Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill

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

March 2014

Prepared by Policy & Strategy, Inland Revenue, and the Treasury

CONTENTS

Employee allowances 1

Overview 3

Employee accommodation 4

Issue: Support for accommodation framework 4
Issue: "Net benefit" test 5
Issue: Taxable accommodation benefits and definition of "accommodation" 6
Issue: Application of exemptions to payments 7
Issue: Lump sum reimbursements 8
Issue: Definition of "workplace" 8
Issue: Accommodation subject to sections CW 16B to 16F 9
Issue: "Office or position" 10
Issue: Meaning of "living premises" 10
Issue: Guidance on "reasonable daily travelling distance" 11
Issue: Out-of-town secondment accommodation payments made by company employee is seconded to 11
Issue: Extension of two-year rule to new employees 12
Issue: Distant workplace 13
Issue: Multiple workplace rule should apply to those with a home office 14
Issue: Capital project exemption should be extended 15
Issue: Associated person restriction should be removed from "project of limited duration" 15
Issue: Change of expectation from over- to under-time limits 16
Issue: Change of expectation from under to over time limits 17
Issue: Clarification of status of time limits 17
Issue: Timing of change in expectation 18
Issue: Travel to distant workplace 18
Issue: Application date 19
Issue: Retrospective application should apply regardless of pre-December 2012 position 20
Issue: Amendments to proposed section CZ 30 21
Issue: Choice to backdate application 21
Issue: Treatment of applications to re-file before bill passed 22
Issue: Canterbury earthquake measures application date 23
Issue: Generic rule should be added for adverse events 23
Issue: Exceptional circumstances – Canterbury provisions 24
Issue: Increased monitoring requirements resulting from the new rules 24

Employee accommodation – determining taxable value 26

Issue: Accommodation provided where the employee normally works shifts at a distant workplace for regular periods from which they cannot return home on a daily basis 26
Issue: FIFO workers' accommodation 27
Issue: Mobile workers and multiple workplace rule 28
Issue: Valuation of accommodation when the employer requires the employee to live "on the job" 28
Issue: Total exemption should be granted for ministers of religion 31
Issue: Simplification of proposed section CW 25B 32
Issue: Adjustment for work use of church-provided accommodation 32
Issue: Adjustment for employee contribution to church-provided accommodation 33
Issue: Ministers of religion employed by charities 33
Issue: Definition of "minister of religion" 34
Issue: Meaning of "market rental value commensurate with duties" 35
Issue: Adjustment for use of accommodation for business purposes 35
Issue: Adjustments to taxable value of accommodation and accommodation payments 36
Issue: Valuation of overseas accommodation 37
Issue: Defence valuation rule should be extended to cover police housing 38

Meals 39

Issue: Support for proposed meal exemptions 39
Issue: Inclusion of allowance, daily allowance and reimbursement in exempt income 39
Issue: Provision to clarify relationship with FBT rules 40
Issue: Ensure clarity between allowances, FBT and entertainment tax rules for on-premises meals 40
Issue: Extend section CX 19 to cover benefits that if paid as an allowance would be exempt 41
Issue: Clarification: two exemptions are provided 41
Issue: Light refreshments on premises should also be available to part-time employees 42
Issue: Light refreshments should be extended 42
Issue: Scope of working meal exemption too narrow 43
Issue: Meal provision drafting issues 43
Issue: Meal exemption time limit 44
Issue: Restarting of time period for exemption 45
Issue: Flexibility of time limits 45
Issue: Application date of meal allowance provisions 46

Distinctive work clothing 47

Issue: Clothing proposal should proceed 47
Issue: Exemption should be extended 47
Issue: Exemption requires amendments to ensure plain clothes police covered 48
Issue: Wording of proposed section CW 17CC(3)(c)(ii) should be revised 49

Determinations 50

Issue: Drafting clarifications in clause 21 50
Issue: Determinations for a "wide" group of employees 50
Issue: Determination on communication payments 51
Issue: Consultation on determinations 51
Issue: Determination power should not be limited as proposed 52

Other matters 53

Issue: Extension of FBT health and safety exemption to reimbursing payments made by employers 53
Issue: Eye care payments 53
Issue: Travel costs for FIFO workers 55
Issue: Minor drafting matters 55
Issue: Other minor drafting matters 56

Thin capitalisation rules 57

Overview 59

General comments 60

Issue: General comments on the changes 60
Issue: Treatment of look-through entities 61
Issue: Allowable debt test for single non-resident controllers 62
Issue: Complexity of the proposed amendments 63
Issue: Introduction of a de minimis threshold 64
Issue: Revised guidance on the rules 65
Issue: Grandparenting 65
Issue: Changes to the introductory section 66
Issue: Application date 66

Persons the rules apply to 67

Issue: Use of the term "acting as a group" 67
Issue: The meaning of "control by any other means" is unclear 68
Issue: Meaning of "settlements" on a trust 69

Non-resident owning body 70

Issue: General comment on the definition 70
Issue: Use of "ownership interests" and "direct ownership interests" 71
Issue: Use of the term "approximately" 71

Issue: Proportionality does not imply acting together 72
Issue: Shareholder agreement clause is too wide 73
Issue: Rights exercised as recommended by a person 74
Issue: Exclusion for security interests is appropriate 76

Asset uplifts 77

Issue: Asset uplift proposal should not proceed 77
Issue: Asset uplift rules should only apply prospectively 78
Issue: Uplift as part of a larger restructure 78
Issue: Exemptions to the uplift rule are appropriate 79
Issue: Optional nature of the exemptions 80

Worldwide group debt test 81

Issue: Extent of owner-linked debt rule 81
Issue: Carve-out for widely held debt 82
Issue: Direct ownership interests and amendments to section FE 41 84

Other matters 85

Issue: References to "associated person" in sections FE 2 and FE 26 85
Issue: Extension of on-lending concession for trusts 85
Issue: Grouping rules for trustees 86
Issue: Reference to non-resident owning body in section FE 25 87
Issue: Worldwide group of those acting together 87
Issue: Exclusion of indirect CFC and FIF interests 88
Issue: Rules to ensure debt and asset is used only once 89
Issue: Technical amendment to section FE 18 89
Issue: Drafting matters 90

Black hole expenditure 91

Overview 93

Applications for resource consents, patents and plant variety rights 94

Issue: Support for the proposals 94
Issue: Expenditure incurred on lapsed resource consents should be deductible 94
Issue: Application date for proposed amendments to sections DB 19 and DB 37 95
Issue: Clarification of deductible patent and resource consent expenditure 96

Claw-back for subsequent applications or disposals 97

Issue: Support for the proposals 97
Issue: The claw-back provision overreaches 97
Issue: When clawed-back income should be returned 98
Issue: Claw-back of deductions for subsequent applications 98
Issue: Remove unnecessary provisions in proposed new section CG 7B 99
Issue: Relationship between proposed new section CG 7B and sections EE 25 and EE 57 100
Issue: Inclusion of "plant variety rights" in section EE 57 100

Fixed-life resource consents 102

Issue: Support for the proposal 102
Issue: Other fixed-life resource consents 102

Company administration costs 103

Issue: Support for parts of the proposals 103
Issue: Extend application of proposed section DB 63B to include all fees paid to a recognised stock exchange 103
Issue: Tax treatment of special shareholder meeting costs 104
Issue: Clarification of "meeting costs" 105
Issue: Application dates for the proposed new sections DB 63, DB 63B and DB 63C(1) 106

Other submissions 107

Issue: Further "black hole" expenditure issues 107

Foreign account information-sharing agreements 109

Overview 111

Opposed to the changes 112

- Issue: Should the proposed legislation for foreign account information-sharing agreements be advanced? 112
- Issue: Privacy concerns 115
- Issue: Discrimination 116
- Issue: The US basis of taxation 116
- Issue: Reporting “overreach” 117
- Issue: Sovereignty issues 118
- Issue: Other matters raised 119

Technical matters 124

- Issue: Criminal penalties 124
- Issue: Transition period 125
- Issue: Timeframes for reporting 126
- Issue: Excluded choices 127
- Issue: Permitted choices 128
- Issue: The information required to be provided 129
- Issue: “Reasonableness” standard 130
- Issue: “Contemplated by the agreement” too broad 130
- Issue: Defining a “valid request” 131
- Issue: Guidance for New Zealand financial institutions 132
- Issue: Solicitors’ trust accounts 132
- Issue: Information provided and Privacy Act breaches 133
- Issue: Tax credits 133

Matter raised by the Committee 135

Deregistration of charities 137

Overview 139

End of “tax charity” status and grace-period for compliant entities 140

- Issue: Compliance with the relevant constitutional documents or other information supplied to the Charities Commission or Board at the time of applying for registration 140
- Issue: It is unclear why “day of final decision” should be used as an end point for the grace-period 141
- Issue: Grace-period for compliant entities should be retrospective 142

Transition from tax-exempt status 143

- Issue: The application of other income tax exemptions to deregistered charities 143
- Issue: Market value should be an option for valuation 144
- Issue: The operation of new section HR 11(5) should be clarified 144
- Issue: Entities should be able to elect to be a Māori authority retrospectively 145

Treatment of accumulated assets 146

- Issue: New sections CV 17 and HR 12 should not be introduced, pending a thorough review 146
- Issue: The tax on net assets should be paid a year after the day of final decision, rather than a year after deregistration 147
- Issue: Gifts of money should be excluded from the net assets calculations 148
- Issue: The tax on net assets should not apply to entities which have retrospective income tax liabilities 150
- Issue: Split application date should be reconsidered 150
- Issue: Section HR 12 should be limited to tax which would have been payable had the entity never been charitable 151
- Issue: Clarifying the meaning of “liabilities” 153
- Issue: New section HR 12 should not apply to entities which are re-registered before the 12-month period ends 153

Effect of deregistration on fringe benefit tax and donee organisation status 154
Issue: Consequences for donors should be dealt with at an administrative, rather than legislative level 154
Issue: Extending donee status to all registered charities 155
Issue: No protection for donors in relation to gifts to approved donee organisations on Inland Revenue's website 155
Drafting issues 157
Issue: Use of the terms "ceased charities" and "date of cessation" 157
Issue: Use of the term "person" 157
Issue: Use of the term "Charities Commissioner" 158
Issue: Use of undefined terms 158
Issue: Eligibility to derive exempt income in section HR 12 159
Issue: Clarify what "distribution" means 159
Issue: Clarify whether gifts are to be disregarded in section HR 12 regardless of their current form 160
Issue: Clarify the definition of "net assets" 160
Issue: Suggested alternate approach to the amendments to section CW 41 161
Issue: Clarify that non-compliance with the entity's constitution or rules does not necessarily mean it does not meet the requirements in new section CW 41(1) 162
Issue: Drafting should recognise that the effective date of registration could be before the day an entity is registered 162
Issue: Use of the term "day of final decision" 163
Issue: The drafting of section HC 31 should mirror that of section HR 11(1) 163
Issue: Section CV 17 need not deal with the timing of derivation of the relevant income 164
Issue: Proposed amendments in clauses 110 and 123(6) are potentially misleading 164
Issue: Drafting of donee organisation status 165
Issue: Extension of FBT status 166
Issue: Drafting of section HR 12 166
Other matters 167
Issue: Administrative guidance on meaning of "benevolent", "philanthropic", "cultural" and "charitable" should be provided 167
Issue: "Declined" charities 167
Issue: Amendments should be made to the Charities Act 2005 168
Issue: The rules should also apply to charities which are required to obtain approval from the Commissioner of Inland Revenue 168
Issue: An exemption from income tax should be given where an entity has a short break in registration 169
Issue: New section HR 11 should be broadened to apply to other entities that cease to be eligible for a tax exemption 171
Issue: Guidance should be given on how to establish the cost of prepayments 171
Issue: Mistakenly applying funds for a non-charitable purpose 172
Issue: Consideration should be given to enacting more tax exemptions 172
Issue: Exemption for amateur sport promoters 173

Tax status of certain community housing entities 175

Overview 177
Support for the policy intent underlying the community housing entity proposals 178
Eligibility criteria 179
Issue: Recipient class defined by reference to an income threshold 179
Issue: Provision of new housing criterion 180
Issue: Reinvestment of profits criterion 181
Issue: Registration with the new Regulatory Housing Authority criterion 181
Regulation-making power 183
Other matters 184
Issue: Use of the term "business" 184
Issue: Use of the terms "beneficiaries" and "clients" 184

Issue: Scope of the exemption provision 185
Issue: Scope of the donee status provision 186
Issue: Continuation of the tax-exempt status for already deregistered charities 186

Other policy matters 189

Land-related lease payments 191

Issue: Support for aspects of the reform 191
Issue: Glasgow-type leases are akin to freehold estates 191
Issue: Glasgow-type leases should be depreciable property 192
Issue: Application date of Glasgow lease amendment 193
Issue: Premium paid on grant of Glasgow leases 193
Issue: Lease transfer payments amendment is not necessary 194
Issue: Drafting of the lease transfer payments provision 194
Issue: Scope of lease transfer payments amendment 195
Issue: Aligning section DB 20B with new section CC 1B 196
Issue: Residential premises exemption needs amendment 196
Issue: Wash-up of deductions if the lease is terminated early 197
Issue: Permanent easement exclusion 198

Financial arrangements – agreements for the sale and purchase of property or services in foreign currency 199

Issue: Support for proposed changes 199
Issue: Lowest price clauses and interest explicitly included in agreements for non-IFRS taxpayers 199
Issue: Definition of 12-month ASAP 200
Issue: Definition of "foreign ASAP" 201
Issue: Revenue account property/trading stock 201
Issue: Transitional provisions 202
Issue: Deposits/payments for progress made 203
Issue: Sale and purchase of services 203
Issue: Consistency requirements 204
Issue: Interest-free loans 204
Issue: Appropriate spreading methods for foreign currency ASAPs 205
Issue: Use of spot rates to convert foreign currency payments 206
Issue: Elections by non-IFRS taxpayers to use foreign currency hedging 206
Issue: Future and discounted valuing 207
Issue: Life financial reinsurance contracts which may be foreign ASAPs 208

Acquisition date of land 209

Issue: The amendment is not needed 209
Issue: The drafting of section CB 15B 210
Issue: The timing of the test of a person's intention and purpose 211
Issue: Proposed section CB 15B should be deleted or reconsidered more substantially 212
Issue: Purpose and intention of the subsequent nominee, nominated transferee or assignee 213
Issue: Definition of "interest in land" 214
Issue: Alignment with the definition of "land" 215
Issue: Previous interests and estates in land with an option 215
Issue: Timing in subpart FB and FC 216
Issue: Section 225 of the Resource Management Act 1991 217
Issue: Proposed section CB 15B should not apply to other land-related provisions 218
Issue: Correction of the application date of new section CB 15B 218
Issue: Clarify that the application date can be retrospective 219
Issue: Deferral or limitation of the application date 219

Repeal of the substituting debenture rule 221

Issue: Support for the proposal 221
Issue: Transitional provision and application dates 221
Issue: Transitional provision – clarifications 222
Issue: Transitional provision – effect on shareholder continuity 223

Issue: Tailoring the transitional provision 223
Issue: Grandparenting of existing transactions 224
Withholding tax and inflation-indexed bonds 226
Classification of mining permits as real property for tax purposes 227
Issue: Whether the amendment creates uncertainty 227
Issue: Classification of mining permits as real property for goods and services tax purposes 228
Employee share schemes and PAYE 229
Associated persons and person with a power of appointment or removal 230
Extending the tax exemption for non-resident offshore oil rig and seismic vessel operators 231
Issue: Extending the exemption to other vessels 231
Issue: Modular rigs 231
Issue: Prospecting activities 232
Issue: Extended exemption 232
Underground gas storage 233
Issue: Scope of the proposed provision 233
Issue: Grandparenting existing arrangements 233
Over-crediting of imputation credits in excess of FIF income 234
Whether a trustee of a head-trust is a settlor of a sub-trust 235
Taxation of life insurance business – matching expenditure to income 236

Remedial matters 239

GST remedials 241
Issue: Retirement villages and rest homes 241
Issue: Dwelling definition 242
Issue: Requirement to be registered 243
Issue: Wash-up rule – definition of actual deduction 244
Issue: Wash-up rule – registration after acquiring goods and services 244
Issue: Procurement of a lease 245
Issue: Section 11(8D) – drafting suggestions 245
Issue: Surrenders and assignments of land 246
Issue: Surrender of an interest in land 246
Issue: Other rights and obligations in respect of land 247
Issue: Deemed supply of land on disposal 247
Issue: Zero-rated services supplied to non-residents 248
Issue: Scope of the hire purchase definition 249
Issue: Apportionment rules 250
Issue: Agency rules 250
Issue: Credit and debit notes 251
Issue: Zero-rating tooling costs 251
Issue: Non-resident registration rules 252
Issue: Wash-up rule 253
CFC remedials 254
Issue: Foreign exchange gains and losses on liabilities 254
Issue: CFCs with offshore branches should be able to join test groups 254
Issue: Application date for relocation of apportioned funding income 255
Issue: Section DB 55 should not be repealed 256
Issue: Repeal of section DB 55 application date 257
Issue: Repeal of DB 55 savings provision 258
Issue: Nexus requirement under section DB 55 258
Issue: Removing Australian unit trusts from the Australian exemption 259
Issue: Application date for removing Australian unit trusts from the Australian exemption 260

Issue: Further guidance material on CFC remedials 261
Issue: Indirect interests in FIFs 261
Issue: Extending the on-lending concessions and exemptions for group funding 262

Mixed-use asset remedials 263

Issue: Support for remedial amendments 263
Issue: Minor technical issues with remedial amendments 263
Issue: Further mixed-use asset amendments 264
Issue: In certain circumstances, the asset value is too high for land 264
Issue: Quarantined losses and depreciation recovery income 266
Issue: Taxation of exempt income when distributed to shareholders 268
Issue: Clarification of application to shareholders who lease assets to subsidiaries 269
Issue: Amendment to deal with capital use of a mixed-use asset 269
Issue: Different definition of "asset income" for quarantining rules 271

Look-through companies 273

Issue: Support for the amendment 273
Issue: Further reforms to the LTC rules 273

Unacceptable tax position shortfall penalty 274

Issue: Support for the amendment 274
Issue: Drafting 274

Setting new due date for payment of tax 275

Issue: Extension of provision 275

Serious hardship 276

Issue: Support for the proposal 276
Issue: Relevant factors in determining "serious hardship" 276

WFF – changes to definition of "family scheme income" 277

PIE remedials 278

Issue: Entry and exit fees 278
Issue: Disposal of certain shares by a PIE 278

Removal of 20% uplift from land improvement provisions 280

Remitted amounts on discharge from bankruptcy 281

Loss group contingent on group loss company satisfying its liabilities for deductible expenditure 282

Issue: Income derived in trust by public and local authorities 288
Issue: Spreading of income derived from land 290

Rewrite amendment 291

Issue: Rewrite amendments relating to use of foreign balance dates 291
Issue: Tax Administration Act 1994: Cross-references to sections 108 and 109 291

Non-cash dividends 293

Issue: Drafting correction 293
Issue: Reconciling tax treatment of bonus issues 293

Minor drafting points 294

Matters raised by officials 295

Child Support 297

Issue: Deferred application dates 297
Issue: Payment waiver when non-parent receiving carer is in receipt of a social security benefit 297

Mineral mining remedials 299

Employee allowances

OVERVIEW

The bill proposes changes to the rules regarding employee allowances, employee expenditure payments and employer-provided accommodation. The proposals follow an extensive review and consultation, including an officials' issues paper published in November 2012.

The main changes are in relation to the treatment of employer-provided accommodation and accommodation payments, particularly when employees are on secondment or involved in a capital project. The accommodation will be tax-free up to certain time limits. The time limits are extended for Canterbury earthquake recovery projects. Other changes include better aligning the legislative treatment of meal payments with employer practice, which is to treat them as non-taxable in many cases, where they are not a salary substitute.

Twenty five written submissions (from 20 submitters) addressed the employee allowances proposals. Generally submitters were supportive of the overall aims of the proposals, subject to areas where clarifications or amendments were sought. The majority of submissions were in relation to the proposed accommodation rules, including the rules regarding valuation of accommodation.

Issue: Support for accommodation framework

Clauses 11, 12 and 20

Submissions

(Business New Zealand, Corporate Taxpayers Group, Deloitte, Ernst & Young, New Zealand Institute of Chartered Accountants, New Zealand Law Society, PricewaterhouseCoopers)

Business New Zealand submitted that the proposed changes were a positive and flexible step forward and should proceed.

The remaining submitters also expressed support for the proposed reforms, subject to areas where they considered clarifications or amendments would be appropriate (captured below in specific submission points).

Deloitte noted that this has been an area of uncertainty for taxpayers and any move to codify sensible rules that minimise compliance costs was appreciated.

Ernst & Young noted its appreciation that the changes represented the outcome of a considerable amount of consultation.

New Zealand Institute of Chartered Accountants noted its support of the key policy objectives of improving clarity, certainty, fairness and efficiency.

Comment

The proposals in the bill take into account three key policy objectives:

- to improve clarity and certainty, thereby improving compliance;
- to improve fairness by ensuring employees pay their fair share of tax and that social assistance payments are targeted at those in genuine need; and
- to enhance economic efficiency by ensuring that the tax rules in this area are not an impediment to business decision-making.

Officials note the support for the general approach taken in the proposals and that, as mentioned by a number of submitters in written and oral submissions, the proposals have been developed following extensive consultation.

Recommendation

That the submissions be noted.

Issue: "Net benefit" test

Submission
(KPMG)

The submitter agrees with the guiding principle that accommodation, accommodation payments, and meal and clothing payments should be taxed as they provide a private or domestic benefit, but that in many cases this private benefit is either incidental to the business objective or is minimal or hard to measure and apportionment is not practical. In such cases the private benefit should be ignored.

