts of the form, such as determining the end-of-year net income of the close company in which they are a major shareholder.

Recommendation

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

Issue: Settlor test for Working for Families tax credits in section MB 7

Clause 92

Submission
(NZICA)

The use of the settlor test for Working for Families tax credits should be reviewed as the settlor test makes the rules very complex and difficult to apply. Alternatively, the definition for settlor in the context of section MB 7 should be clarified.

Comment

Officials consider the use of the settlor test continues to be appropriate. Section MB 7 attributes the net income of a trust (including trust-owned companies) to the settlors of that trust for inclusion in family scheme income. The definition of settlor in section MB 7 is the same as that used throughout the Income Tax Act 2007. The only exception is a specific exclusion in section MB 7 that a person is not a settlor for family scheme income solely as a result of providing personal services for less than market value in the administration of the trust or the maintenance of trust property.

The submitter has raised the issue whether a person is a settlor if they are a beneficiary who has a credit balance (undrawn funds) in their beneficiary account with the trust. This is a wider question of who meets the definition of settlor in the Income Tax Act 2007, although the answer will have implications for parents who are or may be subject to income attribution under section MB 7. Inland Revenue is considering its response.

Recommendation

That the submission be noted.

Issue: Negative amounts calculated under section MB 4 — close company income

Clause 91

Submission
(NZICA)

The formula in section MB 4 is being amended to confirm that it cannot result in a negative amount. This amendment should not proceed. A negative amount should be allowed to avoid double counting the same income.

Comment

Section MB 4 as proposed in the bill specifically states the amount to be included in family scheme income "is the greater of zero and the amount given by the formula". This clarifies the previous wording, which referred to the amount of family scheme income calculated under the section being "reduced by" the total dividends paid. The drafting confirms the long-standing policy that negative amounts are not taken into account. Similar wording exists in section MB 7, stating that the amount of dividends being deducted cannot exceed the amount of net company income attributed to the shareholding trustee.

Dividends received by a person are included in family scheme income as they are taxable income of the person. Section MB 4 seeks to attribute income that is retained in the close company; represented in the formula by net income of the company less total dividends paid. This avoids double counting of income which is earned and paid out as dividend in the same year.

It is possible that close company income would be attributed under section MB 4 to a parent in one year and when company income is paid out as a dividend in the following year is included as family scheme income in that following year. It is also possible that this does not occur, as the person may not be eligible for Working for Families tax credits in either of those years or may not be involved in the close company in one year. The scope of the WFF tax credit is to provide financial assistance for families in need in that year rather than looking at overall family income across several years. Disallowing negative amounts is consistent with this annual focus.

Recommendation

That the submission be declined.

Issue: Updating Working for Families tax credit references

Clause 89, 90, 118

Submission
(Matter raised by officials)

There should be a consistent use of the term "family scheme income" to refer to income calculated under subpart MB. The term "net income" should not be used when referring to income calculated for the family scheme. Also, a provision's heading still refers to Family Support which has since been renamed.

Comment

This Bill corrects references in the Income Tax Act 2007 and uses "family scheme income" when referring to income calculated for the family scheme in subpart MB. There are other references to "net income" used to calculate a Working for Families tax credit (in the Tax Administration Act 1994) and "net income" under subpart MB (in the Health Entitlement Cards Regulations 1993) where the context of the section means that "family scheme income" is the most appropriate term. These other references should be amended to refer to "family scheme income".

The heading to section 84 of the Tax Administration Act 1994 refers to family support payments. Family support was renamed as the family tax credit from 2008. Also, section 84 refers to the disclosure of information to prevent double payment of a Working for Families tax credit. The heading should be amended to reflect the purpose of the section.

Recommendation

That the submission be accepted.

Clauses 38 and 55

Issue: Description of the problem is incorrect

Submission
(Law Society)

The way the problem has been described in the bill commentary – namely that deductions may be allowed for notional payments – is inappropriate. The financial arrangements recognise notional payments in other situations.

Comment

Officials agree that a clearer problem description would be that taxpayers may be able to claim deductions for payments where there is no economic substance. This will be reflected in the Tax Information Bulletin on enactment.

Recommendation

That the submission be noted.

Issue: Change of spreading method adjustment should be removed

Submission
(KPMG, NZICA)

The requirement to perform a change of spreading method adjustment for taxpayers who have been claiming deductions (or paying income tax) on interest-free loans should be removed.

The bill proposes that this adjustment be performed in the 2014/15 income year, which will have begun for some early balance-date taxpayers before the bill receives Royal assent. If the adjustment is to be kept, taxpayers should have the option of performing this adjustment in the 2015/16 income year.

Comment

The purpose of requiring the change of spreading method adjustment is to reverse any deductions a taxpayer has previously taken under an interest-free loan. Without this requirement, taxpayers will not have to reverse these deductions until the loan expires, which may not be for many years. This could provide a significant timing advantage. Officials therefore do not agree that the change of spreading method adjustment should be removed.

Officials also disagree with deferring the timing for this adjustment. While some early balance-date taxpayers will have already started the 2014-15 income year before the bill receives Royal assent, we do not expect them to have to file their tax returns until well after this occurs. In addition, officials consider that affected taxpayers have been aware of this change for some time.

Recommendation

That the submissions be declined.

Issue: Application date of the proposal

Submission
(Corporate Taxpayers Group, NZICA)

The application date for this change should be deferred until the 2014/15 income year.

Comment

Officials agree. This change would align the application date of the proposal with the year the change of spreading method adjustment is required. It will also mean the change generally applies prospectively.

Recommendation

That the submission be accepted.

Issue: Compliance costs

Submission
(NZICA)

This change should only be enacted after consideration is given to the associated compliance costs.

Comment

The IFRS financial reporting spreading method generally reduces compliance costs by allowing amounts financial arrangements to be spread as they are under IFRS accounting. However, good tax policy can require a departure from IFRS treatment where it would produce an inappropriate result for tax purposes. This amendment is a reflection of this policy.

Recommendation

That the submission be noted.

Issue: Drafting of the proposal

Submission
(Ernst & Young)

The wording of proposed section EW 15D(2)(ad) is unclear and should be revised.

Comment

Officials agree.

Recommendation

That the submission be accepted.

OVER-CREDITING OF IMPUTATION CREDITS IN EXCESS OF FIF INCOME

Clauses 15 and 86

Issue: Need for amendment

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

The amendment is unnecessary because the current rules provide the correct result over time.

Comment

The proposed amendment addresses a mismatch arising under the current tax rules in relation to imputed dividends paid by Australian companies under the trans-Tasman imputation rules but where the investment is taxed under the foreign investment fund (FIF) rules. This mismatch arises because the imputation credits are calculated on the basis of the dividend paid but income tax arises only on the FIF income. The actual dividend is not taxed. When the dividend exceeds the FIF income, the resulting excess imputation credits could be used to offset tax on other income such as salary and wages. Allowing the New Zealand investor to receive imputation credits in excess of their tax liability on their Australian investment is inconsistent with the policy rationale underlying the imputation regime, which is to eliminate double taxation of New Zealand company profits.

Double taxation only arises to the extent of FIF taxation. The proposed amendment limits the amount of imputation credits – which are attached to a dividend received from an Australian company – which a resident can use to offset the New Zealand tax. The amendment requires the imputation credits to be calculated on the basis of the resident's FIF income from that company, rather than on the actual dividend.

Officials consider that this is an effective and simple solution. Officials do not agree with the submission that it would be appropriate to allow imputation credits in excess of the amount that offsets the New Zealand tax on the FIF income which the Australian investment produces.

Officials consider the amendment is consistent with the existing rule that allows a tax credit for foreign tax paid on the dividend received by New Zealand resident even though the actual dividend is not subject to New Zealand tax because the shareholder is subject to the FIF rules. However, in this case, the foreign tax credit is limited to the New Zealand tax liability on the FIF income.

Recommendation

That the submission be declined.

Issue: Allowing excess credits to be carried forward or backwards

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

If the submission above is not accepted, excess imputation credits should be able to be carried forward or carried backwards and offset against FIF income in other periods.

Comment

Where an Australian investment is subject to the FIF rules, officials consider it is appropriate to place a limit on the amount of trans-Tasman imputation credits attached to a dividend received from the Australian investment in that year. The amount of imputation credits should be calculated on the basis of the New Zealand resident investor's FIF income from the company in that year.

Any solution involving the carry forward or the carry backwards of imputation credits would be very complex for both taxpayers to comply with and for Inland Revenue to administer. The proposed amendment requiring the amount of imputation credits to be calculated on the basis of the New Zealand resident's FIF income from an Australian investment provides an effective and simple solution to the problem of over-crediting of imputation credits in excess of FIF taxation.

The solution suggested by the submission would also not be consistent with the rule that allows a credit for foreign tax paid on a dividend received by New Zealand resident even though the actual dividend is not subject to New Zealand tax because the investment is taxed under the FIF rules. However, in this case, the foreign tax credit is limited to the New Zealand tax liability on the FIF income, and there is no provision for the carry forward or the carry back of credits.

Recommendation

That the submission be declined.

Issue: Limiting amendment to certain FIF calculation methods

Submission
(KPMG)

The limitation on imputation credits should only apply if the FIF income calculation method used is the fair dividend rate (FDR) or cost method.

Comment

The proposed amendment will require imputation credits attached to dividends paid by an Australian company to be calculated on the basis of the New Zealand shareholder's FIF income, rather than on the actual dividend. Officials consider there is no basis for distinguishing between FIF calculation methods. The amendment should therefore apply equally regardless of the FIF calculation method used.

Recommendation

That the submission be declined.

DEDUCTIONS FOR HOLDERS OF DEBT – COMPLIANCE CHANGE

Issue: Support for compliance change

Clause 29

Submission
(KPMG, Corporate Taxpayers Group, New Zealand Law Society)

The submitters support the change to allow creditors an automatic bad debt deduction in certain situations.

Recommendation

That the submission be noted.

Issue: Situations to which the compliance change applies

Clause 29

Submission
New Zealand Law Society

The submitter seeks confirmation that holders of financial arrangements that have been discharged without consideration or that have become irrevocable or unenforceable through the lapse of time will still be entitled to a bad debt deduction if written off as bad after the discharge or lapse of time.

Alternatively, it is submitted that the proposed amendments be extended to include other situations where a debt has been compromised, namely, when a financial arrangement has been discharged without consideration, or has become irrevocable or unenforceable through the lapse of time.

Comment

The primary object of the proposal is to minimise compliance costs faced by small taxpayers and only in situations where it was clear the debt was bad. The rationale was that the requirement for a debt to be written off before a bad debt deduction is taken can be unnecessarily onerous for creditors. This is because they would need up-to-date knowledge of the financial state of the debtor in order to take the bad debt deduction in time. In some situations, creditors are not informed of upcoming liquidations or bankruptcies so they would need to regularly check the companies register or public listings for updates on the financial status of debtors.

In comparison, officials consider that the compliance criteria for creditors of debts that have been discharged without consideration or become irrevocable or unenforceable through the lapse of time are not onerous. These creditors should have adequate notice

that the debtor is unable to meet their obligations in full and have sufficient time to write off the debt as bad under current rules.

Furthermore, the requirement to write off a bad debt is a way of proving that taxpayers have turned their mind to the debt and that the debt is truly bad. In the case of a remission of law or a composition with creditors, it is highly likely the debt is a bad debt and the creditor should be allowed a deduction (as is intended under current policy settings). Officials do not consider it necessary to prove the debt is bad by writing it off and therefore removing the compliance cost for these creditors is appropriate.

In comparison, debts that have been discharged without consideration or become irrevocable or unenforceable through the lapse of time are not necessarily bad debts. Officials consider that to amend the bad debt deduction rules so that it is not necessary to write off the debt would make it too easy to take a deduction and could present a risk to the revenue base. In these cases where it is not clear that the debt is a bad debt, officials consider that the current write-off compliance criteria should remain.