The historical approach taken by many taxpayers and their advisers has been to tax employer-provided accommodation only when there is a tangible benefit to the employee (that is, when the employee does not incur a cost from maintaining a home in their normal workplace). This "net benefit" approach has been used to tax the private benefit, if any, enjoyed by the employee from receipt of accommodation.

The submitter considers the net benefit approach gives the correct outcome and that the new rules appear to give much the same outcomes as this approach, and so it is not clear why the new rules are necessary. Instead, changes recommended by the 2010 Rewrite Advisory Panel should be retrospectively legislated so that the Commissioner's Statement of December 2012 no longer has application.

Comment

The guiding principles that underlie the proposed changes are that where the payments or accommodation provide a private benefit they should generally be taxable except when they are low in value or hard to measure, and are not provided as a substitute for salary or wages.

However, drafting legislation specifically on these principles would provide too much interpretative uncertainty and therefore potential inconsistency of application. For example, should "low in value" be some absolute amount or vary depending on the circumstances, and "hard to measure" is a subjective judgement. The proposed accommodation rules instead include a range of pragmatic tests to determine the boundary between when an accommodation benefit is private (taxable), and work-related (not subject to tax).

As noted in the Regulatory Impact Statement, in coming to the approach proposed in the bill, other options were considered.

One of those options was the "net benefit test". Under this approach, when an employee maintains a home elsewhere for their use, it is argued there is no benefit from accommodation provided by the employer and, therefore, no tax should arise. Officials did not recommend this approach for several reasons, including:

- If applied properly, it would require an ongoing subjective evaluation of an employee's personal affairs to determine the correct tax outcome, involving additional administration and compliance costs. Likewise, determining the correct tax outcome may not be possible at the time of payment so a retrospective assessment could often be necessary, with attendant compliance and administrative costs.

- It has no upper time limit so accommodation could potentially be tax-free for many years. Ultimately, there is a private benefit associated with the employer-paid or provided accommodation and the longer the payment/provision continues, the argument that the retention of the other property is an extra cost created by the secondment is less tenable, and more likely to be a personal choice of the employee.
- It would present significant fairness and equity issues, with the potential for employees working side-by-side and incurring similar expenses having different tax and social assistance outcomes, depending on personal circumstances and how these are assessed in determining the taxable element of any accommodation payments.
- The tax base risk as, whether or not provided as cash allowances, the accommodation is equivalent to cash.

As the submitter has noted, for a number of years, many practitioners have applied a kind of net benefit test but, as the Commissioner of Inland Revenue's statement on accommodation of 6 December 2012 indicated, the test has no foundation in law.

Officials remain of the view that the approach proposed in the bill is more appropriate and have noted that many submitters have welcomed the increased certainty and clarity this approach provides.

The submitter has referred to the recommendations of the Rewrite Panel in 2010. Inland Revenue's view is that the amendment made through the Rewrite process merely sought to restore a pre-existing ambiguity. Officials have also undertaken considerable policy work since this recommendation was made, resulting in the proposals contained in this bill.

Recommendation

That the submission be declined.

Issue: Taxable accommodation benefits and definition of "accommodation"

Clause 11

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

The bill proposes amending section CE 1, which sets out what amounts of accommodation benefits are to be included in employment income. As drafted it arguably limits the amounts included in income. We suggest revising the amendment to include in a person's income the value of accommodation, accommodation allowances or other payments or expenditure incurred on account of accommodation to the extent to which such items are included in income under sections CE 1B to CE 1D. *(Ernst & Young)*

Clause 11 of the bill should be amended to clarify that "accommodation" remains employment income under section CE 1, by retaining the current wording of section CE 1. *(New Zealand Law Society)*

The words "board or lodging should be removed from clause 11 and replaced with "accommodation". "Board or lodging" is inconsistent with the rest of the Act. *(Corporate Taxpayers Group, Deloitte)*

The section YA 1 definition of "accommodation" should be revised to include a reference to "board or lodging" rather than that term being used on an apparently isolated basis in section CE 1(1)(bb). This would mean that the clause 32 amendment to section CX 28 would be unnecessary. *(Ernst & Young)*

"Market value" and "board or lodging" should be removed from section CE 1(1)(bb) and replaced with "the value of accommodation". *(New Zealand Institute of Chartered Accountants)*

New section CE 1(1)(bb) is redundant as new section CE 1B will treat the market value of employment-related accommodation as income. *(KPMG)*

Comment

Officials agree there should be some clarification of the linkage between these taxing and valuation provisions. Officials recommend accepting the submission to remove "market value" and "board and lodging" from section CE 1(1)(bb) and replacing it with "accommodation" and adding "board and lodging" into the definition of "accommodation". This means the provision for taxing accommodation would be section CE 1(1)(bb) with the various rules to value the accommodation in section CE 1B to CE 1E.

The reference to "benefit" in the current law should not be reinstated however. This is because the current reference to the "benefit" of accommodation being taxable has led to confusion about what exactly is taxable, including arguments that the "net benefit" test should be applied.

Recommendation

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

Issue: Application of exemptions to payments

Clauses 20, 33 and 34

Submission
(Ernst & Young)

The exemptions contained in proposed sections CW 16B to 16F (secondments and projects, conferences and overnight stays, and multiple workplaces) should also apply when employers make payments to enable the employee to obtain accommodation in these same circumstances.

The same applies in respect of the Canterbury earthquake provisions in proposed sections CZ 29 and 30.

Comment

No change is necessary as the situations raised in the submission are already covered in the draft legislation.

Recommendation

That the submissions be declined.

Issue: Lump sum reimbursements

Clause 20

Submission
(PricewaterhouseCoopers)

Some employers pay allowances as regular lump sum reimbursements based on estimates. Assuming the other criteria apply, confirmation is needed that this will be covered by proposed section CW 16B(1)(c)(ii). We also suggest the inclusion in section CW 16B of a similar provision to the existing estimation provision in section CW 17(3).

Comment

As worded, the proposed provision in section CW 16B(1)(c)(ii) does not preclude the payment of a reasonable allowance or lump sum, rather than the actual amount incurred by the employee on accommodation. However we do agree that any allowance should be reasonable and therefore applying the criteria currently in section CW 17(3) that allow the employer to make a reasonable estimate of expenditure should be paralleled in section CW 16B.

Recommendation

That the submission be accepted.

Issue: Definition of "workplace"

Clause 20

Submissions
(Council of Trade Unions)

"Workplace" should be more clearly defined to fit all circumstances, including mobile workplaces. The definition in section 5 of the Employment Relations Act 2000 could be appropriate – "a place where an employee works from time to time; and includes a place where an employee goes to work".

Alternatively, a more expansive definition from section 2 of the Health and Safety in Employment Act 1992 could be considered, which defines "place of work" as:

> A place (whether or not within or forming part of a building, structure, or vehicle) where any person is to work, is working, for the time being works, or customarily works, for gain or reward; and, in relation to an employee, includes a place, or part of a place, under the control of the employer (not being domestic accommodation provided for the employee), –
>
> (a) where the employee comes or may come to eat, rest, or get first-aid or pay; or
> (b) where the employee comes or may come as part of the employee's duties to report in or out, get instructions, or deliver goods or vehicles; or
> (c) through which the employee may or must pass to reach a place of work.

Comment

Officials consider that the Employment Relations Act 2000 definition is no clearer than the one proposed in the bill. The second definition (from the Health and Safety in Employment Act 1992) is too constrained as it refers to places under the control of the employer. While that constraint may be appropriate for health and safety matters, the proposed amendments in the bill are intended to also cover situations when employees are working at places not under the control of the employer, such as the premises of a client of the employer.

Recommendation

That the submission be declined.

Issue: Accommodation subject to sections CW 16B to 16F

Clause 11

Submission
(New Zealand Law Society)

It should be made clear that treating "accommodation" as employment income is subject to proposed new sections CW 16B to 16F.

Comment

Officials do not consider it necessary to expressly state that the treatment of accommodation as employment income is subject to sections CW 16B to 16F. Having a general rule with subsequent exemptions, as proposed in the bill, is consistent with the rest of the structure of the Income Tax Act.

Recommendation

That the submission be declined.

Issue: "Office or position"

Clause 11

Submission
(Ernst & Young)

There should be clarification of any distinction between the terms "office or position" and "employment or service" in the context of section CE 1.

Comment

For the accommodation to be treated as employment income, the draft bill requires it to be provided to the person in relation to their employment or service. The current legislation requires accommodation to be provided in relation to the person's office or position. The intention of using "employment or service" is to update the provision to be consistent with the rest of the Income Tax Act. However we note that this may mean that accommodation provided by non-resident employers would inadvertently not be covered. Officials propose ensuring this does not occur by extending the definitions of "employer" and "employee" for the purposes of the allowances provisions.

Recommendation

That the submission be noted and that an extension to the definitions of "employer" and "employee" be included to ensure that accommodation provided by non-resident employers is not inadvertently excluded.

Issue: Meaning of "living premises"

Clause 11

Submission
(New Zealand Institute of Chartered Accountants)

It is unclear what "living premises" in the definition of "accommodation" refers to and what features would be required for something to be considered "living premises". The meaning should be clarified.

Comment

The wording "living premises" is contained in the existing definition of "accommodation" and has therefore been included in the proposed revised definition for consistency. Officials are not aware of any issues with "living premises" in the existing definition.

Recommendation

That the submission be declined.

Issue: Guidance on "reasonable daily travelling distance"

Clause 20

Submission
(New Zealand Law Society)

Additional guidance should be provided on the scope of the term "reasonable daily travelling distance" through examples provided in proposed new section CW 16B or in a determination issued by the Commissioner.

Comment

The concept of reasonable daily travelling distance is already contained in the Income Tax Act in relation to relocation payments (section CW 17B). Guidance was requested by taxpayers at the time this provision was introduced and was subsequently published in *Tax Information Bulletin* Vol 21, No 9 (December 2009). Officials will cross-reference to this *Tax Information Bulletin* in the edition that will be issued subsequent to the employee payments changes being enacted.

Recommendation

That the submission be noted and that officials will provide guidance on where to find information on "reasonable travelling distance".

Issue: Out-of-town secondment accommodation payments made by company employee is seconded to

Clause 20

Submission
(BDO Wellington Ltd)

Proposed sections CW 16B and 16C provide time-limited exemptions for accommodation when an employee is working away from home on a secondment or capital project. In order to qualify, the accommodation must be provided or paid for by the employer. In situations when an employee is seconded by their employer, Company A, to another company (Company B) and the accommodation is provided by Company B, but the employee remains employed by and paid by Company A, the exemption would not be available.

Comment

Officials agree that, on the proposed wording, this situation would not receive the accommodation exemption contained in proposed section CW 16B. There does not appear to be any reason why the exemption should not apply in these circumstances and therefore officials recommend an amendment to include this situation.

Recommendation

That the submission be accepted.

Issue: Extension of two-year rule to new employees

Clause 20

Submission
(KPMG, Russell McVeagh)

As currently drafted, the two-year exemption rule for out-of-town secondments does not apply to new employees of an employer. The exclusion of new employees is not warranted. Employers should not be penalised based on how they decide to resource a project (transferring an existing employee or hiring a new one). We understand the rule is aimed at avoiding salary sacrifice arrangements, but believe the conditions attached to the rule are sufficient to deal with abuse. It is unclear what a "new employee" is – how long do they need to have been employed before they are no longer "new"? There is no such distinction in relation to the three-year exemption for capital projects, or the five-year exemption for the Canterbury rebuild. We see no reason to treat the two-year rule differently.

Alternatively, proposed section CW 16E should be amended so that it contemplates a scenario where an individual is employed with a specific out-of-town secondment in mind, followed by the possibility of a period of work at a workplace that is not a distant workplace.

Comment

The exclusion of new employees from the out-of-town secondments rule was deliberate. As the submitter has noted, this is due to the potential for salary substitution arrangements in what can be a wide range of situations. While, as the submitter has stated, the exclusion of new employees does not apply in respect of the three-year exemption for capital projects and the up to five-year exemption for the Canterbury rebuild, this is to ensure that there is no disparity of treatment for new and existing employees working on the same project in what is considered to be more limited situations. Officials consider the more restrictive approach in relation to secondments is valid due to the risk of behavioural changes in the way new employees are remunerated – for example, contracts with new employees that would normally be for three years could be changed to two-year contracts to take advantage of the exemption.

We note that new employees will qualify for the two-year exemption in some limited situations including when:

- The employee is newly recruited to work at a particular work location but is then sent to work at another work location temporarily – for example, an individual is recruited to work in Auckland but is then sent to work in Dunedin for a month before returning to Auckland.
- An employee working for one employer is seconded to work for another employer on a temporary basis, with the expectation that the employee will return to work for the original employer – for example, an individual working for an Australian accountancy firm is sent to work for an affiliated New Zealand firm in Auckland for 18 months.

Russell McVeagh has proposed amending proposed section CW 16E so that where an employee is hired for a specific out-of-town secondment but there is the possibility that a period of work will follow at a workplace that is not a distant workplace, then the two-year secondment exemption should apply. Officials consider this to be too low a threshold. As noted in the first of the above examples, when the new employee has been employed to work in a local workplace and is immediately sent to a distant workplace for a period with the expectation that they will return to the local workplace, the exemption will apply. There needs, however, to be a greater degree of certainty than the possibility that an employee may subsequently work at the local workplace in order to mitigate the salary substitution concerns.

Recommendation

That the submission be declined.

Issue: Distant workplace

Clause 20

Submission

(Council of Trade Unions, KPMG, New Zealand Institute of Chartered Accountants)

The definition of a "distant workplace" that requires there to be a new workplace is problematic (proposed new section CW 16B(4)). We do not see that the word "new" in this section serves a useful function and recommend it is removed, or replaced. We consider that this will potentially result in the exemptions not applying in situations where it is intended they apply. *(Council of Trade Unions)*

The definition of "distant workplace" refers to a new workplace not within reasonable daily travelling distance of the employee's residence. This has the potential to create confusion – for example, if the employee temporarily relocates to the distance workplace, their residence is likely to be within reasonable travelling distance. *(KPMG)*

Further guidance should be given on what constitutes an employee's "residence" for the purposes of the allowances rules. It will be clear in many circumstances – for example, when the employee's family remain in their home location and the employee returns home at weekends. It is less clear if the employee's spouse accompanies them to the secondment location, they rent out their family home and do not return there for the duration of the secondment. It is not clear in what situations, if any, an employee's residence may be deemed to shift to the secondment location and therefore the exemptions become unavailable. There is real uncertainty as Inland Revenue has asserted, in relation to tax residency, that a home rented out to others can still constitute "an abode available to the taxpayer". *(New Zealand Institute of Chartered Accountants)*

Comment

The inclusion of the word "new" was intended to emphasise that the employee needed to be going to a workplace other than their usual workplace. Officials agree that the use of the word "new" may cause some confusion as suggested by the submitter, particularly in the context of the multiple workplace rule where some employees may go to the same places on a regular basis. We recommend that the word "another" be used instead.

The employee's residence being referred to is their residence before the secondment and the distance test is assessed at the time immediately before the commencement of the secondment, not after. This concept of "residence" is also used in existing provisions in relation to relocation payments (section CW 17B) and officials are not aware that any issues have arisen in that context. Some guidance on this point can be included in the *Tax Information Bulletin* following enactment of the bill.

Recommendation

That the submission regarding the word "new" be partly accepted and that "another" be used in its place.

That the submission regarding residence be noted.

Issue: Multiple workplace rule should apply to those with a home office

Clause 20

Submission
(Tax Team)

Proposed section CW 16F(2)(b) should not preclude the application of the multiple workplace exemption if an employee has a workplace which is a home office, but that home office is not the "distant workplace".

Comment

Proposed section CW 16F (multiple workplace rule) excludes employees who have two workplaces, one of which is a home office. This is to protect the revenue base from situations – for example, when an employee takes a permanent job that is located at a workplace that is distant from their home and, by virtue of working a small portion of time from home, gains tax-free accommodation (with no upper time limit) whenever they are working at their workplace rather than their home. This is contrasted with the intended coverage of the exemption, where an employee has a workplace near their home and is also required to work at other, distant, workplaces on either an ad hoc or regular basis.

We note that in situations when an employee works from home and has two or more distant workplaces, accommodation at the second and subsequent distant workplaces would be exempt under section CW 16F.

Recommendation

That the submission be declined.

Issue: Capital project exemption should be extended

Clause 20

Submission
(Council of Trade Unions)

It is not clear why the extension to three years is only for capital projects. There could well be projects of substantial length that do not have the principal purpose to "create, build, develop, restore, replace or demolish a capital asset". Employees could be required to move to work on other large projects lasting more than three years, such as to design and then implement major organisational change. The longer time limit should apply to any defined project.

Comment

The two and three-year time limits were set following extensive consultation. The November 2012 officials' issues paper, *Reviewing the tax treatment of employee allowances and other expenditure payments*, proposed a time limit of one year for all secondments. Feedback suggested this would be too short for a significant proportion of temporary shifts such as work-related secondments. Consultation indicated that a two-year limit should cover the vast majority of cases. However there were still concerns in relation to longer-term projects particularly in the construction industry. The three-year extension for capital projects (and transitional five-year extension for Canterbury rebuild projects) was therefore proposed.

Officials do not consider it is warranted to extend the proposed capital projects exemption to cover a wider group of projects. The extended exemption was developed in response to feedback from consultation and is intended to deal with situations such as large infrastructure projects in remote areas. Extending the three-year exemption to any project would effectively turn the proposed two-year secondment limit into a three-year limit, which in some cases would seem to be more than a temporary shift.

Recommendation

That the submission be declined.

Issue: Associated person restriction should be removed from "project of limited duration"

Clause 20

Submission
(Deloitte, KPMG, New Zealand Institute of Chartered Accountants)

A "project of limited duration" (three-year accommodation exemption) will exclude a project carried out under a contract between an employer and one or more persons associated with the employer. This restriction is not warranted and is not applied for out-of-town secondments (the two-year accommodation exemption). It is not uncommon to have transfers of personnel between related parties for project work, particularly trans-Tasman. Accommodation should be able to be exempted for up to three years provided all the other criteria are met. Paragraph (b) of the definition of "project of limited duration" should therefore be removed. If there is an anti-abuse rationale for this provision, such concerns should be dealt with by way of a more targeted provision.

Comment

The three-year exemption for projects of limited duration is designed for situations when employees are sent to work on large projects that their employer is contracted to deliver, or deliver aspects of, for an unrelated third party. In contrast, the two-year exemption contemplates secondments to another location carrying out their employment duties more generally – this could be work on internal or external projects. The three-year exemption is intended to be more limited than the two-year exemption, covering only the delivery of external projects. Extending the exemption to cover projects for associated parties would increase the fiscal risk of the proposal.

Recommendation

That the submission be declined.

Issue: Change of expectation from over- to under-time limits

Clause 20

Submissions
(Ernst & Young, Council of Trade Unions)

There should be express clarification of the intended treatment of secondments under proposed section CW 16B in relation to situations when initial employer expectations may have been for a secondment longer than two years (and therefore accommodation would be taxable) but those expectations subsequently change to a less than two-year secondment, or a change in circumstances causes the secondment to be cut short before its intended end, inside the two-year period. *(Ernst & Young)*

In these situations the exemption on accommodation should become available, backdated to the start of the project or secondment. *(Council of Trade Unions)*

Comment

Officials agree that clarification is required on the treatment of secondments when the initial expectation is for a secondment of longer than two years but the expectation subsequently changes to less than two years. We recommend an amendment to the proposed definitions of "out of town secondment" and "project of limited duration" in section CW 16B(4) to clarify that to qualify for the exemption there must be an expectation, at the outset, that the period of the secondment or project will be within the respective two or three-year time limits. This means that if, during the course of the secondment the expectation changes from being over the time limits to within the time limits, the accommodation will still remain taxable.

Accordingly, officials do not agree with the Council of Trade Unions' submission that a retrospective exemption for the full period of accommodation should be available when an expectation subsequently falls within the time thresholds. If this approach were taken, taxpayers could potentially be switching backwards and forwards between taxable and non-taxable throughout the life of the secondment or project. This would add significant administrative and compliance costs which is inconsistent with a key aim of the proposed rules to improve certainty.

Recommendation

That the submission be accepted in respect of clarifying that the expectation needs to be determined at the outset of the secondment or project, but declined in terms of being able to retrospectively revisit qualification for the exemption.

Issue: Change of expectation from under to over time limits

Clause 20

Submission
(Council of Trade Unions)

When an employer re-estimates the length of the project from being under the relevant two, three or five-year limit, to over the limit, the exemption for accommodation should continue to apply for the original two, three or five years.

Comment

A change in expectation will trigger a change in the prospective treatment of the accommodation, from the date of that change in expectation. The time limits are intended to be a maximum time limit, not a safe harbour, and therefore it is not appropriate to continue to receive an exemption when the expectation has changed. We note that the legislation ensures the exemption is not clawed back for the period before the change in expectation.

Recommendation

That the submission be declined.

Issue: Clarification of status of time limits

Clause 20

Submission
(KPMG)

Proposed sections CW 16B and 16C should be reviewed to more clearly reflect the policy intent of the proposed exemption. It is not clear currently that the tests are a maximum threshold rather than a safe harbour.

Comment

Officials do not consider that the proposed rules require amendment as submitted. The legislation requires the exemption to be read in conjunction with the defined terms, in particular "out-of-town secondment" or "project of limited duration".

Recommendation

That the submission be declined.

Issue: Timing of change in expectation

Clause 20

Submission
(KPMG, New Zealand Institute of Chartered Accountants)

The point in time a change in expectation will be treated as having occurred (for the purpose of exemption time-limits) should be clarified as when the employer and employee have modified the terms of their employment in a way that binds both parties. *(KPMG)*

Further guidance should be given in the legislation as to determining when a change in expectation occurs. *(New Zealand Institute of Chartered Accountants)*

Comment

The point in time at which an expectation is treated as having changed is when the employer has a firm expectation that the secondment or project will last longer than initially expected. This may be evidenced by modification in the employee's terms of employment, but in many cases there may not be such a written agreement. Rather there may be other documentation such as board minutes, planning documents, correspondence with the third party for whom the employer is undertaking the capital project and so on, that will suffice to demonstrate that the expectation has changed.