Recommendation

That the submission be declined.

Issue: Application date of compliance change

Clause 29

Submission
(Ernst & Young, NZICA, Corporate Taxpayers Group)

The time of application of the changes should not depend on when taxpayers have filed their returns. Taxpayers who have applied the current law should be allowed to claim a bad debt deduction from the 2008-09 year onwards. (Ernst & Young and NZICA)

The application date should be amended if it is intended to have effect for any taxpayers from the 2008-09 year other than those who have not yet filed their returns for any relevant previous year (Ernst & Young and Corporate Taxpayers Group). An amendment should be made so that the proposed change is retrospective to confirm tax filing positions previously adopted and simply prevent taxpayers from reopening historic positions to take advantage of the amendment (Corporate Taxpayers Group).

Comment

The current application date of 2008-09 was chosen on the basis that it would ensure targeted taxpayers affected by the high compliance criteria (primarily small investors in failed finance companies) would be able to benefit from the amended tax rules.

In theory, taxpayers that would be disadvantaged by the originally proposed application date (and that the submitters are proposing the change should extend to) are those that made an economic loss on a financial arrangement, failed to write off the bad debt in time, and returned income under current law. Officials are not aware of any such taxpayers and it is considered highly unlikely that taxpayers would have taken this tax

position. To extend the application date to such taxpayers could result in high administrative costs and potential operational implications. However, to ensure a fair result, officials agree that the proposed change should extend to taxpayers who filed taking the position described above in years from 2008-09. It is considered that as there will be very few (if any) taxpayers who applied the current law and will benefit from the retrospective application date, any additional administrative costs incurred as a result of accepting this submission would be negligible.

Officials also agree that, as currently drafted, where a taxpayer has filed an income tax return prior to the date of Royal Assent, and claimed a bad debt deduction when the debt was not written off in time, that taxpayer will still technically be non-compliant with the Act. This class of taxpayer should be entitled to access the new rules. Officials therefore agree that an amendment be made so that the proposed change is retrospective to confirm tax filing positions previously adopted, however, as noted in the comment above, taxpayers will not be prevented from reopening historic positions to take advantage of the amendment.

Recommendation

That the submission be accepted in part.

DEDUCTIONS FOR HOLDERS OF DEBT – BASE MAINTENANCE CHANGE

Issue: Support for base maintenance change

Clauses 26 and 29

Submission
(NZICA, Corporate Taxpayers Group)

The submitters support the principle that holders of debt should only be able to take a deduction for the true economic cost.

Recommendation

That the submission be noted.

Issue: Base maintenance change – current law is sufficient

Clause 29

Submission
(NZICA)

The current rules sufficiently achieve the desired outcome of limiting deductions for bad debts to the economic cost and therefore the amendment should not proceed. While the base price adjustment (BPA) may not always be performed in the same year as the bad debt deduction is taken, this is a timing difference only and the overall outcome is appropriate.

If this is not accepted, the BPA formula should be amended to eliminate the timing mismatch rather than the bad debt rules.

Comment

Officials agree that, overall, the BPA (a wash-up calculation that is performed when the financial arrangement comes to an end) will mean the correct tax outcome should eventually be reached under current law. However, as noted by the submitter, the creditor is able to benefit from a timing advantage because the bad debt deductions could be taken well before income from the BPA is recognised. This result is not in line with the current policy settings for bad debt deductions, and it means taxpayers can take a deduction for an amount greater than the cash/economic loss incurred. Furthermore, the timing advantage also presents a risk to the integrity of the revenue base especially if a BPA is never performed meaning the timing advantage becomes a permanent tax advantage. It is these advantages that the base maintenance change is seeking to rectify.

Officials consider the interaction of the bad debt rules and BPA formula result in the correct outcome for taxpayers, and that an amendment to the BPA formula is therefore unnecessary. Bad debt deductions have always been outside the financial arrangement rules. There are two main reasons for this. Firstly they apply to debts other than financial arrangements, and secondly, deductions for bad debts are not part of the usual income/expenditure on financial arrangements and need to be dealt with separately as bad debts.

Recommendation

That the submission be declined.

Issue: New regime for bad debt deductions arising from financial arrangements

Clause 29

Submission
(Baycorp)

Given the complexity of the bad debt rules and their interaction with the financial arrangement rules and the base price adjustment calculation, a new policy should be set with one regime rather than the current interaction of two regimes (financial arrangements and bad debt deductions).

Comment

Amending the financial arrangement rules was considered during the policy development. However, officials believe that the (complex) financial arrangements rules generally work well and amending these rules would add additional complexity which may unintentionally affect other arrangements.

Furthermore, as noted in an earlier submission, bad debt deductions have intentionally been placed outside the financial arrangement rules, firstly because they apply to debts other than financial arrangements, and secondly, because deductions for bad debts are not part of the usual income/expenditure on financial arrangements and need to be dealt with separately as bad debts.

Given that officials consider the proposed new rules will achieve the desired outcome, it is considered unnecessary to introduce a new regime to the Income Tax Act.

Recommendation

That the submission be declined.

Issue: Incorrect result when the consideration paid for a debt is less than the face value

Clause 29

Submission
(KPMG, Corporate Taxpayers Group, Baycorp)

Where a debt is purchased for less than its face value and is later remitted, the base maintenance change neglects the fact that the "amount remitted" component will potentially produce an income result in the base price adjustment (BPA) formula, and result in over-taxation. This is an unintended outcome of the rules, but one for which the full bad debt deduction is currently needed as an offset. The bill restricts the available bad debt deduction without similarly limiting the corresponding income under the BPA formula. The one-sided nature of this amendment needs to be addressed.

If it is intended that bad debt deductions be taken under two provisions (subsection DB 31(2) for income amounts and subsection DB 31(3) for principal amounts), this should be made clear in the legislation. (Baycorp)

Comment

Officials consider that, together, the financial arrangement rules (including the BPA) and the proposed bad debt deduction provisions will achieve the correct result. That is, the proposed rules sufficiently allow deductions to be taken when a debt is transferred for less than the face value of the loan. This can be illustrated by an example.

> *Example*
>
> A debt with a face value of $50m is acquired for $1m by Company B who is a dealer in the financial arrangements. Company B does not receive any income from the debtor and the entire $50m debt is eventually remitted by law. Company B has suffered an economic loss of $1m.
>
> On remission Company B performs a BPA (wash-up calculation) as follows:
> BPA: consideration – income + expenditure + amount remitted
> = ($1m) – $0 + $0 + $50m
> = $49m income
>
> Under the new rules, bad debt deductions could be taken as follows:
> - $1m under subsection DB 31(3) of the Income Tax Act 2007 – being a deduction for the amount not received by a dealer in financial arrangements, but limited to the consideration paid for acquiring the debt; and
> - $49m under subsection DB 31(2) of the Income Tax Act 2007 – being a deduction for an income amount (the BPA income) not received.

Officials have discussed the application of the rules with the submitters, and after further consideration Corporate Taxpayers Group and KPMG are comfortable that the

legislation works as intended and that deductions can be taken under both subsections DB 31(2) and (3).

Officials do not consider it necessary or desirable to amend the legislation to clarify the application of the rules. However, the intended application of the rules will be explained in a *Tax Information Bulletin* following enactment of the bill.

Recommendation

That the submission be declined.

Issue: Drafting for limited recourse arrangement rule

Clause 29

Submission
(NZICA, Corporate Taxpayers Group , Baycorp)

The definition of "limited recourse arrangement" as currently drafted is confusing and should be redrafted as it is not clear what the proposed definition is intended to capture.

Comment

Officials agree that the definition of "limited recourse arrangement" could be made clearer. The rule regarding limited recourse arrangements is intended to be an anti-avoidance measure to ensure dealers and holders are only able to take bad debt deductions for the true money at risk.

Without this rule it would be possible for one party (party 1) to borrow money from another party (party 2) by way of a limited recourse arrangement (Loan A). The amount borrowed under Loan A could be used to fund the purchase of a debt (the underlying debt). The limited recourse arrangement for Loan A could then be structured so that the borrowed funds were only repayable up to the amount received under the underlying debt. Without a limited recourse arrangement rule party 1 could take a bad debt deduction for the full amount owing under the underlying debt, even though they have not made a true economic loss because the money effectively comes from party 2 and is only repayable to the extent that the underlying debt is repaid. In this situation party 1 should only be able to take a bad debt deduction up to the amount that truly represents an economic loss. If they were able to take a deduction for more than this, they would receive an excessive and unjustified advantage.

Recommendation

That the submission be accepted.

Issue: Rationale for limited recourse arrangement rule

Clause 29

Submission
(New Zealand Law Society)

Proposed subsection DB 31(4C), an anti-avoidance provision which limits bad debt deductions for dealers and holders to the amount not subject to limited recourse, should be removed. As currently drafted, it extends too far because it prevents a deduction being taken where a true economic loss has been suffered.

Comment

Officials agree that a bad debt deduction should be allowed where a true economic loss has been suffered. As noted in the previous submission, it is recommended that the drafting of the limited recourse rule be amended to ensure it is clear what the provision is intended to capture. This redrafting will ensure that the submitter's concern is addressed and that where a true economic loss has been suffered, the limited recourse arrangement rule will not prevent a bad debt deduction from being taken.

Recommendation

That the submission be noted.

Issue: Exception to limited recourse arrangement rule

Clause 29

Submission
(Baycorp)

A collection agreement, where the collection is outsourced and a commission amount is paid for that collection service, should not be a limited recourse arrangement.

Comment

Officials do not see how a collection agreement, as described above, would fall within the current definition of "limited recourse arrangement". The base maintenance change is intended to ensure bad debt deductions are limited to the true economic loss and the limited recourse arrangement rule is a supporting anti-avoidance measure to ensure this result is achieved. A collection agreement would only be affected by this anti-avoidance measure if there is a limited recourse component to the agreement.

Recommendation

That the submission be noted.

Issue: Application date of base maintenance change

Clause 26 and 29

Submission
(NZICA, Baycorp)

As currently proposed, taxpayers who have taken excess deductions will be required to return those amounts as income in the 2014-15 year. If the amendment proceeds, it should be prospective only. (NZICA)

The rule which requires certain income to be returned in the 2014-15 year is not appropriate. This is especially so given the submitter considers the application of the current rules does not provide a windfall but is a necessary consequence of how the bad debt rules and the base price adjustment (BPA) calculation are set up to work. As currently drafted, a taxpayer could be overtaxed after receiving both BPA income and income under the proposed claw-back rule. Retrospective legislation should be avoided to provide certainty to taxpayers. (Baycorp)

Comment

Under the current tax rules holders of debt can take bad debt deductions for amounts owing even where the holder has not suffered an economic loss. This result is not in line with the existing policy for bad debt deductions. It also results in an unjustified timing advantage and presents a risk to the integrity of the revenue base.

As drafted, the base maintenance changes will apply from the date of introduction of the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill, and there will be a retrospective claw-back rule to require taxpayers who have taken excess deductions (that is, deductions exceeding the cost of acquisition and any income returned), to return those amounts as income in the 2014-15 year. The effect of the claw-back rule is that the rule is retrospective for financial arrangements that are in existence in the 2014–15 year, and affected taxpayers must return extra income prospectively (in the 2014–15 year). Officials consider that this is justified because it puts them back in the same position they should be in, in line with the policy intent. There is no concern with financial arrangements that have ended prior to the 2014–15 year, as the BPA (wash-up calculation) that would have been performed should have squared-up any excess deductions taken.