Officials agree that further guidance might be helpful but do not consider that legislative change is necessary. It is not practical or appropriate to try and capture all the possible ways in which the expectation may be evidenced in the legislation. Rather, more detail can be provided in the *Tax Information Bulletin* following enactment of the bill.

Recommendation

That the submission be declined, subject to noting officials will provide further guidance in the *Tax Information Bulletin*.

Issue: Travel to distant workplace

Clause 20

Submission
(KPMG, New Zealand Institute of Chartered Accountants)

It is not clear why proposed section CW 16B(1)(c)(iii) has been included. Examples and further explanation would be helpful.

Comment

Proposed section CW 16B(1)(c)(iii) is intended to cover accommodation provided while an employee is undertaking necessary travel to and from a distant workplace. This is in contrast to proposed section CW 16B(1)(c)(ii) which covers the accommodation at the distant workplace.

Examples of accommodation covered by proposed section CW 16B(1)(c)(iii) are:

- where an employee is required to travel to London for work and it is necessary to stay a night in Hong Kong between flights; or
- where an employee from Auckland is required to attend a meeting in Canberra that starts early in the morning. No direct flights are available from Auckland to Canberra and the first flight from Auckland on the day of the meeting would not reach Sydney in time to catch the necessary connecting flight to Canberra. The employee could either fly to Canberra the day before (in which case the accommodation would be covered under proposed section CW 16B(1)(c)(ii) or stay the night in Sydney and then take the first morning flight from Sydney to Canberra, in which case section CW 16B(1)(c)(iii) would apply.

Officials have noted the submission and will include an example in the *Tax Information Bulletin*.

Recommendation

That the submission be noted.

Issue: Application date

Clause 34

Submission
(Business New Zealand, Corporate Taxpayers Group, Deloitte, KPMG)

The application date of the accommodation proposals should be backdated to 6 December 2008 at the election of the employer (four years before the Commissioner of Inland Revenue's Statement of 6 December 2012).

Comment

The general proposition put forward by a submitter in oral evidence was that taxpayer-favourable changes codifying existing practice should generally be applied retrospectively back four years *(Corporate Taxpayers Group)*. The bill effectively achieves this as the proposed application date of the accommodation provisions is 1 April 2015, with employers being able to elect to apply the rules back to 1 January 2011 (provided they have not taken a tax position that the accommodation was taxable before 6 December 2012, the date of the Commissioner's Statement outlining Inland Revenue's interpretation of the law).

Submitters expressed concern that the Commissioner's Statement of 6 December 2012 altered what they considered to be current practice in relation to the treatment of allowances. They therefore submit the application of the new rules should be backdated to four years before the Commissioner's Statement (6 December 2008). This is because the Statement required any voluntary disclosure in relation to expenditure on account (for example, when the employee entered into a tenancy agreement in their own name for the accommodation and the employer then paid the landlord directly) to be taken back four years. Disclosure in relation to actual accommodation and allowances need only go back two years from the date of the Commissioner's Statement.

Officials do not consider that the application of the proposed changes should be backdated to 2008. The proposed optional retrospective application is designed to give employers the option of applying the new rules in place of the Commissioner's Statement in the period between the issuing of that Statement and the application date of 1 April 2015, and to allow a further two years backdating to create some equivalence with the rule for the Canterbury earthquake rebuild. Allowing application back to 6 December 2008 would be a retrospective application of more than eight years which officials consider would potentially give rise to significant administrative costs and undermine the finality of tax positions.

Recommendation

That the submission be declined.

Issue: Retrospective application should apply regardless of pre-December 2012 position

Clause 34

Submission
(Tax Team)

Proposed section CZ 30 should allow the application of the proposed sections CE 1B and CW 16B to CW 16F (the accommodation provisions) to taxpayers who have paid tax in relation to the provision of accommodation before 6 December 2012. Accordingly, proposed section CZ 30(2) should be deleted.

Comment

This submission is a variant of the preceding submission on the retrospective application date. Taxpayers have submitted that there was uncertainty about the treatment of accommodation following the Commissioner's Statement of 6 December 2012 as, in their view, this changed Inland Revenue's previous position. The transitional provision takes account of this view taken by taxpayers by allowing the employer to elect to apply the proposed new rules rather than those outlined in the Commissioner's Statement, so long as a tax position has not been taken before the Statement that the accommodation was taxable. This means anyone having taken a position after 6 December 2012 generally will not be disadvantaged by having treated the accommodation as either taxable or non-taxable. We consider that people should be bound by their tax positions before 6 December 2012 as these positions are based on the particular facts in each case and are likely to be appropriately based on the law as it was being interpreted and applied at that time.

Recommendation

That the submission be declined.

Issue: Amendments to proposed section CZ 30

Clause 34

Submission
(Tax Team)

Proposed section CZ 30 should make it clear that proposed sections CE 1B and CW 16B to CW 16F apply to a taxpayer's provision of accommodation (or incurring of related expenditure) from 1 January 2011, notwithstanding that the provision of such accommodation may have begun before 1 January 2011.

Comment

Officials agree that accommodation or accommodation expenditure provided or incurred from 1 January 2011 should fall within the proposed new rules. We consider that the legislation does allow for the portion provided or incurred on or after 1 January 2011 to be covered by the rules (but not the portion provided or incurred before 1 January 2011) provided the other relevant criteria, such as the expectation test, are met.

Recommendation

That the submission be noted and that the proposed legislation should already allow some portion of accommodation straddling the 1 January 2011 application date to be treated as non-taxable provided the other criteria, such as the expectation test, are met.

Issue: Choice to backdate application

Clause 34

Submission
(Corporate Taxpayers Group, Deloitte, KPMG)

The bill allows employers to elect to apply the new accommodation provisions retrospectively, but does not cover the employee's ultimate obligation to pay tax on all taxable income. The provision should either be extended to cover this obligation or it should be clarified that there is no obligation on the employee to account for any unpaid tax. *(Corporate Taxpayers Group, Deloitte)*

Employees should also be able to elect to apply the rules retrospectively. In situations when the amount was treated as taxable, but would not be under the new rules, employees may want to apply the new rules but there is no guarantee employers will want to re-file past returns. Employees should therefore also have the option to apply the transitional provisions to reopen past tax assessments and receive a refund of PAYE deducted. *(KPMG)*

Comment

The bill proposes allowing the accommodation provisions to be applied retrospectively by the employer as it is the employer that has the obligation to deduct PAYE in respect of the employee's taxable employment income. We do not consider it necessary to also provide an option for the employee as the employer and employee ought, as necessary, to discuss what option should be taken by the employer. Legislating for the employee to take a position could lead to considerable confusion and complexity if the employer and employee take different tax positions.

Recommendation

That the submission be declined.

Issue: Treatment of applications to re-file before bill passed

Submission
(PricewaterhouseCoopers)

Taxpayers require certainty over how Inland Revenue will treat applications to re-file PAYE and individual income tax returns before the passage of the bill. In addition, the recovery of PAYE could result in the reassessment of an employee's tax returns. If there is a reassessment of an employee's tax returns that increases their residual income tax liability, confirmation is sought that the use-of-money interest rules will not apply.

Comment

The proposed rules are not planned to come into effect until the bill has been enacted. Applications to re-file in order to take advantage of the retrospective election to apply the new rules therefore cannot take place until the new rules are in effect.

If a reassessment results in tax being payable, the use-of-money interest rules will apply, as usual. For example, if a taxpayer has taken a net benefit approach, and is not covered by the proposed exemptions, they will be taxable.

Recommendation

That the submission be declined.

Issue: Canterbury earthquake measures application date

Clauses 33 and 34

Submission
(Ernst & Young)

Clauses 33 and 34 propose new transitional rules providing specific periods for accommodation exemptions in relation to employees working in the Canterbury area following the 2010–11 earthquakes. The exemptions would apply from 4 September 2010 unless the accommodation has been treated as taxable before 6 December 2012. These exemptions should not be excluded from applying if the accommodation was treated as taxable before 6 December 2012.

Comment

The restriction on backdated application where accommodation has been treated as taxable before 6 December 2012 does not apply in respect of proposed section CZ 29 which contains the Canterbury accommodation transitional rules. Officials note, however, that this could be made clearer by expressly stating that the restriction does not apply to section CZ 29.

Recommendation

That the submission be noted and that officials will ensure the section is clarified to reflect the position that the Canterbury earthquake accommodation rules will apply back to 4 September 2010 regardless of the tax position taken before 6 December 2012.

Issue: Generic rule should be added for adverse events

Clause 33

Submission
(New Zealand Institute of Chartered Accountants)

We support the specific Canterbury rules but consider it appropriate to add generic rules for accommodation provided or paid for by employers carrying out rebuild work after an event in the nature of an "adverse event" or other event declared by the Governor-General by Order in Council.

Comment

While officials appreciate that there might be some administrative case in having generic rules for adverse events, we consider that there are too many variables to have a set of generic rules for adverse events. Events of the magnitude of the Canterbury earthquakes clearly require significant rebuild projects that justify extended timeframes, but this may not be true of all adverse events. As the general rules regarding two and three-year exemptions will apply in the first instance, officials consider it preferable to deal with adverse events on a case-by-case basis. If more time is needed, this can be assessed and legislated for at the time.

Recommendation

That the submission be declined.

Issue: Exceptional circumstances – Canterbury provisions

Clause 33

Submission
(New Zealand Law Society)

An "exceptional circumstances" provision is included in proposed new section CW 16C. The Canterbury provision (proposed section CZ 29) effectively mirrors, with more concessionary time limits, the exempt income rules in proposed section CW 16B and 16C but does not contain an "exceptional circumstances" provision. This should be included.

Comment

As the submitter has noted, there is an "exceptional circumstances" provision included in proposed section CW 16C. This provision also applies for Canterbury accommodation. Proposed section CZ 29 alters the time limits in section CW 16C in respect of Canterbury rebuild-related accommodation, but the remainder of the rules in that section continue to apply, including the "exceptional circumstances" provision.

Recommendation

That the submission be noted.

Issue: Increased monitoring requirements resulting from the new rules

Submission
(Business New Zealand)

The proposed changes mean that businesses' payroll and finance teams will need to be extra vigilant about any changes in circumstances that often occur with projects as they progress. Changes in expectations, meaning a secondment will last more than two or three years will affect the tax treatment of accommodation payments. It is important therefore that businesses are provided with sufficient information about when Inland Revenue believes expectations are changed (how probable does the expectation need to be) and how this should be documented, particularly over the next few years, to minimise tax compliance errors.

Comment

Officials note the submitter's comments regarding additional monitoring regarding expectations. The new rules are designed to increase certainty, thereby reducing compliance costs compared with other options. However, we acknowledge that there will still be some compliance costs involved in ensuring employers meet the rules. We note also that the proposed time limits for exempt accommodation are more generous than those currently applicable following the Commissioner's Statement on accommodation of 6 December 2012.

As noted in comments on earlier submissions, officials also propose including some comment regarding expectations in relation to time limits in the *Tax Information Bulletin* following enactment of the bill.

Recommendation

That the submission be noted.

EMPLOYEE ACCOMMODATION – DETERMINING TAXABLE VALUE

Issue: Accommodation provided where the employee normally works shifts at a distant workplace for regular periods from which they cannot return home on a daily basis

Submission

(Corporate Taxpayers Group, KPMG, Petroleum Exploration and Production Association of New Zealand, PricewaterhouseCoopers, Seaworks)

Submitters have raised concerns about particular situations when an employee is required to stay at their workplace because they are unable to return home to their normal residence at the end of their working shift.

It should be made clear how to treat these situations when accommodation is provided where no alternative is available – for example, oil rigs or overnight ferries. *(Corporate Taxpayers Group)*

Confirmation is sought that shift workers accommodated on drilling rigs or offshore platforms for the length of their shifts (which are often multi-week) are not taxable under the new rules, or if they are then a change to the bill is sought. *(Petroleum Exploration and Production Association of NZ)*

Clarification is sought over whether unusual situations such as oil rig workers are going to be addressed via legislation or determinations issued by Inland Revenue. *(PricewaterhouseCoopers)*

A specific exemption is required for workers when it is not possible to return to their normal residence at the end of the shift – for example, employees who work on ships. *(Seaworks)*

Comment

Officials agree that accommodation in these types of situations should be exempted on the basis that the accommodation does not constitute normal long-term living premises. Other examples might include double-cab trucks which may be used occasionally for sleeping in, and accommodation provided for workers in Antarctica. The private benefit in such cases is likely to be small or hard to measure. We therefore consider accommodation provided for employees on oil rigs, ships, trucks or other similar workplaces or at Scott Base should be excluded from the definition of "accommodation" if, because of the requirements of their employment, the employee is unable to return home during the period of the performance of their duties. Similarly, such things as beds provided at a fire or ambulance station should not be considered accommodation (and therefore exempted) as their use by an employee is confined to the employee's shift and therefore not available as a normal residence.

While we have endeavoured to identify all such cases, there may be some identified after the legislation is passed. To deal with specific cases, we recommend the Governor-General having a regulatory power to exempt on a case-by-case basis through an Order in Council.

Recommendation

That the submission be generally accepted. Officials recommend a specific exemption of identified cases and an exemption mechanism via an Order in Council be used to deal with any similar cases that are subsequently identified.

Issue: FIFO workers' accommodation

Clause 20

Submission
(KPMG)

Related to the above submission, concerns arise in respect of fly-in fly-out (FIFO) workers where an employee is flown to the work site for a number of days and is then flown back to their home base/country for a number of days of rest. This is common in mining industries. FIFOs should be included in the multiple workplace rule.

Comment

Officials note there will be a range of situations that could be described as FIFO. There will be some FIFO workers who fall within one of the proposed accommodation exemptions, in which case they can apply those rules. For example, an employee who is sent to work on a roading project in the Pacific Islands for a period of 18 months and who works two weeks on and one week off, and flies home for that one week off. This situation would be covered by the "project of limited duration" exemption and therefore the Pacific Island accommodation would be exempt.

The issue of FIFO workers is likely to be confined to those who are either employed directly in a FIFO role (rather than a secondment or project situation) and/or those undertaking long-term FIFO work. The issue for FIFO workers working at overseas locations is more one of compliance costs given there will be no PAYE deduction as their employers are non-resident) and therefore the employee will need to include the accommodation in their tax return and establish its value. However, this is arguably a result of the employee's decision to reside well away from their place of employment. As a general rule, therefore, their accommodation should be taxed at market value.

We do not consider it appropriate to extend the multiple workplace rule as suggested. As we understand the submission, it would involve extending the rule to cover workers who have only one workplace and that workplace is distant from their home. While the submission refers to workers in mines overseas, we do not consider this situation is any different to a worker who lives in Wellington and accepts a permanent job in Auckland but chooses to keep their family in Wellington and commute. In these situations, accommodation should be taxable as the employee has chosen to work well away from their place of residence. We note also however, that in situations when the accommodation provided to the FIFO worker is of the type discussed in the preceding submission (for example, oil rigs) they will be exempt on that basis.

Recommendation

That the submission be declined.

Issue: Mobile workers and multiple workplace rule

Clause 20

Submission
(Council of Trade Unions)

The circumstances of mobile workers (workers on passenger or freight road, rail, ships and aeroplanes) should be more clearly addressed with respect to the exemption of accommodation. For these workers it is not their place of work that changes as they drive, sail or fly from place to place, but rather their position relative to their usual residence. It is not clear from the current wording that these workers could access the multiple workplace exemption. We suggest expressing the entitlement in terms of changes in “accommodation base” or similar, rather than “workplace”.

Comment

This submission also relates to the earlier submission regarding workers who cannot return home at the end of their shift. The multiple workplace rule is intended to cover situations when an employee has to work at more than one workplace on an on-going basis. In some of the cases referred to it is possible the multiple workplace rule as drafted will apply – for example, if they have duties at the location they travel to, as well as on the vehicle they travel on. In other cases, for example, if all their employment duties are carried out on the vessel, the multiple workplace rule would not apply.

Officials agree these situations should be exempt as the accommodation provided is not what would be considered to be normal/long-term living accommodation. As discussed above, we consider accommodation at workplaces provided when the employee is unable to leave at the end of their shift should be exempted. This exemption should deal with the situations raised in this submission.

Recommendation

That the submission accepted in part, in terms of agreeing that these types of accommodation should be exempt.

Issue: Valuation of accommodation when the employer requires the employee to live “on the job”

Submission
(Dilworth Trust Board, Ernst & Young, Independent Schools of New Zealand, KPMG, New Zealand Institute of Chartered Accountants)

Certain employees, such as boarding school staff, are required to live in particular accommodation on their employer’s premises as part of their employment. In many cases these premises are located in high-value areas. Obligations placed on these staff, such as health and safety requirements, and the location of the accommodation (for example, in close proximity to, or within, boarding schools) hinder the “quiet enjoyment” of the accommodation. Submitters consider that such accommodation has only an incidental private benefit, and therefore taxation on the full market rental value is not appropriate.

Submitters' preference is for a legislative exemption from taxation in circumstances when:

- the employee is required to live in particular employer-provided accommodation in order to perform their employment duties;
- there are health and safety rules and regulations imposed on an employer in conducting its business which require the employee to live in employer-provided accommodation;
- the employee has significant restrictions imposed which restrict their freedom and enjoyment in occupying the employer-provided accommodation; and
- there is no salary sacrifice arrangement.

(Dilworth, Independent Schools, KPMG)

If a total exemption is not provided, submitters alternatively seek (in order of preference) and in the above circumstances:

- a cap on the taxable benefit – capped at a percentage of the employee's salary, similar to the approach proposed in the bill for ministers of religion; or
- a discount to the market rental value.

(Dilworth, Independent Schools)

Dilworth Trust Board, in supplementary submissions, has made clear that it considers the only appropriate option to be a complete exemption.

Ernst & Young suggests the issue should be dealt with by way of providing an additional adjustment when accommodation is "on the job" and does not provide full, uninterrupted possession, use and enjoyment because the employee is on call or needs to be available to attend to others' needs.

New Zealand Institute of Chartered Accountants also submitted that a discount should be applied when the employee did not have "quiet enjoyment", citing examples of Department of Conservation workers in a DOC hut, wardens in student hostels, caretakers or live-in managers of a lodge, hotel, or motel, and live-in care providers in care facilities and rest homes. "Quiet enjoyment" is a key factor in determining market value – it would be normal commercial practice to reduce rents if quiet enjoyment cannot be provided or is impaired.

If the primary submission regarding an exemption or special valuation rule for "on the job" accommodation is not accepted, there should be a power for the Commissioner of Inland Revenue to determine the taxable value of employer-provided accommodation.

Alternatively, or additionally, the Commissioner should issue guidance on the factors to be taken into account in determining market rental valuations to provide practical guidance to taxpayers.

There will be cases when it is impractical to use or ascertain market value in some situations – for example, when an employer provides accommodation to a large number of employees across a wide geographic area or when accommodation provided is in excess of the employee's everyday needs. In such cases, taxpayers should be able to seek a determination of the taxable value from the Commissioner of Inland Revenue.

Comment

The general issue of accommodation for employees that is situated at their place of work was considered in the course of the allowances review. Officials considered that taxing the accommodation benefit in these situations at its market value would be appropriate, on the basis that even though there may be some significant drawbacks to "living on the job", an employee for whom the work premises are their permanent residence may still obtain a substantial private benefit, even if there is a work need for them to live on the property.

Other options that were considered for the treatment of such accommodation were:

- taxing the full market value adjusted for a range of factors;
- capping the taxable element at a benchmark value; and
- capping the taxable element as a proportion of salary.

These three options were not preferred because they risked not capturing the full private benefit, leading to risks of salary substitution. Each also had administrative and compliance cost issues – for example, benchmark values require appropriate reference properties to be identified and agreed, and capping at a proportion of salary would mean that employees with variable reward structures (such as overtime or performance pay) would likely need an end-of-year adjustment to the taxable amount.

The preferred option, and that contained in the bill, is to tax the market rental value. While this type of accommodation may be affected by a number of factors that make it less attractive than a similar property nearby, factors that are specific to the property would affect the market rental value and should be able to be factored in by a valuer.

There may also be factors linked to the employee and their job, such as the obligation to live in a particular property not of their choosing. These factors are unlikely to be reflected in the market value of the property as they can vary between individuals, depending on their perceptions and personal circumstances. However, an employee will often take into account the provided accommodation in their decision to take a job. An employer will also often factor this in when setting the overall remuneration package.

One of the policy criteria for the treatment of allowances is ensuring the overall private benefit to the employee is recognised. A market rental value should take account of the value of the particular property (including factors specific to that property) and the wider remuneration package should reflect any disadvantages particular to the employee. Therefore, no further adjustment should be necessary to the market value of the property or to the taxable amount of any accommodation payment.

For these reasons, officials do not consider it necessary to include a special rule to deal with employees who are provided with accommodation on or near the workplace, as a result of a business need of the employer. If the property is subject to particular factors or restrictions on the employee's use or enjoyment of the property, these factors and restrictions should affect the market rental value and be able to be factored in by valuers.

With regard to the submissions on providing a determination-making power or guidelines, officials note that Inland Revenue is intending to issue guidelines on the factors to be taken into account when undertaking a market rental valuation.

Officials do not consider a power to determine the taxable value, or approve taxpayers' determinations of the taxable value is appropriate. This would potentially involve significant administrative costs.

Recommendation

That the submission regarding special legislative treatment of "on the job" accommodation be declined. However, to help taxpayers understand what sorts of factors and restrictions might affect market rental value assessments, Inland Revenue is intending to issue operational guidance in this area.