The reason for the claw-back rule is that, notwithstanding the current legislative wording, it is not considered reasonable for taxpayers to take deductions for more than their economic loss under the financial arrangement. It is not anticipated that a large number of taxpayers will be affected by the claw-back rule; however, it is necessary for base maintenance reasons. There will be a savings provision for taxpayers who are involved in assessments that are subject to the tax disputes process.

Officials agree with Baycorp that there may be some circumstances where the proposed claw-back rule would result in too much tax being paid and therefore recommend a slight amendment to the claw-back rule to ensure the correct policy result is achieved.

Recommendation

That the submission be declined subject to officials' comments.

FINANCIAL REPORTING

Clauses 109–111

Issue: Support for the proposal

Submission
(Corporate Taxpayers Group)

The CTG supports the general proposal that Inland Revenue, as the biggest user of financial statements, should prescribe the minimum financial reporting requirements.

Recommendation

That the submission be noted.

Issue: Support for the consultation requirement

Submission
(CTG, NZICA)

The submitters endorse the requirement that the Minister of Revenue be satisfied that consultation has been appropriate before the Orders in Council are recommended.

Recommendation

That the submission be noted.

Issue: The minimum requirements should be no more than what is presently required

Submission
(NZICA)

That the Inland Revenue requirements should be no more extensive than what Inland Revenue generally requires taxpayers to provide currently.

Comment

Currently Inland Revenue does not set requirements for the specific form and detail of financial statements that it requests. One of the outcomes of the project will be the setting of minimum requirements by Inland Revenue, which will allow some consistency in the information requested.

Officials discussed this with NZICA who advised that compliance cost concerns are behind this submission. Officials have always been aware that the question is the balancing between these compliance costs and the availability of appropriate information. All parties are agreed that there is no point setting the minimum financial reporting requirements such that general purpose financial statements are required and this has never been Inland Revenue's intention.

The consultation process is intended to ensure that this balance is right.

Recommendation

That the submission be noted.

Issue: Timelines for compliance with request to produce financial statements

Submission
(NZICA)

That it be made clear that taxpayers will be given reasonable time to furnish the financial statements following a request by Inland Revenue. The body of the submissions suggests a three month period. The submitter would prefer this to be codified into the legislation rather than confirmed in a statement issued by Inland Revenue.

Comment

The submission raises two separate but associated points, the period and the codification of the period.

NZICA advise that there should be a reasonable time period. Officials agree. Officials expect that the financial statements would be prepared, or largely prepared, as part of the tax return preparation process. Thus the production of financial statements should not be a time consuming exercise.

The NZICA submission seems to envisage that the preparation of financial statements and supporting data analysis may in some cases commence after the request. If this is accepted then the question must be asked as to the basis on which the tax return was prepared.

Generally Inland Revenue allows 28 days for the provision of requested information, but it will take into account circumstances where different periods are appropriate. For example, when the taxpayer is subject to an adverse event a longer period might be appropriate. Alternatively, where the taxpayer is an insolvent company a shorter period might be appropriate.

The 28 days could be codified, but that would reduce flexibility and would be unusual given that none of its other information requests are subject to codified periods. Rather

the more general practice seems to work satisfactorily while proving appropriate flexibility.

Recommendation

That the submission be accepted in principle, but, consistent with current practice, the time period generally be limited to 28 days and that the codification request be declined.

Remedial matters

REMEDIAL CHANGES TO THE TAXATION OF INSURANCE BUSINESS

(Clauses 2(6) and (13), 32 and 33, 36, 37B, 44 to 54, 87, 100 to 101 and 103(44) to (46 and (54))

The bill contains a number of technical remedial changes to the tax treatment of general and life insurance business conducted in New Zealand.

Issue: Reserves – deductions for claims under non-participation policies

Submissions
(Matter raised by officials)

Further technical revision to section DR 4(1) is required to ensure that deductions do not arise for any savings returns to the policyholder that might be included in a claim.

Comment

Clause 33(1) of the bill amends section DR 4 of the Income Act 2007 and improves the Act's internal linkages relating to the rules about deductions for life-risk claims paid under a life insurance policy including reserving amounts (described in sections EY 20 and EY 23). The change ensures that deductions are defined in the context of non-participation policies.

To further ensure that deductions for claims allowed under section DR 4 of the Income Tax Act 2007 are limited to non-participation policies, officials recommend a further technical change by specifying the deduction for a claim does not arise if the life insurance policy is a profit participation policy or the expenditure or loss is in connection with an annuity.

Recommendation

That the submission be accepted, and that section DR 4 be amended by specifying that a deduction does not arise in respect of a claim under a profit-participation policy or an annuity.

Issue: Reserves – setting an opening balance for reserves when general and life insurance business is transferred from non-residents to New Zealand insurers

Submissions

(Matter raised by officials)

The rules for calculating the opening balance for reserve connected with business that is transferred from a non-resident to a New Zealand resident insurer needs to take into account the actuarial assumptions used by the non-resident.

Comment

Clauses 36 and 44 respectively amend sections DW 4 and EY 5 of the Income Tax Act 2007 and set out a method for calculating the opening balance of reserves for insurance business that is transferred by a non-resident insurer to a New Zealand resident insurer. The amendment is intended to remove a risk that insurance business could be transferred from a jurisdiction that does not have similar commercial or tax regulatory environment to New Zealand with the result that deduction entitlements or taxable income could be over-or- understated.

The proposed amendment requires New Zealand resident insurers to restate the closing balance of the transferred reserve as if the relevant insurance policies had been sold in New Zealand. The change focuses on the requirements of the reserve by reference to IFRS 4 but does not specify the assumptions that are used to support the calculation. This omission could, at worst, allow an overstated deduction to result, if for example, a New Zealand-resident insurer were to unduly suppress a risk margin on transfer but later revise the actuarial assumptions supporting the reserve to create a deduction in New Zealand. A further risk is that the amounts required by financial reporting and the judgement exercised by accountants under those standards can depart from the assumptions and methods required and used by an actuary.

To prevent this situation from arising, officials recommend that the proposed amendments make particular reference to the rules in the Income Tax Act (rather than IRFS 4) in connection with the assumptions and methods that support the calculation of the various reserves when the transferor is a non-resident. For general insurers this will involve calculating the outstanding claims reserve by reference to a statutory formula that requires an actuarial determination of the insurer's incurred (but not reported) claims, reported claims and an appropriate risk margin.. Life insurers will need to make reference to sections EY 23 to 27. Consequential changes are also required to sections ED 3 and EY 5 to deal with part-year transfers.

Recommendation

That the submissions be accepted, and that sections DW 4(4B) and EY 5(4B) be amended by adding the additional requirement that the opening balance be calculated using actuarial assumptions and methods set out in Income Tax Act 2007.

Issue: Policyholder base income – allocation of income

Submissions

(Matter raised by officials)

Improvements recommended to assist reader comprehension about the application and effect of the allocation rules for investment income derived by non-participation policies.

Comment

Clause 45 amends section EY 15 to clarify its relationship with section EY 19. Section EY 15 defines the income that should be allocated to the policyholder base. Section EY 15(2) specifies that policyholder income is limited to the amount provided for in the formula set out in that section. Any excess income becomes shareholder base income under section EY 19. The purpose of the amendment is to specify when investment income is allocated between the shareholder base and the policyholder base.

The effect of the proposed amendment is unclear as it is currently expressed. Officials recommend that the amendment be redrafted. To support the operation of the allocation rule in section EY 15(2), it is also recommended that the definition of "investment income" in section EY 15(1) be amended so that it includes income that arises from the operation of the Income Tax Act 2007. The change does not extend the scope of the policyholder base but clarifies that income created by the Income Tax Act from investments can also be apportioned between the policyholder and shareholder bases. Under current law, income deemed to arise under the Income Tax Act from investments is arguably treated as policyholder income only.

Consequential changes are also recommended to sections EY 16(2), the deduction rules for non-participation policies, to reflect the clarified relationship between sections EY 15 and EY 19.

Recommendation

That the submission be accepted, and that section EY 15(2) be amended so that the reference to section EY 19 be removed. Section EY 15(1) be amended by clarifying that the term "investment income" also includes income from investments that arises through the operation of the Income Tax Act 2007.

Issue: Profit participation policies – discounting future entitlements to income

Submissions

(Financial Services Council, Matter raised by officials)

The changes proposed to sections EY 17 and EY 21 of the Income Tax Act 2007 should also apply to sections EY 28 and EY 29. *(Financial Services Council)*

The amendments to section EY 17 and EY 21 should be reworded to assist comprehension of the sections. *(Matter raised by officials)*

Comment

Clauses 46 and 49 amend sections EY 17 and EY 21 of the Income Tax Act 2007 to ensure that any claim the shareholder base has on future income derived on investment income is correctly valued. The change involves replacing the current discount factor which requires a risk-free rate, with a discount rate that is actuarially determined. The discount rate used should be the same as the one used by a life insurer for financial reporting purposes. The relevant discount rate is net of tax. The amendments in the bill ensure that the Income Tax Act allocates the correct amount of future income to the shareholder base.

The Financial Services Council has asked that the proposed amendment also apply to sections EY 28 and EY 29 which deal with "other profit". "Other profit" is income or expenditure that arises when there are changes in actual cashflows when contrasted against expected cashflows connected with the assets created by profit participation policies. The submission seeks a change to the way the Income Tax Act values policy liabilities in sections EY 28 and EY 29.

Following discussions with the Financial Services Council, officials consider that the matter relates to the way the Income Tax Act 2007 expresses the concept of future amounts which are used to calculate a life insurer's exposure to policy liabilities and contractual claim over future earnings from managing policyholder assets. The discussions have also pointed to wider legislative matters affecting the calculation of "other profit" in sections EY 28 and EY 29. Officials are currently reviewing the operation of the rules for calculating "other profit", and the Financial Services Council's submission will be considered as part of it.

As such, officials do not recommend making the change suggested by the Financial Services Council at this time, but will consider the matter for a future taxation bill.

Officials do consider, however, that there is benefit in altering the amendment affecting the definition of "present value (actuarial net)" in the bill. Rather than prescribe the manner of discounting, which carries the risk of mandating requirements that would normally not be used by life insurers, officials recommend changes to clauses 46 and 49

in connection with the amendments to sections EY 17 and EY 21 to specify that future amounts be recognised net of tax.

A further change is recommended in sections EY 17(2)(c) and EY 21(2)(c) that would substitute the words "future bonus declarations" with "portions of future profits". Life insurers do not receive bonus declarations from managing policyholder assets – they receive a share of future profits.

Recommendation

That the submissions be declined in part. Sections EY 17 and EY 21 be amended so that future amounts are calculated net of tax. In sections EY 17(2)(c) and EY 21(2)(c) replace the words "future bonus declarations" with the phrase "portion of future profits".

REMEDIAL AMENDMENT TO THE TIME BAR FOR AMENDMENT OF INCOME TAX ASSESSMENT

Clause 114

Issue: Remedial amendment to the time bar for amendment of income tax assessment

Submission
(Corporate Taxpayers Group)

The Corporate Taxpayer Group supports the proposal to clarify that the time bar applies to the Commissioner reducing the amount of a net loss on the basis that this restores the original policy intent.

Comment

Officials note the submission in support of the amendment to the time bar.

Recommendation

That the submission be noted.

Issue: FIF management fee rebates

Submission

(Deloitte)

The legislation should be amended so that a person is not taxed on rebates of fees they have derived in relation to an interest in a FIF where the person has not been allowed a deduction for the payment of the fees, irrespective of the source of the rebate of fees. As the amendment would simply align the legislation with existing policy, it should have an effective date of 1 April 2009, when the relevant rule was introduced.

Comment

Section EX 59(2) treats a person with an interest in a FIF as having no income from the interest for a period other than FIF income. Section EX 59(2B) contains an exception where the amount derived by a person from an interest in a FIF is a rebate of fees and the person was allowed a deduction for the payment of the fees.