Issue: Total exemption should be granted for ministers of religion

Clause 24

Submission
(Inter-Church Working Party on Taxation)

The proposal in clause 24, inserting a new section CW 25B, continues with some adjustments the administrative position regarding accommodation for ministers of religion that has been in place since 1957. This position caps the taxable value of such accommodation at 10 percent of the minister's remuneration. A total exemption is sought, consistent with the position in Australia, the USA, Canada and the United Kingdom. This would avoid administrative complexity with little revenue effect.

Comment

Officials' preference regarding valuation is for a market rental value approach to be applied generally. In relation to ministers of religion however, as the submission indicates, there has been a longstanding administrative practice that has capped the benefit of church-owned accommodation at 10 percent of stipend. This practice has been codified in proposed section CW 25B, on the basis that removing the existing practice would place significant additional cost at relatively short notice on individual churches at a time when they have other significant financial obligations, such as making earthquake strengthening repairs. Ministers' social assistance entitlements (such as Working for Families tax credits) and obligations (such as the repayment of student loans) would also be affected.

Continuation of this practice would be subject to the tax-exempt amount being capped at a reasonable rental value to reflect the original expectation inherent in the administrative practice that the accommodation provided to ministers would be modest. This proposal was not intended to be a general tax exemption for ministers of religion. By simply codifying current practice, compliance costs should not be materially changed and the 10 percent of stipend rule represents a significant discount to market value in most cases.

Recommendation

That the submission be declined.

Issue: Simplification of proposed section CW 25B

Clause 24

Submission
(Inter-Church Working Party on Taxation)

If a total exemption is not provided to ministers of religion, proposed new section CW 25B could be simplified. The formula approach is unnecessarily complex and reference to rental value is not required. Rather, it is possible to just calculate the deemed income that is liable to tax.

Comment

Officials agree that the same outcome can be achieved by including a simplified formula in the taxing provision without reference to market value.

Recommendation

That the submission be accepted.

Issue: Adjustment for work use of church-provided accommodation

Clause 24

Submission
(Inter-Church Working Party on Taxation)

The adjustment component of the valuation formula for accommodation provided to ministers of religion gives rise to unnecessary administrative costs. Past practice has been to use a 15 percent adjustment where a study or office is provided in the house. The new rules will require measurements to be taken in every property to apportion the floor area between private and work use. Continuation of the 15 percent approach would be appropriate.

In addition, the adjustment as drafted applies only to areas used "exclusively" for work purposes. We submit that this should be "predominantly" as areas used for work will also have some element of private use.

Comment

Officials consider that the "adjustment for work" use should apply only when such use occurs rather than as a uniform 15 percent across all properties. We do, however, agree that requiring the area to be used exclusively for work purposes is too restrictive. We note that other submitters have also raised the issue of the word "exclusively" in the general accommodation taxing provision (discussed later in this section). We agree that the word "exclusively" should be replaced, but recommend using "wholly" or "mainly" as "predominantly" is not a commonly used term in the Income Tax Act.

Recommendation

That the submission regarding a 15 percent adjustment be declined, but that the submission in relation to "exclusively" be partly accepted, subject to officials' comments.

Issue: Adjustment for employee contribution to church-provided accommodation

Clause 24

Submission
(KPMG)

New section CW 25B(4) should include an adjustment to market rental value if there is a contribution towards rent by the employee (that is, an adjustment that would otherwise be made under section CW 16B(4)(b)).

Comment

The 10 percent of stipend rule is generous relative to market value and reducing the taxable amount further for any contribution from the minister does not seem appropriate. Furthermore, the recommended drafting will not refer to market value.

Recommendation

That the submission be declined.

Issue: Ministers of religion employed by charities

Clause 24

Submission
(KPMG, The Selwyn Foundation)

As drafted, the rule regarding valuation of accommodation provided to ministers of religion will not be applicable when the accommodation is provided directly by a charitable organisation. This means some hospices and rest homes run by charitable organisations with in-house chaplains will not qualify. Proposed section CW 25B should be amended to ensure these situations are covered. *(KPMG)*

Proposed section CW 25B relates to accommodation provided by a religious body or organisation, however, this is not defined. Certain charities affiliated with churches engage ministers to work with residents of retirement villages, and similar situations arise in regard to hospices and rest homes with in-house chaplains. A definition of "religious society or organisation" should be included in the bill to ensure these situations are covered. *(The Selwyn Foundation)*

Comment

The focus of the 10 percent rule is those situations previously covered by the longstanding administrative practice, which is accommodation provided by the churches. The specific provision is for reasons of the financial disruption that might arise in relation to the housing already provided if market value was suddenly applied. While there may arguably be some equity issues relative to chaplains in hospices, schools and rest homes, there is also a counter equity argument in relation to other employees who do not receive discounted housing. Including these affiliated groups would widen the coverage beyond the longstanding practice and open up scope for additional housing benefits to be provided to employees in the charitable sector, instead of salary increases.

Recommendation

That the submission be declined.

Issue: Definition of "minister of religion"

Clause 24

Submission

(Inter-Church Working Party on Taxation)

The definition has been broadened from traditional definitions to incorporate ministers of non-Christian religions, as it should be. However, the new wording has the potential to create uncertainties and departs from that which has been accepted since 1993. The 1993 definition should continue in the legislation, with references to "church" replaced with "religion", and restricted to charities registered under the Charities Act.

Comment

Officials agree that the definition could be further refined, but consider that the definition proposed by the submitter can be simplified.

Recommendation

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

Issue: Meaning of "market rental value commensurate with duties"

Clause 24

Submission
(KPMG)

Clarification is needed on the meaning of a market rental value that is "reasonably commensurate with the duties of the person as a minister and for the location in which they perform their duties" in proposed section CW 25B(3)(a)(iii).

Comment

The intention of the provision is to ensure that the accommodation provided to a minister of religion that is subject to the special valuation rule of limiting taxable value to 10 percent of stipend is of a standard and in a location that is appropriate for the minister's role. As noted earlier, this reflects the original expectation inherent in the administrative practice that the accommodation would be modest. For example, it would be expected that the accommodation is located within or close to the area in which the minister's congregation resides, rather than in an expensive suburb some distance away.

Recommendation

That the submission be noted.

Issue: Adjustment for use of accommodation for business purposes

Clause 12

Submission
(Corporate Taxpayers Group, Deloitte)

The legislation as drafted allows an adjustment to the taxable market rental value of accommodation where part of the accommodation is used "exclusively" for business purposes. The standard of "exclusively" is too high and should be changed to "predominantly".

Comment

Officials agree that there may be problems with the use of "exclusively". However we recommend using the words "wholly or mainly" instead as "predominantly" is not a commonly used term in the Income Tax Act.

Recommendation

That the submission be partly accepted, with the word "exclusively" being replaced by "wholly or mainly".

Issue: Adjustments to taxable value of accommodation and accommodation payments

Clause 12

Submissions

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

Proposed new section CE 1B(4) allows adjustments to reduce the taxable value where employees are sharing the accommodation, employees make a contribution towards the accommodation, or when part of the premises is used exclusively for work purposes. Similar adjustments should be able to be made, as appropriate, when allowances or other payments are made – for example, when part of the premises is used for work. *(Ernst & Young)*

Section CE 1B(4)(b) as currently worded implies an adjustment for an employee contribution would only be made when an employer incurred external costs in providing accommodation and seems to assume these costs would equate to a market rental value. All employee contributions or payments should be taken into account when determining the taxable income amount. *(Ernst & Young)*

Apportionments under section CE 1B(4)(a) for employees sharing the premises should be allowed to be made on an alternative reasonable basis. As drafted the bill requires equal apportionment between employees. This may not always produce the most appropriate result. Allowing an alternative approach would allow appropriate distinctions to be made – for example, when there is not equal sharing in terms of space, facilities or time used. *(Ernst & Young, New Zealand Institute of Chartered Accountants)*

Comment

As the submissions note, proposed section CE 1B(4) specifically provides for adjustments to reduce the taxable amount to take into account employees sharing accommodation, employee contributions and use of the property for work purposes. These adjustments are already available under existing law but are not stated in the provisions determining the value of the accommodation benefit. Accordingly, section CE 1B(4) is intended to provide greater certainty for taxpayers. It is not the intention to tighten the adjustments that are currently available. These adjustments are primarily relevant when accommodation is directly provided by the employer. However, as the Ernst & Young submission notes, it may be appropriate to take into account business use of the premises even when the employer provides an allowance or reimbursement. Ernst & Young have also indicated that an employee may also make a contribution when they receive an allowance. Accordingly, we recommend these situations be reflected in the proposed legislation.

With regard to section CE 1B(4)(b) (employee contributions), the intention is that all employee contributions should be recognised.

With regard to section CE 1B(4)(a) (shared accommodation), officials initially considered allowing apportionment between employees on an equal or unequal basis. However, for simplicity, an approach of equal apportionment is preferred.

Recommendation

That the submission in relation to employee contributions and business use be accepted.

That the submission regarding allowing unequal apportionment be declined.

Issue: Valuation of overseas accommodation

Clause 12

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

As currently worded, proposed section CE 1C appears to give employers the choice of median or average market rental values. These may differ significantly. The rules need to be made clearer. *(Ernst & Young, KPMG)*

One of these terms should be removed or, if the intention is to give a choice, an explanation should be given. *(New Zealand Institute of Chartered Accountants)*

Inland Revenue should provide guidance on acceptable New Zealand market rental benchmarks. *(KPMG)*

The current drafting is unclear about whether the New Zealand equivalent value can be determined with reference to just one of the three factors set out in the proposed section, rather than all three. It is also unclear whether the New Zealand value to be considered is to be a proxy for the employee living within a reasonable travelling distance of their place of employment and for comparable accommodation. The wording needs to be amended to clarify the policy intention. *(KPMG)*

Comment

The section is intended to give employers the choice of median or average market values. Officials understand that some employers use the average market rental but there are also employers who use the median, hence the choice. The fact that there is a choice could be made clearer in the legislation.

We agree the proposed section is unclear about whether one or all of the three factors set out in the provision must apply and recommend amending the section to make clear that it is intended all three factors are applied.

The cap on the value is the median or average value where the employee would be living if they were working for their employer in New Zealand – for example, if the employer is based in Wellington, the New Zealand value to be used would be a Wellington value, unless the value of the overseas accommodation is less. Officials do not consider that clarification is needed in the legislation but will include some discussion in the *Tax Information Bulletin*, including sources such as the Ministry of Business, Innovation and Employment's data on market rental values.

Recommendation

That the submissions be noted and that section CE 1C be made clearer that there is a choice of using average or median values. Officials also recommend amending proposed section CE 1C to make clear that the three factors set out in the section must all be met, rather than just any one of the three.

Issue: Defence valuation rule should be extended to cover police housing

Clause 12

Submission
(Police Association)

Proposed section CE 1D provides an exception to the general rule that the taxable value of accommodation is the market rental value of that accommodation. This exception applies to housing provided by the New Zealand Defence Force. We submit that police housing, particularly in hard-to-fill, remote locations, should also be covered by the specific Defence rule in proposed section CE 1D. There are around 250 houses in hard-to-fill locations.

Comment

As a general rule officials consider all accommodation should be valued on a market rental value basis, which under normal circumstances should take into account any factors specific to the property. However, given the compulsion on New Zealand Defence Force personnel to accept a posting anywhere in New Zealand, the New Zealand Defence Force has historically considered it appropriate to take a national approach to considering market rental value of New Zealand Defence Force accommodation. Additionally, the New Zealand Defence Force had an historic administrative arrangement with Inland Revenue over how market value was to be discounted to take into account the range of specific restrictions applying to their housing. The Government agreed that these arrangements should be reflected in the proposed legislation given the unique nature of the accommodation arrangements.

While, as the submitter has noted, there are a number of similarities between the Police and the Defence Force, we consider there are sufficient differences given the historical positions and the level of compulsion associated with accepting postings to different locations. We do not therefore consider that the exemption should be extended to police housing.

Recommendation

That the submission be declined.

MEALS

Issue: Support for proposed meal exemptions

Clause 22

Submissions
(Business New Zealand, Corporate Taxpayers Group, Council of Trade Unions, New Zealand Institute of Chartered Accountants)

Submitters were generally supportive of the proposed meal exemption, subject to various comments which are captured in specific submissions below.

Recommendation

That the submissions be noted.

Issue: Inclusion of allowance, daily allowance and reimbursement in exempt income

Clause 22

Submission
(Corporate Taxpayers Group, Deloitte, Ernst & Young)

Based on a literal reading of proposed section CW 17CB(1) allowances, daily allowances and reimbursement payments may not be included, as the section applies to "expenditure the employer incurs for or on behalf of an employee for a meal". We suggest including a statement along the lines of, "This includes a reimbursement payment or an allowance to an employee for a meal".

Comment

The focus of the provision is payments in relation to meals. This could be made a little clearer in section CW 17CB(1). For example, meals provided by the employer on the employer's premises are not intended to be covered as they will remain fringe benefits and subject to any exemptions under the FBT rules. This point is discussed in the next submission.

Recommendation

That the submission be accepted and that the legislation be clarified so that the proposed coverage of the provision includes meal reimbursement payments and meal allowances.

Issue: Provision to clarify relationship with FBT rules

Clause 22

Submission
(Corporate Taxpayers Group)

The FBT rules are intended to take precedence over proposed section CW 17CB, meaning that meals provided directly by an employer to an employee would continue to be potentially subject to the FBT rules. We submit that clause 22 should be amended to clarify that the direct provision of a meal by an employer is subject to the FBT rules.

Comment

As the submitter has noted, this matter was discussed with officials before the introduction of the bill but could not be included in time for the bill's introduction.

Recommendation

That the submission be accepted.

Issue: Ensure clarity between allowances, FBT and entertainment tax rules for on-premises meals

Clause 22

Submissions
(Business New Zealand, Corporate Taxpayers Group, Deloitte)

Further analysis should be undertaken to ensure there are no gaps between the interactions of the proposals in the bill, the FBT rules and the entertainment tax rules. *(Business New Zealand)*

A legislative gap remains in section CW 17CB as it is not clear how meals and refreshments provided to employees on-premises – for example, a staff meeting held over lunchtime with lunch provided. Section CW 17CB does not apply as it operates only when the employee is working away from their normal workplace. We consider there are limited circumstances when food and drink should result in taxable income to an employee, and the existing entertainment and FBT rules should be left to deal with such benefits. *(Corporate Taxpayers Group, Deloitte)*

Comment

This issue should be addressed by the proposed clarification of the interaction of proposed section CW 17CB with the FBT rules. The FBT rules in turn contain a provision in section CX 29 that clarifies when on and off-premises meals are fringe benefits, by reference to the entertainment tax rules.

Recommendation

That the submissions be noted.

Issue: Extend section CX 19 to cover benefits that if paid as an allowance would be exempt

Clause 31

Submission
(Corporate Taxpayers Group, Ernst & Young)

Clause 31 proposes amending section CX 19 in relation to benefits provided instead of allowances that would be exempt from income under a number of specified provisions, but not including the proposed new section CW 17CB (work-related meals). Section CX 19 should also expressly include benefits that are provided instead of allowances paid, which are exempt under proposed new section CW 17CB.

Comment

Officials agree that proposed section CX 19 should also include a reference to section CW 17CB.

Recommendation

That the submission be accepted.

Issue: Clarification: two exemptions are provided

Clause 22

Submission
(New Zealand Institute of Chartered Accountants)

The legislation should be redrafted to reflect more clearly that two exemptions are being introduced – an exemption of up to three months for meals when an employee is required to work away from their normal work location, and a general exemption for working meals and light refreshments when an employee is working off the employer's premises. The current drafting is confusing and does not clearly reflect there are two separate exemptions.

Comment

Officials do not consider that the provision needs redrafting as submitted, but note that explanation of the two exemptions was included in the Commentary to the bill and will also be included in the *Tax Information Bulletin* to be published following enactment of the bill.

Recommendation

That the submission be declined.

Issue: Light refreshments on premises should also be available to part-time employees

Clause 22

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

The seven hours a day requirement appears to discriminate unfairly against part-time employees who may still be entitled to light refreshments during their working hours and whose employment duties may also require them to be away from their employment base for most of their working hours.

Comment

The time limit was designed to limit the risk of salary substitution. This risk is already partly reduced by the provision that precludes arrangements when the employee would be entitled to additional salary if the meal benefits were not provided, although it does not cover indirect salary substitution. In these circumstances the seven hours limit can be removed.

Recommendation

That the submission be accepted.

Issue: Light refreshments should be extended

Clause 22

Submission
(New Zealand Law Society)

The concept of light refreshments in proposed section CW 17CB(2)(c) should be extended to cover snack food items such as biscuits and fruit as well as fluids such as tea and coffee.

Comment

It is intended that such small snacks be exempted so specifying this in the legislation would be useful.

Recommendation

That the submission be accepted.

Issue: Scope of working meal exemption too narrow

Clause 22

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

Proposed section CW 17CB(2)(a) exempts meals that are arranged as an alternative to a formal meeting. This section should be amended to include meals provided as part of a formal meeting. This could be achieved by inserting the words "or part of" after "alternative to". *(New Zealand Institute of Chartered Accountants)*

The criteria for a working meal to be exempt income should be broadened to capture all working meals that take place as part of an employer's business activities when an employee's duties require them to attend and participate. *(New Zealand Law Society)*

Comment

Officials agree that the words "or part of" could be added to the section as suggested in the New Zealand Institute of Chartered Accountants' submission. With regards to the New Zealand Law Society submission, officials do not consider such amendment is necessary as these situations will be covered by the legislation as drafted.

Recommendation

That the submission to insert the words "or part of" be accepted.

That the New Zealand Law Society submission be declined.

Issue: Meal provision drafting issues

Clause 22

Submission
(KPMG)

The reference to "employer's workplace" in new section CW 17CB should be replaced with "workplace" (as that term is defined in new section CW 16B) for clarity.

Similarly the reference to "employment base" should also be replaced with workplace or alternatively "employment base" should be defined. "Accommodation base" should also be defined.

Comment

The reference to "employer's workplace" in new section CW 17CB is necessary as otherwise employees who are working at a client's workplace (for example, an auditor working at the client's workplace) would not qualify for the exemption. "Employment base" is consistent with use elsewhere in the Income Tax Act, in particular in relation to sustenance allowances.

Officials do not consider it necessary to define the terms as suggested – the ordinary dictionary meaning is sufficient.

Recommendation

That the submission be declined.

Issue: Meal exemption time limit

Clause 22

Submission
(KPMG)

We support the intention of the new rule, however, see no reason why the meal exemption time limits should not match the accommodation periods. They should be aligned for consistency.

Comment

Providing an exemption for an employee's meal costs when they are travelling away from home for work recognises that employees may have to spend more on their food and drink than they would otherwise. When an employer reimburses the cost of a work-related meal, the amount saved by the employee (in other words their normal expenditure on the meal) is arguably taxable. However, it would not be practical to carry out an apportionment each time a meal payment is made. The bill seeks to find a practical solution.

Any comparison between meal costs when travelling on a work trip and normal day-to-day meal costs is likely to be between the costs of dining out and self-catering. On short term trips an employee usually stays in a hotel, or similar accommodation, without self-catering facilities, and therefore has to buy catered food. When undertaking a longer journey or secondment, this is likely to change after a period of time. An employer is likely to be reluctant to fund restaurant meals on a long-term basis and the employee will often move to self-catering accommodation. At that point the meal costs are not likely to be significantly greater than the normal day-to-day costs at home and the case for allowing tax-free treatment diminishes.

Therefore, the rule proposed in the bill exempts meal payments linked to work-related travel for a period of up to three months. This time limit is designed to recognise that when an employee is away from their normal work location for a short period they are likely to incur significantly higher costs for meals but that these costs are likely to normalise after a period of time.

Recommendation

That the submission be declined.

Issue: Restarting of time period for exemption

Clause 22

Submission
(New Zealand Institute of Chartered Accountants)

The legislation should clarify that the three-month exemption period will begin again in situations when an employee is carrying out consecutive out-of-town secondments (in different locations).

Comment

Officials consider that the proposed provision is sufficiently clear, but propose that examples be provided in the *Tax Information Bulletin* following enactment of the bill.

Recommendation

That the submission be noted.

Issue: Flexibility of time limits

Clause 22

Submissions
(KPMG, New Zealand Institute of Chartered Accountants)

If the submission regarding matching the meal exemption time limits with those for accommodation is not accepted, the Commissioner of Inland Revenue should have a legislative discretion to extend the period for exempt meals. *(KPMG)*

In addition, the Commissioner should have the flexibility to extend the time limit in exceptional circumstances. This ability exists in relation to accommodation and should be mirrored for meals. *(KPMG, New Zealand Institute of Chartered Accountants)*

Comment

The accommodation extension is designed to ensure that if some serious adverse event occurs that prevents the employee from leaving the accommodation as expected and within the statutory time limits, there is no taxable impact as a result. Officials agree that this "exceptional circumstances" rule should be mirrored for meals. Officials do not agree, however, that a more general discretion to extend the time period should be permitted. The "exceptional circumstances" provision is a very restricted ability to extend, in order to ensure clarity and consistency in the rules, and a more general discretion would undermine that consistency and clarity.

Recommendation

That the submission regarding a general discretion to extend time limits be declined.

That the submission in respect of the exceptional circumstances flexibility be accepted.

Issue: Application date of meal allowance provisions

Clauses 2 and 22

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

Before the release of the officials' issues paper, *Reviewing the tax treatment of employee allowances and other expenditure payments* in November 2012, a number of employers were treating meals as tax-exempt when related to work travel, on the basis that very little private benefit arose to the employee as the meals were required for work. The issues paper determined that work-related meal payments are taxable on the basis that meal payments have an inherent private value because people need to eat. This has been subject to debate between taxpayers and Inland Revenue.

The proposed application date of 1 April 2015 creates significant uncertainty about how meal payments should be treated before that date and creates a risk that earlier positions will be challenged by Inland Revenue.

The application of the meals provision should therefore be backdated to, at a minimum, the November 2012 issue of the officials' issues paper *(Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants)*; or preferably the statute bar, using a similar transitional provision to that for accommodation *(Corporate Taxpayers Group, Deloitte).*

Comment

Officials agree the provision should be backdated to 1 April 2011, subject to the employer not having a tax position that the payments were taxable. Employers will have taken different tax positions and providing the ability to elect to retrospectively apply the rules would allow the status quo to continue without the risk of audit or the need to re-open positions provided they fall within the proposed new rules.

Recommendation

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

DISTINCTIVE WORK CLOTHING

Issue: Clothing proposal should proceed

Clause 23

Submissions
(Business New Zealand, Corporate Taxpayers Group, Ernst & Young)

Extending the existing definition of "distinctive work clothing" outlined in section CX 30(2) for clothing allowances should provide greater clarity to businesses and therefore should proceed. *(Business New Zealand)*

The proposals ensure neutrality between the FBT treatment of distinctive work clothing and the allowance/reimbursement rules regarding the same. *(Corporate Taxpayers Group)*

The provision is welcomed subject to one wording suggestion (see subsequent submission regarding section CW 17CC(3)(c)(ii)). *(Ernst & Young)*

Comment

Officials welcome submitters' comments that the proposed changes will provide greater clarity.

Recommendation

That the submissions be noted.

Issue: Exemption should be extended

Clause 23

Submission
(New Zealand Law Society, Waikato District Health Board)

Other employers have historically provided plain clothes that were partly exempt from tax. The submitter accepts the conditions of the exemption in proposed section CW 17CC but it should be widened to include employers who treated such allowances as partly exempt and partly taxable as a matter of practice (rather than limiting to those who specified the treatment in employment terms and conditions). *(New Zealand Law Society)*

The exemption should be extended to allow it to deal with other circumstances, in particular mental health clinicians. The requirement that a uniform is provided, that the allowance was in place on 1 July 2013 and reference to a portion of it having been treated as taxable should be removed from the conditions of the exemption. *(Waikato District Health Board)*

Comment

Although the proposed change is intended primarily to clarify the tax treatment of allowances provided to plain clothes police, it is open to other employees provided they meet the criteria set out in the provision. As many employees are required to wear their own clothing for work, the general position is that allowances for such clothing should be taxable. The proposed exemption is only intended to apply in very limited circumstances, being those where an employee is supplied with a uniform, but because of the nature of their current duties their employer requires them to wear plain clothes. Proposed section CW 17CC deals only with "distinctive work clothing". The proposed change does not alter the tax treatment of other clothing allowances under the general rule in section CW 17 that provides for a payment to be exempt if it can be shown that it is not a private benefit.

Recommendation

That the submission be declined.

Issue: Exemption requires amendments to ensure plain clothes police covered

Clause 23

Submission
(Police Association)

We welcome the decision to provide an exemption that covers the police plain clothes allowance, however as currently drafted it will not necessarily achieve this objective. The requirements relating to an allowance having been treated as partially taxable and partially exempt, and the requirement that these portions retain a constant ratio are problematic.

Comment

Officials have discussed the exemption with officials from Police and representatives from the Police Association. The concerns regarding the current drafting chiefly relate to the requirement in proposed section CW 17CC(3)(c)(ii) that the allowance has been treated as partly taxable and partly exempt. Police historically treated the plain clothes allowance in this way, however in 1998 the taxable component was brought into salary. There are therefore concerns about whether this condition would be met.

The exemption in section CW 17CC is intended to cover police plain clothes allowances and therefore officials recommend some minor drafting changes, which have been discussed with the submitter and will be incorporated into the revised tracked version of the bill, to ensure these allowances do indeed fall within the definition.

Recommendation

That the submission be accepted.

Issue: Wording of proposed section CW 17CC(3)(c)(ii) should be revised

Clause 23

Submission
(Ernst & Young)

Proposed section CW 17CC(3)(c)(ii) refers to general terms and conditions of employment providing for part of a payment to be treated as exempt income of the employee. Technically it may be argued that no contractual agreement or general terms and conditions can determine the tax characterisation of any particular payment. To avoid uncertainty the submitter suggests it would be preferable to refer to the allowances as "tax-free" or as being receivable by employees on a net basis.

Comment

As noted above, officials are recommending some changes to section CW 17CC to ensure police plain clothes allowances fall within the exemption. As a result the wording identified by the submitter is being altered.

Recommendation

That the submission be noted and that the provision is being redrafted as a result of the previous submission.

Issue: Drafting clarifications in clause 21

Clause 21

Submissions
(Corporate Taxpayers Group, Deloitte)

Proposed section CW 17(2B) would require that the expenditure in question is incurred, or an amount paid, because the employee is "performing an obligation" required by their employment or service. This may cause some concerns in the absence of very clear commentary. *(Corporate Taxpayers Group)*

Proposed paragraphs (b) and (c) should be deleted from proposed new section CW 17(2B) on the basis they would be superfluous to any income nexus requirements which already exist by way of sections DA 1 and DA 2. They could also create uncertainty and possible dispute over whether employees are deriving any or all employment income "through the performance of the obligation" and who should judge the "necessity" of performing the obligation. *(Ernst & Young)*

Comment

Officials note that while there is some cross-over between the general permissions and limitations on deductibility in sections DA 1 and DA 2 of the Income Tax Act and proposed paragraphs (b) and (c) of proposed new section CW 17(2B), these paragraphs are included for clarity. The drafting of the proposed section is intended to codify the principles from case law in this area, namely that the expense must be connected with the employee carrying out their job.

Recommendation

That the submissions be declined.

Issue: Determinations for a "wide" group of employees

Clause 21

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

As drafted, a determination can only be made when the payment is made to or on behalf of a "wide group" of employees. We consider this to be an ambiguous term requiring clarification – either by removing the word "wide" or by way of commentary that gives clarity to the meaning of "wide". *(Corporate Taxpayers Group)*

"Wide" should be removed as it is uncertain. *(New Zealand Institute of Chartered Accountants)*

Comment

The determination-making power is proposed to be available only in respect of payments made to a wide group of employees to ensure that issues on which the Commissioner is asked to make a determination are of sufficient importance to the wider business community. Officials do not consider this to be an issue that requires amendment to the draft legislation, but some clarification could be included in the *Tax Information Bulletin* following enactment of the bill.

Recommendation

That the submissions be declined subject to officials' comments regarding the inclusion of some further clarification in the *Tax Information Bulletin*.

Issue: Determination on communication payments

Clause 21

Submission
(Deloitte)

Given the general uncertainty we recommend that a determination is issued as soon as the bill is enacted clarifying how communication costs (including phone lines, mobile phones and internet connections) should be taxed.

Comment

This submission is noted by officials. The merits of issuing a determination on this issue will be considered on enactment of the legislation and provided an application is made for a determination on this matter.

Recommendation

That the submission be noted.

Issue: Consultation on determinations

Clause 21

Submission
(PricewaterhouseCoopers)

We welcome the ability for the Commissioner to issue determinations and expect there will be a desire for these to be issued shortly after enactment. We would welcome consultation on which determination would be of most benefit to the tax community.

Comment

Officials note the submission. As discussed above, the merits of issuing a particular determination will be considered on enactment and following taxpayer application for a determination on a given payment. Officials are also willing to consult with interested parties on which issues deserve priority.

Recommendation

That the submission be noted.

Issue: Determination power should not be limited as proposed

Clause 21

Submission
(Ernst & Young)

The power to make determinations in this area should not be limited as proposed but rather generalised to cover all employer-provided items, including accommodation, meals and work clothing as well as other matters. The Commissioner of Inland Revenue would then be able to consider and deal expeditiously with various employer and employee situations and issues that may arise from time to time, but which do not fit appropriately within the boundaries already provided by the statutory provisions.

Comment

Before 1994, the Commissioner of Inland Revenue approved whether allowances and other employer payments could be treated as tax-exempt. This process created inconsistencies and was resource-intensive so instead a principles-based approach was included in the Income Tax Act. That approach was based on whether there was a nexus between the payment and the employee's earning their employment income.

This principles-based approach has raised some issues in particular areas and it was considered greater certainty was needed, so various "bright lines" and other rules have been introduced in this bill, dealing with accommodation, meals and clothing. These cover off all the main issues that were of concern. There is also still the general fall-back rule for other situations. Too wide a discretion could take us back to the pre-1994 approach however, and risk inconsistencies. Therefore a narrow discretion is preferred.

Recommendation

That the submission be declined.

OTHER MATTERS

Issue: Extension of FBT health and safety exemption to reimbursing payments made by employers

Submission
(Corporate Taxpayers Group, Ernst & Young, New Zealand Institute of Chartered Accountants, Tax Team)

Currently benefits provided to employees related to their health and safety are exempt from FBT under section CX 24. This would include the provision of safety equipment and clothing. However, if the employer were to provide the employee with an allowance to purchase their own safety gear, this amount could be taxable on the basis that it would not meet the definition of “distinctive work clothing”. The lack of neutrality between the FBT and allowances treatment is not desirable. Other items raised by submitters as falling under the FBT exemption but not exempt under the allowances/reimbursements treatment are eye and hearing tests, and associated aids, and influenza vaccinations.

Comment

Submitters note there is a disparity between the FBT rules and the allowance/reimbursement rules in relation to the treatment of health and safety-related benefits. Officials recommend further consideration of whether there should be greater alignment of the two sets of rules. However we do not recommend making any changes in this bill. This is because further analysis and consultation will be required to determine the potential effect of any such changes, and as noted below in relation to a submission regarding eye care, consideration may need to be given to whether certain items should continue to fall within the FBT exemption.

Recommendation

That the submission be declined.

Issue: Eye care payments

Submissions
(Police Association, Tax Team)

There should be an exemption for reimbursement payments for eye tests for employees who spend at least half their working day on VDU duties. *(Police Association)*

There should be a rule in both the FBT and PAYE (allowances) rules to exempt from tax a portion of vision aid (glasses or lenses) costs. This could be done by either inserting specific eye care provisions or a general health and safety exemption which includes eye care. Any such provision should have retrospective application. *(Tax Team)*

Comment

Submitters note there is currently a disparity between the FBT and reimbursement (PAYE) rules regarding the treatment of costs of eye examinations. The FBT rules contain an exemption from FBT for benefits related to health and safety, irrespective of whether these benefits are provided on or off the employer's premises. This FBT exemption came about because various health and safety benefits were exempt if provided on the employer's premises but not if they were provided off-premises.

When this amendment was introduced in the Taxation (Depreciation, Payment Dates Alignment, FBT and Miscellaneous Provisions) Act 2006, the Commentary to the bill and the subsequent *Tax Information Bulletin* (Vol 18, No 5, June 2006) made it clear that eye examinations were something that was contemplated as covered in appropriate circumstances. This was largely in relation to employees working for periods at VDU computer monitors.

We note that the most recent advice from the (then) Department of Labour (*Guidelines for using computers*, November 2010) states that several long-term scientific studies comparing computer users and non-computer users have shown that natural eyesight deterioration is not necessarily increased through computer use. The *Guidelines* also state that it is not a legal requirement for an employer to pay for an eye examination, although it may be good staff relations in circumstances where an employee is required to spend a significant amount of time at computers and/or monitors.

The cost of eye examinations and corrective lenses are not considered exempt when paid to the employee by way of reimbursement rather than paid directly by the employer. As noted above, when paid directly by the employer, they fall within the FBT rules, which contain an exemption from FBT for health and safety benefits. If paid by the employee and then reimbursed by the employer, the question of whether they are taxable is determined by reference to section CW 17.

The key determining factor is whether the expenditure would be deductible to the employee (if it were not for the limitation on claiming employment expenditure). What is deductible is determined by referring to the general deductibility rules in section DA 1 and the limitations contained in section DA 2. The issue for eye examinations and corrective lenses is the private limitation, which essentially means payments of a private or domestic nature will not be exempt income because they arise from the employee's personal circumstances rather than from their employment.

It is therefore possible that consideration needs to be given about whether, in fact, eye examinations and payments for corrective lenses should fall within the health and safety FBT exemption. As noted in relation to the general submission on the extension of the FBT health and safety exemption to allowances and reimbursements, this is something that requires further consideration and therefore officials do not recommend proceeding with this matter in this bill.

Recommendation

That the submissions be declined.

Issue: Travel costs for FIFO workers

Submission
(KPMG)

At present it is unclear whether an FBT liability is created when an employer transports a fly-in fly-out worker to and from the workplace. We consider many employers would be guided by the accommodation treatment and apply the net benefit test. Such travel should be treated as non-taxable if there is no private benefit to the employee. This is a cost to a business from locating employees to carry out their duties in typically high risk areas. This can be contrasted with the arguments for taxing accommodation, which is a necessity of life.

Comment

The intention of the review and the proposed legislation is to deal with the rules regarding the treatment of employee allowances and other expenditure payments, not fringe benefits. The FBT rules are not being altered so, to the extent to which the costs referred to by the submitter give rise to a fringe benefit, which may or may not be taxable, the position remains unchanged. The submission is therefore outside the scope of this bill but this does not preclude it being considered at a later time if there is sufficient concern from affected parties.

Recommendation

That the submission be declined.

Issue: Minor drafting matters

Clause 20

Submission
(Ernst & Young)

The word "on" should be removed from the opening words of proposed section CW 17CB(5)(a) as it is duplicated in the following subparagraphs.

There appears to be a duplicated reference to "distant workplace" in the proposed section YA 1 definition of that term.

Comment

Officials agree that these references are duplicated and can therefore be removed.

Recommendation

That the submission be accepted.

Issue: Other minor drafting matters

Clauses 12 and 20

Submission
(KPMG)

The reference in new section CE 1C(1) should be to new section CE 1B(1).

The reference to “for 1 or more nights” in the definition of “period of continuous work” appears to be redundant.

New section CW 16E(b)(ii) appears to be redundant as the two-year time limit is already explicit in the definition of out-of-town secondment in new section CW 16B(4).

Comment

Officials agree that the reference in CE 1C(1) should be amended as suggested. Officials do not consider the remaining suggested changes are necessary.

Recommendation

That the submission regarding CE 1C(1) be accepted.

That the remaining aspect of the submission be declined.

Thin capitalisation rules

OVERVIEW

The thin capitalisation rules form part of New Zealand's international tax rules and are designed to protect our tax base.

The thin capitalisation rules have generally been operating effectively. However, Inland Revenue's investigators, through their normal audit work, have come across some situations where the rules appear deficient. The bill proposes changes to the rules that will address these deficiencies.

Two primary changes are proposed in the bill. The first expands the thin capitalisation rules so they apply when a group of non-residents appear to be acting as a group and own 50 percent or more of a New Zealand investment. This will address the fact that the rules currently only apply when a single non-resident controls a New Zealand investment, even though groups of investors can often act together in a way that mimics control by a single investor.

The second change proposed is to ignore shareholder-linked debt when taxpayers are calculating their allowable level of New Zealand debt under the rules. This will prevent non-residents from excessively gearing their New Zealand investments when they have excessively geared their worldwide operations with shareholder debt.

The bill also proposes three further changes:

- expanding the rules so they apply more broadly to trusts that have been settled by non-residents;
- ignoring revaluations in asset values where the revaluation is generally not permitted under accounting standards; and
- requiring individuals and trustees to exclude their indirect interests in offshore companies if their interest is held through a company they are associated with.

Ten submissions were received in relation to the thin capitalisation proposals included in the bill. Most generally supported the changes but raised a number of issues. As a result, officials are recommending changes to clarify when the rules apply and to reduce the compliance costs of the proposed amendments. Officials are also recommending a number of drafting and technical changes.

GENERAL COMMENTS

Issue: General comments on the changes

Clauses 2(25), 87 to 98 and 123(32)

Submissions
(PricewaterhouseCoopers, KPMG, Ernst & Young, Corporate Taxpayers Group, Deloitte, Staples Rodway, New Zealand Council of Trade Unions)

Several submitters supported the proposed changes to the thin capitalisation rules in principle. They noted there were gaps in the current rules and that it was appropriate for these to be closed.

Some submitters, however, expressed concern with certain elements of the changes, such as a lack of certainty over when the rules will apply. Others did not support all aspects of the proposed changes such as the proposal to disregard certain uplifts in asset values.

One submitter suggested the changes should not proceed: the thin capitalisation rules play a role when non-residents decide to invest in New Zealand. Extending the thin capitalisation rules to cover non-residents that act together may therefore deter investment in New Zealand. Further, the thin capitalisation rules discriminate against non-resident investors since they do not apply to domestic investment. *(Staples Rodway)*

Another submitter said the proposed changes are too cautious and that more work should be done to prevent tax avoidance by overseas investors. Consideration should be been given to further lowering of the safe harbour level of allowable debt (currently 60 percent of assets). Further, the burden of proof on whether overseas investors are "acting together" should be placed on taxpayers – any company where 50 percent or more of its shares are owned by non-residents should be subject to the thin capitalisation rules unless the shareholders can demonstrate they are not acting together. *(New Zealand Council of Trade Unions)*

Comment

Officials note the comments supporting the broad direction of reforms and suggest changes recommended in this report will address many submitters' concerns. These changes should, for example, increase certainty over when and how the rules will apply.

Officials do not agree that the changes should not proceed. Most submitters acknowledged there are weaknesses in the current rules and that these need to be dealt with.

Officials consider it appropriate that the thin capitalisation rules apply only to non-resident-controlled companies. This is the international norm.

Officials also do not agree that the reforms are too cautious. Throughout the policy development process submitters have stressed the importance of certainty when taxpayers are making decisions about large investment projects. Placing a strong burden of proof on taxpayers that they are not acting together would create significant uncertainty. The rules have been designed to be as certain as possible while still providing appropriate base protection.

Changes to the "safe harbour" were not considered as part of the review of the thin capitalisation rules. This was because the safe harbour was only recently lowered (as was recommended by the Victoria University of Wellington Tax Working Group).

Recommendation

That the submissions supporting the reforms be noted and that the other submissions be declined.

Issue: Treatment of look-through entities

Submission
(KPMG)

If an entity is treated as look-through for New Zealand tax purposes, such as a limited partnership, and is used as an investment vehicle in New Zealand, the tested entity for thin capitalisation purposes will be the individual partners, not the partnership.

This is illogical. The tested entity should be the limited partnership, not the partners in the partnership. Were this change made, the partnership itself would be subject to the thin capitalisation rules on the basis that it is owned by non-residents who are acting together.

This has significant implications for large infrastructure projects such as Public-Private Partnerships (PPPs). These projects typically have high levels of third-party gearing, but it is unlikely that such high gearing would be allowed under the current treatment of limited partnerships. If, however, limited partnerships were treated as the tested entity, the modified rules for entities that are controlled by non-residents acting together would apply. This would mean any third-party debt would (in essence) no longer be counted for the thin capitalisation rules.

Comment

Limited partnerships are transparent for New Zealand tax purposes. This means the partnership is disregarded; instead, the partners are treated as carrying on the business of the partnership. A consequence is that each non-resident partner is considered a single non-resident controller of a New Zealand investment.

Officials do not believe changes should be made to the thin capitalisation treatment of limited partnerships without reviewing the rules for those entities more generally. Treating limited partnerships as opaque for thin capitalisation but transparent for other purposes may provide taxpayers with avoidance opportunities.

We also note that changing the tax treatment of limited partnerships, even if such a change were isolated to the thin capitalisation rules, would be a significant shift in policy. It would be important to consult fully on any such change.

Recommendation

That the submission be declined.

Issue: Allowable debt test for single non-resident controllers

Submission
(KPMG)

The current thin capitalisation rules, where all debt is counted when determining if a company has too much debt, will continue to apply where a single non-resident investor holds a 50 percent or greater interest in a New Zealand investment. For companies controlled by non-residents acting together, however, only related-party debt will be counted.

This puts single non-resident investors at a disadvantage. The proposed rules for non-residents acting together should be extended to single non-resident controllers.

This issue is particularly pertinent for Public-Private Partnerships (PPP) projects. It puts a potential investor in a PPP who is a non-resident acting alone at a disadvantage compared with a group of non-residents acting together.

The submitter did note that the change could potentially allow non-residents to allocate debt that truly belongs elsewhere to New Zealand but contended that other changes to the rules, such as the exclusion of shareholder guaranteed debt from the worldwide group debt test, will limit this ability.

Comment

The proposed changes will deem the worldwide group of a New Zealand company owned by non-resident shareholders who are "acting together" to be just its New Zealand group. In effect, this means these companies will be unrestricted in how much they can borrow from genuine third-parties. This was done for practical reasons. Applying the standard worldwide group test to shareholders acting together is not feasible. It would be extremely difficult to meaningfully consolidate the debts and assets of the company's shareholders (who are presumably unrelated parties) to construct a worldwide group as it relates to their New Zealand investments.

Companies controlled by single non-residents do not face this problem. They can use the worldwide group debt test as it currently stands. This means if the parent company's worldwide operations are highly geared, the New Zealand operation can use the worldwide group debt test to justify a high level of gearing in New Zealand.

The suggested change would also provide companies controlled by a single non-resident with two methods for applying the worldwide group debt test: the existing test (based on the debt-to-asset ratio of the worldwide debt), and the new modified test for those "acting together" (that allows unlimited borrowing from third-parties). The companies could pick and choose the method that would best suit them.

Officials therefore do not support changing the worldwide group debt test for companies controlled by single non-residents at this time.

Recommendation

That the submission be declined.