Where a PIE invests in a FIF and calculates its FIF income using the fair dividend rate method, the PIE will be taxed on management fee rebates received from an investment manager engaged by the FIF, but the management fees are not deductible to the PIE because they are incurred by the FIF, not by the PIE.

As the submitter notes, the policy intent behind the insertion in 2009 of section EX 59(2B) was to ensure tax symmetry with regards to management fees and any related rebates for a FIF investment. Officials therefore consider that in the situation described above, where the PIE has not taken a deduction for the payment of the fees, they should not be taxed on a rebate of those fees, irrespective of the source of that rebate of fees.

Officials also agree with the submitter that any amendment should exclude persons who use the comparative value method for calculating their FIF income, as a full deduction for management fees charged to the FIF is effectively achieved where this method is used.

Because the amendment proposed is a clarification in relation to section EX 59(2B), officials agree that it should be effective from 1 April 2009, with application for the 2009–10 and later income years (i.e., in line with the amendment that inserted section EX 59(2B). The retrospective application should be at the taxpayer's discretion.

Recommendation

That the submission be accepted.

Issue: Definition of "percentage" in a formula

Submission

(Matter raised by officials)

The definition of "percentage" in the formula used by a PIE for calculating amounts attributed to investors should be changed to ensure that it accommodates term funds with a fixed unit value.

Comment

Section HM 36(2) contains a formula which a multi-rate PIE uses to calculate the PIE income (or loss) attributable to each investor.

The formula in section HM 36(2) contains the item "percentage", which, as defined in section HM 36(3)(a), "is the percentage of the investor's entitlement to a distribution by the PIE to the investor class".

In the case of term funds with a fixed unit value (e.g., $1), where investors enter the fund at different times, but for the same price. This is because it is unclear whether the "investor's entitlement to a distribution" referred to is the entitlement that accrues for the period on any given day, or is the total amount that would be distributed to the investor if a distribution was made on that day (and thus would not reflect their pro rata interest in the fund).

The uncertainty could be resolved by amending the definition of "percentage" in the formula to ensure that term funds with a fixed unit value are accommodated.

As this amendment would ensure that the legislation reflects the existing policy position, application for the 2010–11 and later income years is considered appropriate.

Recommendation

That the submission be accepted, and that this change apply for the 2010–11 and later income years.

Australian ICA company definition

Clause 103(4)

Submission
(Ernst & Young Limited)

It is not clear why the proposed definition of "Australian ICA Company" [in clause 103(4)] should refer to a company which "must" establish and maintain an ICA under section OB 2 when the latter section provides a choice. We suggest it refer to a company which chooses to establish and maintain an ICA under section OB 2.

Comment

A company resident in Australia may choose, if eligible, to opt into the New Zealand imputation system, under which the benefit of corporate tax paid in New Zealand is passed onto its shareholders. Once that choice is made and notice given to the Commissioner of Inland Revenue, the Australian company must apply New Zealand's imputation rules. and is referred to as an Australian ICA company.

The main obligation arising for an Australian ICA company is to establish and maintain an imputation credit account (ICA). This involves keeping a record of imputation credits and imputation debits to the ICA.

We agree with the submitter that the drafting of the definition of Australian ICA company should be based on the taxpayer's choice to apply the imputation rules and not solely on the obligation to establish and maintain an ICA. We also recommend that consequential amendments be made to section OB 2 for consistency with the recommended amendments to the definition of Australian ICA company.

Recommendation

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

Issue: Definition of imputation credit account company (ICA company)

Clauses 99 and 103(13)

Submission
(Matter raised by officials)

That section OB 1 be amended to more clearly reflect the distinction between the application of the imputation rules to New Zealand resident companies and the obligation to establish and maintain an imputation credit account (ICA).

That the term “ICA company” be defined to include a New Zealand resident company to which section OB 1 applies, and also an Australian resident company that has chosen to opt into the New Zealand imputation system.

Comment

Clause 99

Section OB 1(1) of the Income Tax Act 2007 (2007 Act), as drafted in clause 99, does not clearly distinguish between which companies the imputation rules apply to and the primary obligations under the imputation rules for an ICA company.

The policy intent for section OB 1 is to state that:

- The imputation rules apply to all New Zealand resident companies, except for the types of companies listed in section OB 1(2).
- The main obligations of an ICA company are to establish and maintain an imputation credit account (ICA).

We recommend that section OB 1(1) and (2) be amended to better reflect this policy.

Clause 103(13)

We also recommend that the definition of “ICA company” in section YA 1 be consequentially amended (in clause 103(13)) to reflect that an ICA company is a company to which the imputation rules apply.

This approach results in the definition of “ICA company” referring to both a New Zealand resident company that must apply the imputation rules and an Australian ICA company that has chosen to apply the imputation rules.

In the 2007 Act, the definition of “ICA company” does not include an Australian ICA company, which differs from its corresponding definition in the Income Tax Act 2004. This omission, inadvertently arising in the rewrite of the imputation rules, arguably results in some administrative imputation rules in the Taxation Administration Act 1994 not applying to Australian ICA companies. The policy intention is that these administrative rules should apply to both a New Zealand resident company and an Australian ICA company.

Recommendation

That the submission be accepted.

COMMENCEMENT AND APPLICATION FOR AMENDING PROVISIONS

Issue: Amending provisions to include income years.

Submission
(Ernst & Young)

The submitter states that the Bill includes reference to various provisions coming into force on a specific date. The submitter believes that the application of many, if not all of those, should also refer to the relevant income (or imputation) years for which they take effect, or for which repealed provisions no longer apply. The submitter requests that all the application provisions should be further reviewed.

Comment

Standing Order 253(1) states that a bill must include a distinct clause stating when the bill comes into force. In this bill, the relevant clause is clause 2. The effect of clause 2 is to give the date or dates on which the text of a principal Act is affected by amendments in a clause of the bill. Such a date is often called the commencement date of the amendment.