Issue: Complexity of the proposed amendments

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

The amendments to the thin capitalisation rules are complex. Given this, the amendments to the thin capitalisation rules should be separated from the rest of the bill and progressed at a slower pace. This would allow sufficient time to ensure all of the amendments are appropriately drafted. *(Ernst & Young, New Zealand Institute of Chartered Accountants)*

The amendments are complex and will impose additional compliance costs on taxpayers, yet the expected fiscal gain, as reported in the regulatory impact statement, is only $20 million over three years. It is not clear the appropriate balance between complexity and revenue protection has been achieved. (*New Zealand Institute of Chartered Accountants)*

Given the complexity of the rules, a mechanism should be introduced that allows taxpayers to apply to the Commissioner of Inland Revenue for a thin capitalisation determination. This would cover whether, and how, the rules apply to the taxpayer – for example, what its New Zealand and worldwide groups are, and its relevant debt-to-asset ratios. (*Ernst & Young)*

Comment

The changes being recommended in this report should address many of submitters' concerns about the complexity and uncertainty in the rules.

Officials do not consider the changes should be broken out from the bill as the next available omnibus tax bill is unlikely to have passed before the beginning of the 2015–16 income year for many taxpayers. Delaying enactment of these provisions could create uncertainty.

We also do not agree than the changes are too complex given the forecast revenue impact. The thin capitalisation rules are an important part of New Zealand's international tax rules, helping ensure non-resident investors pay an appropriate amount of tax in New Zealand. It is important that the rules work effectively. Without the proposed changes the revenue lost could grow over time as the global economy recovers, increasing non-residents' demand for investment opportunities.

In terms of providing a determination mechanism, we note that taxpayers can request binding rulings on elements of the thin capitalisation rules. While binding rulings are restricted to questions of law, such a ruling could cover questions such as whether the rules apply to an entity based on the facts described. There are also numerous complex regimes in the Income Tax Act yet almost all of these do not feature a special determination mechanism. We do not recommend a determination mechanism for thin capitalisation be inserted through this bill.

Recommendation

That the submissions be declined.

Issue: Introduction of a de minimis threshold

Submission

(PricewaterhouseCoopers)

Consideration should be given to the introduction of a de minimis threshold for the inbound thin capitalisation rules. The rules are complex and these changes make them even more so. A de minimis threshold would reduce compliance requirements for smaller non-resident owned companies.

Comment

A de minimis of $1 million of interest deductions would generally allow each company under that threshold to have an additional $400,000 of interest deductions taken in New Zealand compared with if the thin capitalisation rules applied. This could have a moderate fiscal cost.

The question of a de minimis was not raised during the two rounds of consultation while the changes were being developed. Little is known about the type and number of firms that would be covered by a de minimis, their difficulties in complying with the legislation, or whether a de minimis would be the best response.

Given these factors, officials do not recommend a de minimis threshold for the inbound thin capitalisation rules at this time.

The submitter raised the fact that the outbound thin capitalisation rules have a de minimis of $1 million of interest deductions. The rules do not apply below this threshold. Australia similarly has a de minimis, applying to both its outbound and inbound thin capitalisation rules. This will be increasing to $2 million of interest deductions from 1 July 2014.

In terms of providing a de minimis, officials note there are different considerations that need to be borne in mind when comparing the inbound and outbound rules. Given New Zealand's imputation system, New Zealand-owned companies have a natural incentive to pay tax in New Zealand and therefore place their debt offshore. The New Zealand tax base is therefore protected somewhat even for companies that fall below the de minimis threshold of the outbound rules. The same considerations do not apply for non-resident owned companies, who normally do not face the same incentives to pay tax in New Zealand.

Recommendation

That the submission be declined.

Issue: Revised guidance on the rules

Submission
(PricewaterhouseCoopers)

A comprehensive *Tax Information Bulletin* article explaining the thin capitalisation rules was released when they were first introduced. Given the significant changes to the rules in this bill, together with other changes to the rules (such as the introduction of the outbound and banking thin capitalisation regimes), it is timely that Inland Revenue issue revised guidance on the rules in their entirety.

Comment

Officials will prepare a *Tax Information Bulletin* once the bill is enacted, setting out how the new rules are intended to operate.

Officials will pass the request for guidance on the rules in their entirety to the relevant areas of Inland Revenue for consideration alongside their other priorities.

Recommendation

That the submission be noted.

Issue: Grandparenting

Submission
(Staples Rodway)

Grandparenting provisions should be provided so existing investments are not affected by these proposals. Without grandparenting, some existing investments will likely breach their thin capitalisation limits. They will start having interest deductions denied unless they restructure their debt – this restructuring may be costly.

Comment

The application date for these changes is the beginning of the 2015–16 income year (for most taxpayers this will be 1 April 2015). This is a long lead time given the changes were first announced in January 2013. Officials believe this gives taxpayers sufficient time to change their financing arrangements if that is necessary.

Grandparenting would favour existing investments over new investments. It would also create boundary issues in distinguishing whether some funding was the continuation of an existing investment or a new investment. This would require complex or potentially arbitrary rules.

Recommendation

That the submission be declined.

Issue: Changes to the introductory section

Clause 87

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

The proposed changes to section FE 1 refer to adjustments of interest deductions if the level of interest expenditure incurred in New Zealand is too high. This wording is inappropriate as the thin capitalisation rules look only at the amount of debt in New Zealand, not the amount of interest expenditure in New Zealand.

Comment

Officials agree. The introduction to the rules should reflect that they operate based on levels of debt, not levels of interest deductions.

Recommendation

That the submission be accepted.

Issue: Application date

Clause 2(25)

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

The application date of the 2015–16 year is appropriate.

Comment

Officials agree. This application date will ensure taxpayers have the opportunity to consider how the new rules will affect them before they take effect.

Recommendation

That the submission be noted.

PERSONS THE RULES APPLY TO

Issue: Use of the term "acting as a group"

Clause 88

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

The proposed changes refer to persons "acting together as a group" in several places, such as in determining whether the rules apply to a company that is owned by a trustee and other persons acting together with the trustee.

The phrase "acting together as a group" is expressed without any limitation, context or purpose. It is not used elsewhere in the legislation. This creates undue uncertainty as to whether the thin capitalisation rules will apply. A more certain test should be provided.

The phrase "acting in concert" should be used instead of "acting as a group". That phrase has an established meaning in both case law and other legislation. *(Staples Rodway)*

Comment

Officials agree that referring to persons that are "acting together as a group" is not necessary in proposed section FE 2(1)(cc). This section is intended to catch, among other things, companies that are controlled by a group comprising a trustee (or trustees) and other persons where both the trustee and the other persons are subject to the thin capitalisation rules.

In defining whether a company controlled by a group of trustees and other persons should be subject to the rules, officials consider that the same concepts employed in the definition of a non-resident owning body could be used instead. This would mean, for example, the company would be subject to the rules if the group holds debt in proportion to equity in the company.

This should provide more certainty about when the thin capitalisation rules apply when a company's shareholders include a trust.

Proposed section FE 2(1)(d)(iii) also refers to "a group of persons who act together as a group" to settle a trust. In the case of settling a trust it is not possible to use the concepts used for a non-resident owning body. It does not make sense, for example, to refer to proportionality of settlements and debt lent to a trust as there is no link between settlements on a trust and entitlement to income from the trust.

Officials do not think it possible to provide a more certain rule for when the rules should apply to a trust settled by a group of people. During the policy development process, officials asked several submitters if they had any suggestions for a more certain rule. None were received.

Officials consider it important that the rules apply to trusts settled by a group of non-residents acting together. This will ensure a group of investors cannot easily circumvent the rules through the use of a trust.

We note the rule is unlikely to create much uncertainty in practice as trusts are not a common part of a commercial company structure. Further, greater certainty can be achieved by channelling an investment through a company.

In terms of the specific wording of when people are acting together, officials consider that "acting in concert" and "acting together as a group" have much the same meaning. Officials recommend the specific wording used be changed in section FE 2(1)(d)(iii) to "acting in concert" on the basis it is used elsewhere in New Zealand legislation.

Recommendation

That the submission in relation to the wording in proposed section FE 2(1)(cc) be accepted.

That the submission in relation to section FE 2(1)(d)(iii) be declined except in relation to the phrase "acting in concert".

Issue: The meaning of "control by any other means" is unclear

Clause 88

Submission
(Ernst & Young)

The bill proposes that the thin capitalisation rules will apply to a company if a non-resident owning body has control of that company "by any other means". While this phrase is used in the existing rules, its intended meaning has never been clear. Inland Revenue should provide guidance on the meaning of this phrase.

Comment

The proposed extensions of whom the thin capitulation rules apply to are designed to mirror the existing rules. This includes the paragraph that provides the rules apply where a company is controlled by "any other means".

Officials will convey the request for more guidance on the phrase to the relevant areas of Inland Revenue for consideration alongside other priorities.

Recommendation

That the submission be noted.

Issue: Meaning of "settlements" on a trust

Clause 88

Submission
(Ernst & Young)

A trust will be subject to the thin capitalisation rules if 50 percent or more of the settlements on the trust are made by a non-resident. Whether a settlor is non-resident should be tested at the time the settlement is made. A trust should not be subject to the rules if, say, it is settled by a person who is a resident but later becomes a non-resident.

Further, the definition of "settlement" for tax purposes is very wide. It includes the provision of services for below market value, for example. There can be difficulties in determining the value of these types of settlements. For thin capitalisation purposes, a settlement should include only dispositions of property.

Comment

The definition of "settlement" for tax purposes is intentionally very wide, designed to capture all transfers of value to a trust. This is to ensure the rules operate robustly. Officials do not see a strong case for using a narrower definition of settlement only in the thin capitalisation rules.

Officials do not agree that the residence of a settlor should only be tested at the time of settlement. If a resident owner of a New Zealand company moves offshore, the thin capitalisation rules will begin applying to the company. It seems reasonable for settlors of a trust to be treated in a similar manner.

Recommendation

That the submission be declined.

NON-RESIDENT OWNING BODY

Issue: General comment on the definition

Clause 90

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

Whether a company owned by several non-residents will be subject to the thin capitalisation rules will turn on the definition of a "non-resident owning body".

This definition is too vague. A significant degree of uncertainty exists about how the tests will apply in practice to the various forms of investment vehicles and commercial arrangements that are commonly used by international investors. *(New Zealand Institute of Chartered Accountants)*

If appropriate clarity cannot be provided in the definition of "non-resident owning body", the concept should be removed and replaced with a rule that specifies that the thin capitalisation rules would apply to all companies where non-residents in aggregate hold greater than 50 percent of a company (with carve-outs for widely held companies). *(Corporate Taxpayers Group)*

Comment

Officials have recommended several amendments to the definition of a "non-resident owning body". These changes should increase certainty over when a group of non-residents will form a non-resident owning body.

Based on this, officials do not believe it necessary (at this stage) to replace the concept with a broader rule as suggested by the Corporate Taxpayers Group. However, we will continue to monitor the application of these rules to ensure they are working appropriately.

Recommendation

That the submission be noted.

Issue: Use of "ownership interests" and "direct ownership interests"

Clause 90

Submission
(Ernst & Young)

The definition of "non-resident owning body" currently refers to members that have debt in a company in proportion to either their ownership interests or direct ownership interests in the company. This could potentially create confusion as the definition of "ownership interests" includes direct ownership interests.

Comment

The reference to both ownership interests and direct ownership interests is intentional. The provision is intended to catch situations when, for example, a non-resident has debt and equity in the same proportion as other shareholders when considering their direct ownership interests, but not their indirect ownership interests. This might arise if, say, the non-resident also had a minor shareholding through a subsidiary.

Recommendation

That the submission be declined.

Issue: Use of the term "approximately"

Clause 90

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

The definition of "non-resident owning body" includes non-residents that hold debt in a New Zealand company that is approximately in the same proportion to the equity they have in the company. While it is clear that the drafting is trying to catch situations where taxpayers have structured their affairs to intentionally avoid the application of the section, the language is too vague and provides no real guidance on what constitutes "approximate proportionality". The wording should be made more certain.

Comment

As submitters have correctly noted, the purpose of the word "approximately" was to capture situations where taxpayers have structured their affairs intentionally to avoid having proportionate debt and equity, such as having debt and equity that are very close, but not exactly, in proportion.

Officials consider more certainty could be provided by omitting the word "approximately" and changing the rule so that:

- it works off proportionality of any of the four kinds of ownership interest, so non-residents cannot say, have proportionate rights to receive income from the company but slightly different voting rights; and
- a specific anti-avoidance provision is included, providing that an arrangement that has the purpose or effect of defeating the intention of the proportionality rule can be disregarded.

This type of wording proposed for the specific anti-avoidance provision is found in several places throughout the Income Tax Act – including elsewhere in the thin capitalisation rules (section FE 11). This similarity in wording should help provide guidance on when the rule might apply.

The modified test is also more certain as it invokes the purpose of the proportionality rule. That is, to target situations where taxpayers are entitled, in substance, either directly or indirectly, to the same proportion of dividend income and interest income from a company.

Recommendation

That the submission be accepted.

Issue: Proportionality does not imply acting together

Clause 90

Submission
(Staples Rodway)

The issues paper on the thin capitalisation changes in the bill stated that a key issue was non-residents who can "collectively act in the same way as an individual controlling shareholder". This concept is not reflected in the definition of "non-resident owning body". One of the key tests in that definition is whether shareholders hold debt and equity in the same proportion. This is not an indication of acting together. There could be many situations where shareholders hold debt in proportion to their equity but have no effective interaction with each other.

Comment

The thin capitalisation rules are designed to apply to companies with shareholders who have the ability to easily manipulate its debt levels or use debt funding in place of equity funding.

When there is proportionality, the level of debt in a company does not change shareholders' exposure to the risk of holding equity in the company or shareholders' overall return. As debt levels increase, the makeup of the return will change (fewer dividends and higher interest payments) but the sum of interest and dividends will be unchanged. Proportionality is therefore a key situation where shareholders have the ability to replace equity with debt.

It is also arguable that at least some degree of coordination among shareholders is required in order to arrive at proportionate debt and equity. Indeed, many of the investment structures looked at by Inland Revenue involving non-residents that appear to be acting together have involved proportionate debt and equity.

Accordingly, officials consider proportionality to be a reasonable indicator of when non-residents are acting together, albeit an objective test rather than a subjective one.

Recommendation

That the submission be noted.

Issue: Shareholder agreement clause is too wide

Clause 90

Submission
(Corporate Taxpayers Group, Ernst & Young, KPMG, New Zealand Institute of Chartered Accountants, New Zealand Law Society, PricewaterhouseCoopers, Russell McVeagh, Staples Rodway)

A non-resident owning body includes a group of shareholders in a company who fund the company under an agreement amongst themselves (such as a shareholder agreement).

The provision should be changed to refer explicitly to debt funding and exclude provisions relating to borrowing from third parties or equity funding. The provision should be targeted at agreements that set out how the shareholders will act together to fund the entity with related-party debt.

It is common for investors to enter into a shareholder agreement. Doing so should therefore not be an indication of shareholders acting together. The rule will also have high compliance costs. Determining whether the words used in a shareholders' agreement constitutes an agreement of how an investment is to be funded may be difficult. This in turn may lead to taxpayers explicitly avoiding clauses on funding in their agreements to circumvent the test. *(Staples Rodway)*

The bill Commentary states that an agreement that sets out how an investment should be funded in the case of a specified event will not constitute meeting this provision if or until that event happens. This is not clear in the proposed legislation. *(Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants)*

Comment

Officials agree that the shareholders' agreement clause in the definition of "non-resident owning body" could be tightened along the lines suggested by submitters. The area of greatest concern is when non-residents have acted together when deciding how to fund the entity with related-party debt or guaranteed debt. Such an agreement would allow the shareholders to easily use debt in place of equity to fund the New Zealand company, or to put debt that truly belonged elsewhere into the company.

Officials recommend that an agreement between shareholders should create a non-resident owning body only if the agreement sets out how a company will be funded with owner-linked debt (as defined by proposed section FE 18(3B)).

Officials disagree with the submitter than a shareholders' agreement should not be an indication of shareholders acting together. The presence of an agreement between shareholders demonstrates that they are coordinated.

This submitter also raised the possibility that taxpayers may structure arrangements to intentionally avoid the application of this rule. Officials will monitor this and will strengthen the rule if necessary to prevent taxpayers structuring to avoid its application.

Finally, officials agree that the exclusion for contingent funding clauses in a shareholder agreement is not clear in the current drafting. This should be made more explicit.

Recommendation

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

Issue: Rights exercised as recommended by a person

Clause 90

Submissions

(Corporate Taxpayers Group, Ernst & Young, KPMG, New Zealand Institute of Chartered Accountants, New Zealand Law Society, Russell McVeagh)

A non-resident owning body also includes a group of non-residents who exercise their ownership rights in a New Zealand investment in a way recommended by a person, or where a person acts on the group members' behalf to exercise their ownership rights.

These provisions are uncertain and potentially excessive. Arguably the provisions could apply if the ownership rights were exercised as recommended by a person on only one occasion in relation to any matter, no matter how insignificant or immaterial. *(Ernst & Young)*

At the least, guidance needs to be provided on what "in a way recommended by a person" means. *(KPMG)*

The provisions could be satisfied if shareholders exercised their rights consistent with recommendations of a company's board of directors, or if several shareholders appointed the same proxy for the purposes of a given resolution. *(New Zealand Law Society, Russell McVeagh)*.

Our understanding is that all members of a non-resident owning body would need to be taking recommendations from the same person. This is not clear in the legislation. *(Corporate Taxpayers Group)*

Would a private equity firm promoting a particular investment to a group of non-resident investors be caught under these provisions? Similarly, a private equity manager may manage an underlying investment vehicle but this should not be taken as managing the underlying business. These provisions should be changed to apply only when a group of non-resident investors are *required* to act on the instructions of a person. *(Ernst & Young)*

These provisions should be changed to refer to situations when a company is "effectively coordinated by a person or group of people". *(New Zealand Institute of Chartered Accountants)*

Comment

Officials believe these provisions could be amended in a similar manner to those relating to shareholders' agreements. The provisions would only apply if shareholders exercise their rights on the recommendations of a person, or a person acts on shareholders' behalf, in relation to owner-linked debt.

This would significantly increase certainty over when the provisions apply and ensure they do not apply in relation to small or trivial matters. This amendment should also ensure that an investment manager managing their fund will not be misconstrued as managing an underlying business they own, unless the investment manager directs their members on how to debt-fund the underlying business.

Officials do not agree that the provision should be changed to refer to when a group of non-resident investors are required to act on the instructions of a person. This would make the provision too narrow.

It is the intention of this section that all members of a non-resident owning body need to be taking recommendations from the same person in order for the provision apply. The submitter's comment to clarify this will be passed to the bill drafters.

Officials do not believe it necessary to change the specific wording of the section to where investors are "effectively coordinated". The current wording, together with the other changes to these provisions, should clearly encapsulate when the provisions should apply.

Recommendation

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

Issue: Exclusion for security interests is appropriate

Clause 90

Submission

(New Zealand Institute of Chartered Accountants)

The bill proposes that a trust will be subject to the thin capitalisation rules if a person who is themselves subject to the rules has the power to appoint or remove the trustees of that trust. However, there is an exclusion to this rule if the person holds the power to change trustees as a security interest over a loan. This exclusion is appropriate.

Comment

Officials agree. Having the thin capitalisation rules apply to trusts where a person has the power to appoint trustees as a security interest could result in overreach. We understand it is common for banks to request this type of security when lending to a trust. Without the exclusion, a trust that is wholly settled by a New Zealand resident may become subject to the rules if it borrowed from a non-resident owned bank. That would be inappropriate.

Recommendation

That the submission be noted.

Issue: Asset uplift proposal should not proceed

Clause 93

Submissions
(Corporate Taxpayers Group, Deloitte)

The proposal to exclude increases in asset values following company restructures from the asset base for thin capitalisation should not proceed. If accounting allows for an increase in asset values, and the taxpayer can justify that value to its auditors, then that higher value should be able to be used for thin capitalisation purposes.

The submitters also noted that following accounting for determining the value of assets was a deliberate design choice, intended to reduce compliance costs. They argued it is inappropriate to deviate from this principle.

Comment

Generally accepted accounting principles (GAAP) require many kinds of asset, including much intangible property such as goodwill, to be valued at cost. Revaluation of such assets is generally not permitted because a reliable value cannot be determined. The main exception to this rule is when an unrelated party pays for the asset as the amount paid for the asset is a reasonable indication of its actual value.

There is a rare circumstance when increases in asset values can be recognised for accounting in the absence of a third-party purchase. This is when a corporate restructure known as a "business combination" is carried out, where two sister companies are effectively merged. Officials understand that all assets subject to the business combination (including intangible property) may be brought across at fair value – which may be above the asset's book value. However, any changes in asset values that cannot be recognised in the absence of the business combination will not be reflected in the combined businesses' parent's consolidated accounts.

Business combinations can therefore be used to increase the value of a non-resident's New Zealand operations – for example, if there is a non-resident parent company that combines two New Zealand companies. This would increase the amount of debt that the New Zealand companies can hold under the 60 percent safe harbour – despite the fact that there has been no increase in the value of assets in the parent company's consolidated accounts. Officials therefore do not believe this type of asset uplift arrangement should be allowed.

Officials do not consider this change will have any significant compliance impact as business combinations are not common.

Recommendation

That the submission be declined.

Issue: Asset uplift rules should only apply prospectively

Clause 93

Submission

(Corporate Taxpayers Group, Deloitte, PricewaterhouseCoopers)

The asset uplift proposals should only apply to asset value increases occurring on or after the date the rules apply. Identifying historic uplifts in asset values could be difficult and therefore would impose significant compliance costs.

Comment

Officials agree that requiring taxpayers to identify and eliminate historic uplifts in asset values would impose significant compliance costs. It is reasonable for this change to apply only to subsequent uplifts.

Recommendation

That the submission be accepted.

Issue: Uplift as part of a larger restructure

Clause 93

Submissions

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

One exemption to the prohibition on including asset uplifts is when the increase in asset value follows a purchase of a parent company by a non-associate.

As currently drafted, this exemption appears to be too narrow. It should be sufficient that a restructure has arisen following a transaction with an unrelated party which affects a New Zealand company or its worldwide group.