For some amendments, a commencement date is sufficient to specify the intended effect of the amendment. If a provision is intended to apply to payments as they occur, for example, the text of the provision at the time of the payment will determine the tax treatment of the payment. The amended text will then apply to payments made on or after the commencement date for the amendment; the original text will apply to payments made before the commencement date.

Often, however, the effect of the amendment is intended to be more complex. A common example is an amendment intended to affect taxpayers for a specific income year and later income years. For two taxpayers with different income years, a particular day may occur in an affected income year for one taxpayer but in an earlier income year for the other taxpayer. A payment by one of the taxpayers on the day will be intended to have a different tax treatment from a payment made by the other taxpayer on the same day. But the text of the principal Act on that day will be the same for both taxpayers.

To produce the desired effect, the usual practice is to include a provision specifying the transitional effect of an amendment. Such a provision is expressed in terms of the way in which the amending clauses and subclauses apply and is commonly referred to as an application (sub)clause. Standing Orders do not specify the placement of application clauses in the Act and they are customarily included as a subclause in the clause to which they relate.

The need for an application subclause depends on the circumstances of the particular amendment being considered and there are usually some clauses in a tax bill that do not have an application subclause.

Officials note that the commencement dates and application provisions for amendments relating to specific topics are discussed elsewhere under those topics.

Recommendation

That the submission be declined.

Matters raised by officials

UPDATE TO CROSS-REFERENCE: KIWISAVER TRANS-TASMAN PORTABILITY SCHEME

Submission
(Matter raised by officials)

Section 189(5) of the *Taxation (Annual Rates, Trans-Tasman Savings Portability, KiwiSaver, and Remedial Matters) Act 2010* introduced the new trans-Tasman portability scheme for KiwiSaver. The scheme went live on 1 July 2013, following the completion of the necessary legislative processes in New Zealand and Australia.

Under the portability scheme, a KiwiSaver member who permanently migrates to Australia can transfer all of their KiwiSaver funds, including any KiwiSaver member tax credits (MTCs), to an Australian complying superannuation scheme.

Clause 17 of Schedule 1 of the KiwiSaver Act 2006 provides that before any MTCs can be withdrawn from KiwiSaver on retirement, serious illness or death, the member (or their personal representatives) must provide a statutory declaration confirming their eligibility for these MTCs. Any MTCs that were incorrectly claimed are refunded to the Crown.

The trans-Tasman transfer rules allow MTCs to be taken to Australia. So a statutory declaration confirming eligibility/entitlement should be provided, for consistency with the other MTC withdrawal rules.

Comment

The reference at clause 17 should be updated to include transfers under the trans-Tasman portability rules.

Recommendation

That the submission be accepted.

HEALTH ENTITLEMENT CARDS: CORRECTING REFERENCE TO WORKING FOR FAMILIES TAX CREDITS

Clause 118

Submission
(Matter raised by officials)

The Health Entitlement Cards Regulations (the Regulations) contain references to the different components of the Working for Families tax credits. When the tax credits were renamed in 2004, not all references in the Regulations were updated.

The Regulations refer to credits of tax under Part M of the Income Tax Act being included in a person's income when assessing entitlement to the Community Services Card. Since then, Part M has been amended to also include the KiwiSaver member tax credit but the Regulations were not updated to exclude this tax credit.

Comment

A person's entitlement to the Community Services Card is based on their income plus any Working for Families tax credits they receive. The Regulations refer to these tax credits by name. The out-dated reference to the former names for some components of the Working for Families tax credits means a literal reading of the Regulations can lead to an incorrect calculation of income. This is because the name "family tax credit" now applies to what used to be known as the family support tax credit and no longer to the minimum family tax credit. The incorrect name reference could also impact on the authority of Inland Revenue to transfer information on the payment of the minimum family tax credit to the Ministry of Social Development for the purpose of calculating entitlement to the Community Services Card.

It was never intended that the Community Services Card definition of income include KiwiSaver member tax credits. Rather it was intended to only cover the Working for Families tax credits in subparts MA to MF and MZ.

Officials from Inland Revenue, the Ministry of Health and the Ministry of Social Development recommend the Regulations be amended to refer to the correct names of the components of the Working for Families tax credits, and to the correct cross-references in the Income Tax Act 2007 for the Working for Families tax credits.

Recommendation

That the submission be accepted.

CHARITABLE OR OTHER PUBLIC BENEFIT GIFT

Submission
(Matter raised by officials)

That the definition of "charitable or other public benefit gift" be amended to restore the reference to the phrase "gift of money".

Comment

The policy intention is that the tax credit for a charitable or other public benefit gift requires the gift to be made in money, or be a subscription paid to a society, institution, association, organisation, trust or fund referred to in section LD 3.

The rewrite of this definition into section LD 3 omitted the phrase "of money" on the basis the language of the provision provided sufficient direction that the gift was required to be paid in money. However, questions have been raised with officials on whether this drafting approach definitively requires the gift to be paid in money.

Officials recommend that the definition of "charitable or other public benefit gift" be amended to clarify the definition of "charitable or other public gift" is a monetary gift. This is consistent with the long standing policy and the corresponding provision of the Income Tax Act 2004.

We also recommend this amendment apply to charitable or other public benefit gifts made after the enactment of the amending legislation.

Recommendation

That the submission be accepted.

Submission
(Matter raised by officials)

That an incorrect cross reference in section FE 41 to section FE 40 has resulted in an unintended change in legislation arising from the rewrite of the thin capitalisation provisions.

Comment

The issue arises from a submission to the Rewrite Advisory Panel that the association rule in section FE 41 should apply only to determine whether the thin capitalisation rules apply to companies with tiered ownership structures. The submission is that the effect of the current wording in section FE 41 results in the association rule applying for the whole of subpart FE rather than just section FE 41.

The Panel has recommended a retrospective remedial change to correct the drafting, but did not recommend a savings provision.

We agree with the Panel's conclusions and recommendations.

Recommendation

That the submission be accepted.