Similarly, it is not clear if restructures following the acquisition of a foreign parent company are covered under the exemption. The context of the proposed legislation suggests that the company being acquired must be a New Zealand company. This is not appropriate as it will often be a foreign parent company that is purchased.

Further guidance should be provided on when a restructure could be regarded as part of the acquisition of the group by a third party. Restructures can take some time to implement and may occur a year or longer after the acquisition.

Further guidance should also be given on the meaning of the phrase "a reasonable proportion of the change in value of the company's total assets". *(New Zealand Institute of Chartered Accountants, PricewaterhouseCoopers)*

The "reasonable proportionality" requirement should be deleted as taxpayers already have the burden of establishing that any changes in asset values are appropriate. *(Ernst & Young)*

Comment

The intention of proposed section FE 16(1E) is to allow uplifts to be recognised when a third party has, in essence, purchased a group of companies and part of that purchase price relates to the group's intangible property. Officials understand that, immediately following the purchase, any increase in the value of the intellectual property will be isolated to the parent company of the group (that is, the purchased company). The company may then restructure its worldwide operations, in part to spread this increase in value among all of its subsidiaries.

The situations described by submitters, when a foreign parent company is purchased, should therefore be covered by the section.

Officials will consider whether the drafting could be improved to make this intention clearer. This includes when a restructure can be taken as being related to the acquisition of the group by a third party and what constitutes a "reasonable proportion" of the change in asset values.

Recommendation

That the submissions be noted.

Issue: Exemptions to the uplift rule are appropriate

Clause 93

Submission
(Ernst & Young)

The exemptions provided for the asset uplift rule are appropriate.

Comment

Officials agree. The exemptions allow uplifts to be counted for thin capitalisation purposes where:

- accounting allows assets to be revalued as a general principle; or
- where the uplift is a reflection of the price implicitly paid for the asset by a third party, such as might occur when a third party purchases a company's parent.

Recommendation

That the submission be noted.

Issue: Optional nature of the exemptions

Clause 93

Submission
(KPMG)

Section FE 16(1E) currently provides that a taxpayer *may* include a change in asset value under two circumstances. It is unclear if this means taxpayers can elect not to include the change in value.

Comment

The carve outs are intended to be optional. Officials note that, if a taxpayer chooses not to exercise this option because an asset value has in fact gone down, accounting standards may still require that asset to be impaired.

Officials will consider whether the drafting could be improved.

Recommendation

That the submission be noted.

Issue: Extent of owner-linked debt rule

Clause 94

Submissions

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

The bill proposes to exclude debt that is linked to a person who owns part of a company's worldwide group for the purpose of the group's worldwide debt test. Here, a debt is linked to an owner if they are a party to the loan, have guaranteed the loan, or the loan is part of a back-to-back arrangement the owner is party to.

Shareholder guaranteed loans should not be counted as linked to an owner. A shareholder guaranteed loan does not involve provision of funds by the shareholder to the borrowing company. It therefore cannot be a substitute for equity. There may also be difficulties in finding out whether a loan is guaranteed or not, especially if the borrowing company is outside of the New Zealand group. *(New Zealand Institute of Chartered Accountants, New Zealand Law Society, Russell McVeagh)*

There should be an exemption where an owner on-lends third party borrowing to the worldwide group. *(New Zealand Law Society)*

Debt that has been lent to the worldwide group by an owner should not be excluded if that debt is on the same terms as genuine third-party debt. This would ensure the loan is for a commercial level of debt. *(New Zealand Institute of Chartered Accountants)*

Debt should not be counted if it is on arms-length terms and not in proportion to, or a substitute for, equity. *(Corporate Taxpayers Group)*

Comment

Broadly speaking, thin capitalisation rules have three related objectives. These are to ensure:

- that non-residents are not replacing equity with debt when investing into New Zealand;
- only a fair amount of the non-resident's worldwide debt has been allocated to New Zealand; and,
- the New Zealand operation has a commercial level of debt.

When a company is owned by a group of non-residents who meet the definition of a "non-resident owning body", there is no test to determine whether they have allocated a fair amount of their worldwide debt to New Zealand. This test is proxied by the requirement that, in essence, any debt of the New Zealand company (in excess of 60 percent) must be from a third party. This demonstrates that the New Zealand business, on its own, is able to support that level of debt. This provides a reasonable indication that the debt in the New Zealand business is not attributable elsewhere.

Having shareholder-guaranteed loans not counted as owner-linked would weaken this. It would mean that the New Zealand business may not actually be able to commercially support its level of debt – the guarantee may have been required in order for the loan to proceed. This provides an indication that debt that should be allocated elsewhere in the world has been put in New Zealand – since the loan is implicitly supported by assets outside of New Zealand.

For the same reason, officials do not support removing on-lent debt from being counted as owner-linked. If a shareholder borrows an amount and on-lends that, the shareholder is implicitly acting as a guarantor.

The issue of shareholder-guaranteed debt is less significant in the case of a company controlled by a single non-resident. In this case the worldwide group debt test can act to ensure only a reasonable amount of the worldwide group's debt is allocated to New Zealand.

Shareholder guarantees could nonetheless be used to excessively gear the worldwide group. However, officials understand the concerns raised by submitters that a New Zealand company may struggle to get information about guarantees provided by shareholders of the ultimate parent company. On this basis, we recommend that shareholder-guaranteed debt not be treated as "owner-linked" in relation to a company controlled by a single non-resident. Officials will reconsider this position if evidence arises that guaranteed debt is being used to excessively gear a company's worldwide groups.

Officials agree that related-party debt is not necessarily on terms different to arm's-length debt. However, whether debt is truly at arm's length can be difficult to determine. This was noted in the original issues paper on these changes. Further, even if related-party is truly at arm's length, it can still be a substitute for equity. Officials therefore do not favour the submissions that arm's length related-party debt, or arm's length related-party debt that is not in proportion to equity, should be excluded from being owner-linked.

Recommendation

That the submission relating to upstream guarantees of third-party debt be accepted.

That the other submissions be declined.

Issue: Carve-out for widely held debt

Clause 94

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

Proposed section FE 18(3B)(c) provides an exemption to the requirement to exclude owner-linked debt. The exemption applies if a shareholder owns less than 10 percent of a member of the worldwide group and the financial arrangements held by the shareholder are traded on a recognised exchange.

The requirement for the debt to be traded on a recognised exchange is too restrictive. Limiting ownership interests to 10 percent should be sufficient. *(Ernst & Young, New Zealand Institute of Chartered Accountants)*

The requirement for debt to be traded on a recognised exchange should be sufficient as it would be difficult for shareholders to manipulate their debt funding when it is widely traded. The 10 percent ownership threshold is therefore not necessary. *(KPMG)*

A consequential amendment to the definition of "recognised exchange" will be required. As currently defined, a recognised exchange is limited only to an exchange for trading shares or options – not financial arrangements. *(KPMG)*

Comment

Officials agree that it would be difficult to manipulate a company's debt financing through publicly traded debt where the debt is widely traded. Officials also agree that limiting the owner-linked rule to taxpayers with substantial interests reduces compliance costs, as it limits the number of shareholders that a company needs to investigate to determine if they hold owner-linked debt.

Officials therefore recommend that the exemption be changed so it applies when a person owns less than 5 percent of a member of the worldwide group, *or* when the debt of the person is widely traded on a recognised exchange.

The reduced ownership threshold is to counterbalance the removal of the recognised exchange requirement for minority shareholders. Officials note that, with a 5 percent threshold, a maximum of 20 shareholders would need to be considered by the company to determine if they hold owner-linked debt.

Officials note that this rule does not refer to interests held by associates for the purposes of the 5 percent ownership threshold. This is intentional. Otherwise the exemption's purpose as a compliance reduction measure would be defeated. However, it is not intended to provide an opportunity for a non-resident with a significant interest in a company to avoid the application of the owner-linked debt rules by spreading their interests across numerous associated entities. We note that the general anti-avoidance provision may apply to this type of structure.

Finally, we agree that a consequential amendment to the definition of "recognised exchange" is required.

Recommendation

That the submissions be accepted, subject to officials' comments on reducing the ownership interest threshold from 10 percent to 5 percent

---

Issue: Direct ownership interests and amendments to section FE 41

Clause 94

Submission
(Ernst & Young)

Clarification is needed over whether an owner's direct ownership interests should include the direct ownership interests held by their associates. This relates to the amendments to section FE 41 included in the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014.

Comment

Consistent with the amendments to section FE 41 in the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act, a person's direct ownership interests do not include the interests of their associates.

Recommendation

That the submission be noted.

OTHER MATTERS

Issue: References to "associated person" in sections FE 2 and FE 26

Clauses 88 and 96

Submission
(Ernst & Young)

Several proposed paragraphs in section FE 2 provide that the members of a group should be treated as if they are associated. Such a reference is similarly included in proposed section FE 26(7). It is unclear what this is meant to achieve and it should be clarified.

Comment

The reference to associated persons is intended to link in with the rule in section FE 41 which, among other things, sets out how the interests of associated persons are to be combined. This rule, in essence, specifies that interests should not be double-counted.

Officials will consider whether the drafting could be improved.

Recommendation

That the submission be noted.

Issue: Extension of on-lending concession for trusts

Clause 91

Submissions
(Corporate Taxpayers Group, Ernst & Young, New Zealand Institute of Chartered Accountants, Russell McVeagh)

The on-lending concession is generally being extended for trusts so that it applies to all financial arrangements.

This extension is appropriate. *(Corporate Taxpayers Group, New Zealand Institute of Chartered Accountants)*

The extension applies only when a trust has no other property. However, "property" may include rights under financial arrangement contracts that have been entered into. The provision should be amended as a trust may have property that is incidental to its financial arrangements. *(Corporate Taxpayers Group, Russell McVeagh)*

The requirement for a trust to have a New Zealand group consisting of itself alone or itself and other trustees is not necessary. This requirement will automatically be fulfilled by virtue of the requirement that a trust owns no property other than financial arrangements. *(Corporate Taxpayers Group, Ernst & Young)*

Comment

Officials agree with both issues raised by submitters. The extension to the on-lending concession should still be available to a trust that holds property incidental to its financial arrangements.

We also agree that the requirement that a trust have a New Zealand group consisting of itself along (or itself and other trustees) is unnecessary as it will automatically be fulfilled given the requirement that the trust hold only financial arrangements.

Recommendation

That the submissions be accepted.

Issue: Grouping rules for trustees

Clause 89

Submission
(Ernst & Young, New Zealand Law Society)

Proposed amendments to section FE 3(1)(d) will provide that the New Zealand group of a trustee includes all companies controlled by the trustee. It is unclear what "control" means in this context. Arguably all companies that a corporate trustee has legal control over could be caught, regardless of the capacity in which that control is held. *(Ernst & Young)*

It is unclear why proposed sections FE 3(1)(f) and FE 3(1)(g) define the New Zealand and worldwide groups for a "controlling body" as a collective. *(Ernst & Young, New Zealand Law Society)*

Comment

"Control" in section FE 3(1)(d) is intended to refer to the control threshold set out in section FE 27, as held by the trustee in their capacity as trustee of the relevant trust. Officials will consider whether this drafting could be clarified.

Proposed sections FE 3(1)(f) and FE 3(1)(g) operate much in the same way as section FE 27 operates for parent companies. The controlling body is the New Zealand parent and every company under its control is included in its group.

These sections do not determine the New Zealand group of the companies controlled by the controlling body. That is done under proposed section FE 26(4D) and section FE 28. Again, this is much the same as how rules work for standard companies.

Officials note that these sections may no longer be necessary given the recommended changes to section FE 2(1)(cc).

Recommendation

That the submission be noted.

Issue: Reference to non-resident owning body in section FE 25

Clause 95

Submission
(Ernst & Young)

It is unclear why section FE 25 should be amended to include a reference to a "non-resident owning body". Such a body is not a taxpayer and does not itself need to comply with the thin capitalisation rules.

Comment

Section FE 25 sets out how the grouping rules in sections FE 26 to FE 30 operate. The proposed amendments to section FE 25 reflect that these other sections are being modified to provide the New Zealand group of a non-resident owning body. Officials therefore consider that the amendment is appropriate.

Recommendation

That the submission be declined.

Issue: Worldwide group of those acting together

Clause 97

Submission
(Ernst & Young)

The heading of proposed section FE 31D should be amended to clarify that it applies when a non-resident owning body has been identified as a company's New Zealand parent.

A similar provision should be provided if a company's New Zealand parent is a controlling body (that is, determined under proposed section FE 26(4D)).

Comment

Officials will consider whether the drafting could be improved in this section.

Officials note that a similar provision is provided for a company with a New Zealand parent that is a controlling body in proposed section FE 3(1)(g).

Recommendation

That the submission be noted.

Issue: Exclusion of indirect CFC and FIF interests

Submission
(New Zealand Institute of Chartered Accountants)

Proposed section FE 16(1BA) will require individuals or trustees to exclude certain interests in a CFC or FIF held by companies in which those individuals or trustees have a significant interest.

This exclusion is not appropriate in all cases. If the individual or trustee will be taxed on the CFC or FIF income when it is distributed, the relevant assets should be able to be included for thin capitalisation purposes.

Comment

Proposed section FE 16(1BA) will bring the treatment of a person who has a significant indirect interest in a CFC in line with the treatment where they have a significant direct interest in a CFC. Officials consider the proposal should therefore proceed.

The submitter is correct that the individual or trustee will be taxed on their CFC or FIF income when it is eventually distributed. However, until this distribution occurs the individual or trustee may gain significantly from deferral. Officials note this situation could be avoided by placing debt offshore (so thin capitalisation thresholds are not breached) or by placing debt in a company (where any interest denial will generate imputation credits, preventing double-taxation of the eventual distribution).

Recommendation

That the submission be declined.

Issue: Rules to ensure debt and asset is used only once

Clause 92

Submission
(New Zealand Institute of Chartered Accountants)

The bill proposes several new provisions that are designed to ensure the assets and liabilities of an entity can only be included in one New Zealand group and one worldwide group for thin capitalisation purposes.

The rules are complex and further consideration is required to ensure the rules have no unintended consequences. More practical examples on the operation of the rules should also be provided.

Comment

For the thin capitalisation rules to work appropriately, a person's debt and assets should only be counted for one thin capitalisation group. If the assets and debt are counted more than once it can inappropriately affect the amount of debt non-residents are able to put into New Zealand. Officials consider this rule should therefore be kept.

Recommendation

That the submission be declined.

Issue: Technical amendment to section FE 18

Submission
(Matter raised by officials)

Section FE 18(5)(a) deems the debt-to-asset ratio of an entity's worldwide group to be 54.54 percent in several situations. One of these is if the group's members are all resident in New Zealand – that is, the group does not operate outside New Zealand.

This section could arguably apply when a company's worldwide group is deemed to be its New Zealand group, such as under proposed section FE 31D. This would not be appropriate. Officials recommend a technical amendment to section FE 18 to ensure the section does not apply in this case.

Recommendation

That the submission be accepted.

Issue: Drafting matters

Clauses 88, 89, 92, 93 and 96

Submission
(Ernst & Young, KPMG, New Zealand Law Society, PricewaterhouseCoopers)

- Proposed section FE 2(1)(d)(i) should be clarified so it is clear whether the associated person referred to is an associate of a non-resident or an associate of the trust.
- Proposed section FE 2(1)(cc) could be read to require that an entity must meet all of paragraphs (a) to (cb). This is presumably not intended so should be clarified.
- Proposed section FE 2(1)(cc) refers to "entities, including one or more trustee". This could either be read as a group that includes at least one person acting as a trustee, or a group consisting solely of the trustees of one or more trusts. This should be clarified.
- Proposed amendments to section FE 3(1)(b) sets out the worldwide group for an individual. This is unnecessary as individuals cannot apply the worldwide group debt test.
- It is unclear that proposed section FE 16(1D) is intended to apply when shares are being transferred as the section refers to a transfer of assets.
- Proposed section FE 26(2)(bb) sets out when a non-resident owning body is a New Zealand parent. It should be clarified that the requirements in paragraphs (i) and (ii) apply to the non-resident owning body, not the excess debt entity.
- The word "entity" rather than "person" is used in several places. This suggests that only legal bodies are intended to be captured by the relevant provisions. Whether this is intended should be clarified.

Comment

Officials will consider whether the drafting could be improved in these sections.

Recommendation

That the submission be noted.

Black hole expenditure

OVERVIEW

Clauses 16, 39, 41, 42, 44, 54, 55 and 124

This group of amendments addresses the tax treatment of certain items of "black hole" expenditure, which is business expenditure of a capital nature that is neither immediately deductible nor gives rise to a depreciable asset for tax purposes. The amendments address the tax treatment of expenditure on:

- failed or aborted resource consents, patents and plant variety rights;
- certain fixed-life resource consents; and
- paying a dividend, annual subscriptions to be listed on a stock exchange, and shareholder meetings.

Five submitters commented on these aspects of the bill. Generally submitters supported the changes to remove certain distortions arising from tax settings, reduce compliance costs and provide certainty of tax treatment for taxpayers.

However, submitters were concerned about the proposed claw-back provision (proposed new section CG 7B) clawing back a larger amount of deductions than intended. They also noted that other fixed-life resource consents remain subject to "black hole" tax treatment. The proposed non-deductibility of expenditure on special shareholder meetings was not supported by most submitters. Submitters also advocated making the application dates of certain changes retrospective on the basis that the amendments are remedial and/or clarify and confirm current practice.

APPLICATIONS FOR RESOURCE CONSENTS, PATENTS AND PLANT VARIETY RIGHTS

Clauses 39, 41 and 42

Issue: Support for the proposals

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

Four submitters expressed their overall support for these amendments, based on the removal of "black hole" expenditure on aborted or unsuccessful resource consent, patent and plant variety rights applications.

One submitter notes that the amendments expand the scope of eligibility for deductible expenditure under sections DB 19 and DB 37 of the Income Tax Act 2007. *(Corporate Taxpayers Group)*

Another submitter notes the amendments legislatively clarify the deductibility of costs associated with failed and withdrawn patent, plant variety rights and resource consent applications. *(KPMG)*

Comment

Officials note the general support for the proposed amendments.

Recommendation

That the submissions be noted.

Issue: Expenditure incurred on lapsed resource consents should be deductible

Submission
(Corporate Taxpayers Group, Deloitte)

The proposed amendment to section DB 19 should be extended to allow for situations where resource consents lapse or are surrendered. This may happen because its conditions are not met or the resource consent is not exercised. It is appropriate that this expenditure should be deductible as this situation is economically identical to that when a resource consent is refused, withdrawn or not lodged.

Comment

The proposed amendment removes the requirement for taxpayers to have lodged an application for the grant of a resource consent before capital expenditure incurred on an aborted or unsuccessful resource consent can be deducted. This amendment does not currently cover expenditure on a resource consent that is granted but lapses or is surrendered.

Officials agree with submitters that this situation is similar to those covered by section DB 19 as capital expenditure has been incurred on an unsuccessful resource consent. Allowing a deduction for expenditure incurred on lapsed or surrendered resource consents is consistent with the policy intent of removing "black hole" treatment for expenditure on unsuccessful resource consents.

Recommendation

That the submission be accepted.

Issue: Application date for proposed amendments to sections DB 19 and DB 37

Submission
(Corporate Taxpayers Group, Deloitte)

The proposed amendments to sections DB 19 and DB 37 should be made retrospective to 1 October 2005, which is the date their predecessors (sections DB 13B and DB 28B of the Income Tax Act 2004) were inserted, and effective from. These amendments are remedial in nature and ensure that the law reflects the original policy intent of allowing a deduction for capital expenditure incurred in applying for a resource consent or patent that does not give rise to a depreciable asset.

In the regulatory impact statement accompanying these proposed changes, it noted that officials expected that taxpayers would complete abandoned projects and then withdraw them to obtain a deduction under section DB 19. Taxpayers who considered this approach was inappropriate under either resource consent regulations or tax law and have not taken a deduction for expenditure on failed resource consent applications should be able to take the deduction now; this would necessitate making the proposed amendment retrospective.

Comment

The proposed amendment will reduce compliance costs by removing the requirement for taxpayers to apply for the grant of a resource consent to deduct their expenditure. Officials note that this amendment does not clarify the existing policy setting but changes it. Therefore, making the amendment prospective is the appropriate approach. Fiscal cost estimates have also been prepared on this basis.

Recommendation

That the submission be declined.

Issue: Clarification of deductible patent and resource consent expenditure

Submission

(KPMG)

The proposed amendments to sections DB 19 and DB 37 provide only a small increase in additional deductions. Inland Revenue has a narrow view of what constitutes the cost of a patent or resource consent, which is understood to be only the legal and administration costs of the application, so any additional deductions arising from the proposed amendments are likely to be limited. Officials should provide guidance around what additional expenditure will now become deductible under these changes.

Comment

The intent of these changes is to expand the scope of eligibility for a deduction under these sections to instances when expenditure has been incurred by a taxpayer on an intended application which they decide not to lodge. Currently, a taxpayer must have lodged the application before they can receive a deduction. It is not the intent of the proposed changes to extend the types of expenditure deductible under sections DB 19 and DB 37 beyond those types of expenditure that are currently deductible under these sections.

Recommendation

That the submission be declined.

CLAW-BACK FOR SUBSEQUENT APPLICATIONS OR DISPOSALS

Clauses 16, 54 and 55

Issue: Support for the proposals

Submission
(New Zealand Institute of Chartered Accountants)

The submitter expressed overall support for these amendments which claw back (or recapture) deductions for failed expenditure on applications for resource consents, patents and plant variety rights as income when abandoned application property is sold or used as part of another intellectual property right.

Comment

Officials note the general support for the proposed claw-back amendments.

Recommendation

That the submission be noted.

Issue: The claw-back provision overreaches

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

The scope of proposed section CG 7B(4) is currently too wide. In its current form it claws back "the total amount of deductions" that were allowed under sections DB 19, DB 37 or proposed new section DB 40BA. Clawed-back income should only correspond to deductions for expenditure on an aborted or failed application to the extent that property obtained as a result of that expenditure is subsequently used in the lodging of a patent application or in obtaining the grant of a resource consent or plant variety rights.

The proposed claw-back provision does not simply claw back the additional capital costs that the bill proposes to make deductible, but also includes deductions currently (and previously) allowed under sections DB 19 and DB 37. It could also possibly result in the claw back of previously deducted feasibility expenditure. *(KPMG)*

If this proposal is not changed, the clawed-back income should be limited to the lesser of the value of the failed expenditure previously deducted and the disposal proceeds (or the value of the new intellectual property created). *(KPMG)*

Comment

Officials agree with the submission that the drafting of the provision should be changed to reflect the intended policy outcome of only clawing back deductions for expenditure on an aborted or failed application to the extent that property obtained as a result of that expenditure is subsequently used in the lodging of a patent application or in obtaining the grant of a resource consent or plant variety rights.

Recommendation

That the submission be accepted.

Issue: When clawed-back income should be returned

Submission
(Corporate Taxpayers Group, Deloitte)

Proposed new section CG 7B does not specify when the clawed-back income should be returned. While this should be straight-forward to determine when the abandoned application property is sold, it will be less straight-forward when the property is used for the purposes of another resource consent application. Clawed-back income should not arise until the resource consent is granted.

Comment

Officials agree with the submission, and wish to draw the submitters' attention to the wording of proposed section CG 7B(2)(b), which states that a person has income "if the application property is used … in obtaining the grant of a resource consent".

We agree that a timing-of-income provision should be added to provide clarity about which income year the income is allocated to.

Recommendation

That the submission be accepted.

Issue: Claw-back of deductions for subsequent applications

Submission
(Ernst & Young)

The submitter notes it is reasonable to claw back deductions if the application property, for which a deduction under sections DB 19, DB 37 or proposed new section DB 40BA has been taken, is disposed of for consideration. This is equivalent to depreciation recovery income.

The submitter suggests that it is not appropriate to claw back deductions if abandoned application property is later used in making a patent application or obtaining the grant of a resource consent or plant variety rights. There is likely to be uncertainty around whether expenditure incurred on making an application of the above type, that does not represent expenditure on any underlying invention or plant variety, has given rise to any identifiable property and whether it has then been used in obtaining the grant of a resource consent or plant variety rights or making a patent application.

There is also no precedent for such a claw-back provision for either tangible or intangible depreciable property. For example, this does not apply to deductions allowed for unsuccessful software development. Such a claw-back provision would therefore be inconsistent with existing policy settings.

Comment

Officials note the concerns of the submitter but note this claw-back rule is an important integrity measure. Without a claw-back rule for deductions on expenditure on abandoned application property that is subsequently used in a successful application, taxpayers could obtain a timing advantage on their deductions compared with a taxpayer who makes a first-time successful application, for which the expenditure would be depreciable over the life of the resource consent, patent or plant variety rights.

Recommendation

That the submission be declined.

Issue: Remove unnecessary provisions in proposed new section CG 7B

Submission
(Corporate Taxpayers Group)

Paragraphs (a) and (b) of proposed new section CG 7B(1) are superfluous as they repeat conditions which must have been met to satisfy section CG 7B(1)(c).

Comment

Officials agree with the submission and recommend a change to the drafting of the legislation to remove the unnecessary paragraphs.

Recommendation

That the submission be accepted.

Issue: Relationship between proposed new section CG 7B and sections EE 25 and EE 57

Submission
(New Zealand Institute of Chartered Accountants)

When "application property" is subsequently used in the production of an item of depreciable intellectual property, the drafting of the legislation should match what is proposed in the Commentary on the bill, which is that the clawed-back amount will be depreciated over the life of the new asset.

The Commentary on the bill states that the clawed-back amount will be included in the cost of the intangible property to be depreciated over the life of the new depreciable asset. The method adopted by the legislation would seem to be that proposed new section CG 7B(2)(b) deems the amount to be "income" and that the cost is then included in the proposed modifications to sections EE 25 and EE 57. There would seem to be no obvious linkage between these steps and it would be useful if the linkage between proposed new section CG 7B and the other provisions could be signalled in proposed new section CG 7B.

Comment

The submitter has correctly explained the intended interaction between proposed new section CG 7B and the proposed amendments to sections EE 25 and EE 57.

Officials are happy to provide additional clarity around how proposed new section CG 7B links with sections EE 25 and EE 57, by including a "signpost" within proposed new section CG 7B.

Recommendation

That the submission be accepted.

Issue: Inclusion of "plant variety rights" in section EE 57

Submission
(New Zealand Institute of Chartered Accountants)

Clause 55 should be amended to exclude "plant variety rights" as these are already dealt with under clause 54.

The proposed new section EE 57(3)(cb) will only apply if the "expenditure has given rise under section CG 7B to an amount of income". Therefore, the expenditure on a failed plant variety rights application is taken into account for depreciation purposes under the proposed amendment to section EE 25(3)(a) and does not need to be duplicated in the proposed new section EE 57(3)(cb). The total deductions in section EE 60 specifically include the amount of a deduction under section EE 25.

Comment

Officials disagree with this interpretation of the relationship between proposed section CG 7B and sections EE 25 and EE 57 under the proposed amendments to them. Section EE 25 allows a pro-rated deduction for the cost of a plant variety rights application when plant variety rights are granted. The proposed amendment to section EE 25(3)(a) ensures that any expenditure clawed back as income under proposed new section CG 7B is included within the cost of a subsequent plant variety rights application for the purposes of this deduction. Without the proposed amendment, the taxpayer would be entitled to a smaller deduction.

Once they are granted, plant variety rights, being an item of fixed-life intangible property, should be depreciated over their legal life. Section EE 57 determines the "base value" (or the cost) of an item for depreciation purposes. "Total deductions" determined in section EE 60, are then subtracted from the base value to determine the "adjusted tax value" of the item which reflects the item's cost less depreciation deductions claimed in previous years. The item's adjusted tax value is then used when calculating a year's depreciation deduction.

If plant variety rights are not included within proposed new section EE 57(3)(cb), the clawed-back amount would not be added to the base value of the asset, and consequently would not be depreciable.

Recommendation

That the submission be declined.

FIXED-LIFE RESOURCE CONSENTS

Clause 124

Issue: Support for the proposal

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

The submitters expressed their overall support for the addition of resource consents granted under section 15A and 15B of the Resource Management Act 1991 (RMA) to schedule 14 of the Act. This makes expenditure on these resource consents depreciable.

Comment

Officials note the general support for the proposed amendments.

Recommendation

That the submissions be noted.

Issue: Other fixed-life resource consents

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

Submitters noted that there are other fixed-life resource consents granted under section 9 of the RMA relating to restrictions on the use of land that are not currently depreciable. To the extent that these consents have a finite life, they should be included within schedule 14 of the Act and be depreciable.

Comment

Officials would welcome further evidence on fixed-life resource consents granted under section 9 of the RMA in order to assess the scope of the issue. Our approach is to consider black hole expenditure issues on a case-by-case basis.

The addition of resource consents granted under section 9 of the RMA would be more complex than the current proposed changes envisage. Schedule 14 of the Act lists items of depreciable intangible property, and while the Act has a definition of "depreciable intangible property" that requires the property to have an estimable, finite useful life, this criterion is overruled by the inclusion of the property in schedule 14. This prevents the addition of resource consents granted under section 9 of the RMA to schedule 14 because then all section 9 resource consents would be depreciable, whether the consent period is finite or perpetual.

Recommendation

That the submission be declined.

COMPANY ADMINISTRATION COSTS

Clause 44

Issue: Support for parts of the proposals

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

The submitters expressed their general support for the proposed amendments that clarify the tax treatment of expenditure on the payment of dividends, the annual subscription paid to list on a recognised stock exchange and annual shareholder meeting costs.

Comment

Officials note the support for the proposed amendments.

Recommendation

That the submission be noted.

Issue: Extend application of proposed section DB 63B to include all fees paid to a recognised stock exchange

Submission
(Corporate Taxpayers Group, Deloitte)

The bill proposes allowing the annual subscription paid to list on a recognised stock exchange to be deductible. Other listing fees, including the initial cost of listing, are not addressed in the bill. These should be deductible as an initial public offering is an ordinary part of a company's business when it is seeking to access additional equity. It is also a necessary step in growing a business despite the one-off nature of the initial listing fee.

A distinction between initial and annual listing fees is not appropriate from a policy perspective. Denying a deduction for initial listing fees may discourage New Zealand businesses from listing their shares, which goes against the Government's goal of deepening capital markets to promote increased national savings.

There are also a number of other listing fees such as the cost of an already listed company seeking additional capital or operating a dividend reinvestment programme. It is currently a judgement call whether these costs are capital or revenue. To reduce compliance costs and remove distortions, all listing costs should be deductible.

Comment

Officials disagree with these views. From a policy perspective, initial listing fees are a one-off cost incurred to raise additional equity which creates an enduring benefit for the company. This expenditure is of a capital nature and should not be deductible.

The Government has a broad-base, low-rate tax policy framework, which, in general, aims to tax all forms of income evenly at the lowest rate possible. To avoid taxpayers basing decisions on tax advantages instead of commercial merit, the tax system should not be used to encourage (or discourage) certain activities. Officials recognise the Government's goal of deepening capital markets but note that the Government has other policy options at its disposal to support this objective that do not conflict with the overall tax policy framework.

There is a significant difference in the nature of the benefit arising from expenditure on initial and annual listing fees respectively. While companies must pay a subscription annually to a recognised stock exchange to remain listed, the initial cost of listing is a one-off expense from which the benefits of additional equity endure for a long period. This forms a justification for allowing a deduction for annual listing fees but denying a deduction for initial listing fees.

Officials' view is consistent with Inland Revenue's 2011 draft interpretation statement, *Deductibility of company administration costs*, which issued draft guidelines on the deductibility of certain company administration costs. It found that expenditure on listing fees was of a capital nature.

Recommendation

That the submission be declined.

Issue: Tax treatment of special shareholder meeting costs

Submission

(Corporate Taxpayers Group, Deloitte, KPMG)

The bill proposes denying a deduction for expenditure on special shareholder meetings. This should not proceed as taxpayers are comfortable with self-assessment at the capital-revenue boundary. There are a number of reasons to hold a special shareholder meeting that would ordinarily be considered revenue – for example, to block a hostile takeover, discuss a major transaction or change the management structure of the company. Expenditure on these meetings will not be deductible under the current proposals. This is not the correct outcome.

Two submitters also proposed making expenditure on special shareholder meetings deductible. *(Corporate Taxpayers Group, Deloitte)*

Comment

The proposed changes to the tax treatment of special shareholder meeting costs cannot be viewed in isolation. Instead, these must be considered in conjunction with the proposed tax treatment of annual shareholder meeting (AGM) costs. Officials have prioritised a reduction of compliance costs over the accuracy of the tax treatment and attempted to balance the proposed concessionary treatment of AGM costs with a revenue-positive treatment of special shareholder meeting costs.

The bill proposes allowing a deduction for all expenditure on annual shareholder meetings in new section DB 63C(1). This is taxpayer-friendly as a special resolution voted on at an AGM could change the capital structure of the company, and therefore under self-assessment the amount attributed to the capital special resolution of the total AGM cost would not be deductible. However, officials do not think apportioning the meeting cost between the revenue and capital resolutions voted on is desirable from a compliance cost perspective. The taxpayer-friendly treatment of AGM costs necessitates that expenditure on special shareholder meetings be made non-deductible to ensure the overall changes to the tax treatment of shareholder meeting costs are revenue-neutral.

Recommendation

That the submission be declined.

Issue: Clarification of "meeting costs"

Submission
(Corporate Taxpayers Group)

Officials should clarify in the *Tax Information Bulletin* commentary what exactly constitutes "meeting costs" for the purposes of the legislation.

The submitter suggests that only direct costs of the shareholder meeting, such as venue hire and catering, should be considered as costs of the meeting for the purposes of proposed new section DB 63C.

Comment

Officials expect that the expenditure items considered as "meeting costs" should be clarified by the Commissioner of Inland Revenue in the appropriate fashion, such as an interpretation statement.

Recommendation

That the submission be noted.

Issue: Application dates for the proposed new sections DB 63, DB 63B and DB 63C(1)

Submission

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

The application date for proposed sections DB 63, DB 63B and DB 63C(1) should be made retrospective. This is because the amendments clarify and confirm existing business practice. This will give taxpayers certainty that earlier tax positions taken will not be challenged.

All submitters suggested that the application date should be made retrospective from the taxpayer's statute bar period.

One submitter suggested that, at the very least, the retrospective application needs to be from the commencement of the 2013–14 income year given the policy was announced in the May 2013 Budget. *(New Zealand Institute of Chartered Accountants)*

Comment

The new provisions constitute a policy change rather than merely a confirmation of existing policy settings. They have been introduced to reduce compliance costs and provide certainty of the tax treatment of certain company administration costs that are on, or near, the capital-revenue boundary. Making the application dates prospective is the appropriate approach.

Recommendation

That the submission be declined.

OTHER SUBMISSIONS

Issue: Further "black hole" expenditure issues

Submission
(Corporate Taxpayers Group)

We support the work undertaken to address certain areas of black hole expenditure. However, there remains a number of black hole expenditure items in the New Zealand tax system that require consideration by officials. A comprehensive solution to black hole expenditure should also be considered.

Comment

As noted above, officials' approach is to consider black hole expenditure issues on a case-by-case basis. A comprehensive solution to black hole expenditure, such as a catch-all provision, is not currently under consideration. Different black hole expenditure issues will require individual policy solutions to ensure that their tax treatment remains neutral, consistent and fair.

Recommendation

That the submission be noted.

Foreign account information-sharing agreements

OVERVIEW

New Zealand has signalled its intentions to negotiate an intergovernmental agreement (IGA) with the United States to clarify the reporting obligations of New Zealand financial institutions under the United States' law commonly known as the Foreign Account Tax Compliance Act (FATCA).

This bill contains amendments that are required to bring any agreed IGA into domestic law and allow New Zealand financial institutions to comply with its terms. The proposed amendments are generally drafted in a broad manner to accommodate the possibility of New Zealand entering into similar agreements with other jurisdictions in the future.

The proposals attracted more than 50 submissions, mostly from individuals (including some from overseas). Submissions from these individuals were unanimously opposed to FATCA and the IGA and, by extension, the proposed changes.

Submissions were also received from the financial services sector and their advisors. These submissions broadly supported the intent of the proposed amendments, and commented on some technical and drafting issues.

OPPOSED TO THE CHANGES

Issue: Should the proposed legislation for foreign account information-sharing agreements be advanced?

Clauses 2(23), 5, 6, 37, 128(1), (2), (5), 123(15), 129, 150, 151, 152 and 158

Submissions

(Andrew Broadwell, Anne Cargill, Arielle Hiscox, Benjamin Popovich, C Tobias, Carol Tapanila, Caroline Hooper, Carrie Fisher, Centre for Freedom and Prosperity, Dan Sullivan, Darlene Hall, Darryl Betham, Dean Tatro, Dr Nathaniel Janke-Gilman, Dr Stuart Jeanne Bramhall, Elliot Sawyer, Grant Kuppernick, Gwen D, Harold David Bonnett, Henry Velthuizen, Ian Fish, James George Jatras, James H Woods, Jason Spears, John Phillips, John Richardson, John Smith, Jonathan Baker, Jonathan Evans, Julian Woodhouse, Kent W Deitemeyer, Kirsten Woods, Lea Turkington, Lindsay Forbes, Lynne Swanson, Marvin Van Horn, Matt Joynes, Matthew Agnew, Matthew Provost, Mr A, Paul Andrew Ross, Rachael Fone, Rebecca Woodhouse, Richard Borain, Robert Fraser, Simon Titheridge, Stephen John Schoenberg, Stephen Rowe, Stephen Tamatoa Cairns, Tiffany Love, Timothy Smyth, Victor Paul)

The aspect of the proposed legislation creating a framework for foreign account information sharing agreements should be withdrawn from the bill.

Comment

Officials are conscious of the fact that, although the submission summarised above does accurately portray the views of the relevant submitters, the primary concern appears to be with New Zealand's proposed entry into an intergovernmental agreement (IGA) with the United States in respect of its Foreign Account Tax Compliance Act (FATCA).[1]

In this regard, there are some key areas of concern that have been consistently raised during the submission process. It is therefore considered appropriate to address each of these key areas in turn. To the extent that submitters have raised concerns that extend beyond these key areas (but are nevertheless opposing the proposed legislation) officials have attempted to respond to those comments too.

First, however, it is important to restate why officials consider that entering into an IGA with the United States is in the best interests of New Zealand. This explanation expands on that provided in the Inland Revenue Regulatory Impact Statement that accompanied the introduction of this bill.[2]

Entering into an IGA

Without an IGA, in order to avoid FATCA penalties, New Zealand financial institutions would need to enter into separate agreements with the United States' Internal Revenue Service (IRS). Under these agreements, the financial institutions would need to:

[1] For the purposes of this report, it is assumed that New Zealand will enter into an IGA on the terms of the "Model 1A IGA" (with corresponding Annex I and Annex II), as published in the US Treasury website: http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.

[2] http://taxpolicy.ird.govt.nz/sites/default/files/2013-ris-arearm-bill-04.pdf.

- identify US accounts and report certain information about these accounts to the IRS on an annual basis;
- withhold 30% on payments from the US to a non-participating foreign financial institutions or to a recalcitrant account holder (account holders who have not provided the required information); and
- close the accounts of these recalcitrant account holders.

Officials consider that New Zealand financial institutions would not be able to comply with these agreements under our existing legislative framework. Private details of individuals may be able to be collected and shared if appropriate amendments were made to customers' terms and conditions. Terms and conditions may also be able to be used to close accounts in appropriate instances. However, it is not clear that a financial institution could ever legally act as a withholding agent for a foreign government. Entering into separate agreements would also impose significant compliance costs on all New Zealand financial institutions.

The only way such agreements could be effected would therefore be for New Zealand to enact specific legislation that allowed financial institutions to comply with their terms. This would solve the issue at one level but would still impose significant compliance costs on New Zealand institutions and would effectively result in those institutions being subject to US regulation.

Entering into an IGA will significantly lower compliance costs on New Zealand financial institutions by providing some clear exemptions from reporting and relieving institutions of having to withhold on payments made to customers. It will also significantly reduce the likelihood that New Zealand financial institutions will have FATCA penalties imposed on them.

In essence, not entering into an IGA and not enacting enabling legislation of some sort would leave New Zealand financial institutions with a choice of:

- not investing either directly or indirectly into the US (to avoid withholding); or
- investing in the US and suffering the withholding penalty.

Officials do not consider either of these options is desirable for the health of the New Zealand financial services sector.

Cost/benefit for New Zealand

Officials do not consider it is possible to accurately predict the cost of Government inaction. This is largely because:

- It is not known what the exact size of investments that the financial services sector, both directly and indirectly, has into the United States.
- It is not possible to accurately estimate the likely returns that financial institutions would receive from the counterfactual of not investing in the United States.

However, in saying this, it is our view that effectively denying New Zealand financial institutions access to the world's largest capital market, or reducing the return from such investments by the 30% penalty, would be likely to have a severe impact on investment returns. Lower investment returns by New Zealand financial institutions has the potential to raise the cost of financial transactions for all New Zealanders, not just those "US persons" that would be the subject of IGA reporting.

Officials also take the opportunity to reiterate that nothing in the IGA alters any substantive United States taxing rights – meaning that, if a New Zealand resident also has US tax obligations, those obligations already exist as a matter of law and nothing in the IGA or the proposed legislation will raise or lower the amount of US tax owing.

International trends/reputational issues

From a Government perspective, officials also note that FATCA is now part of a major global initiative to combat international tax evasion. FATCA is based on the idea of global automatic exchange of certain information by financial institutions. Previously these information exchanges have occurred either on an ad hoc or "on request" basis, or annually by way of agreement between tax authorities under various double tax treaties.

Automatic exchange of information between multiple jurisdictions is now the new international standard for automatic exchange endorsed by the G20 and the Organisation for Economic Cooperation and Development (OECD).

Officials consider there would be a severe reputational risk for New Zealand if it were not to be involved in this international movement. All OECD countries have either signed, or are negotiating, IGAs with the United States in respect of FATCA. The OECD itself has dedicated resources to devising a common reporting model for financial accounts, based on the FATCA model. This tax transparency is seen as complementing its base erosion and profit shifting (BEPS) work. The BEPS initiative is aimed at ensuring that entities and individuals that operate in numerous jurisdictions pay an appropriate amount of tax. Automatic information exchange and transparency in tax affairs is seen as an important compliance tool for this programme.

It is also important to note that, under the IGA and any OECD/G20 model that may be devised in the future, New Zealand will also be the recipient of information in respect of New Zealand tax residents that have undeclared offshore bank accounts. This information will assist in ensuring that all New Zealanders also pay the correct amount of tax on their worldwide income.

Officials consider that the aims of FATCA (which are, ultimately, reduced tax evasion) are being caught up in the wider issue of the United States "citizenship" basis of taxation, which is relatively unusual by international standards. However, officials consider that entering into information exchange agreements that allow countries to levy tax according to its laws is becoming an important part of being a "good international citizen" and will ultimately benefit New Zealand both in a fiscal and reputational sense.

In saying this, officials acknowledge the genuine concern of submitters who consider that New Zealand entering into an IGA and enacting the proposed legislation will have a detrimental impact on their lives.

Key concerns

The key areas of concern raised in submissions are:

- Allowing a financial institution the ability to send IGA-relevant information to Inland Revenue, which in turn will pass it to the Internal Revenue Service (IRS) in the United States, is a breach of the privacy rights of the individuals concerned.

- Allowing this information-sharing is a form of discrimination against a group of people based on their nationality, arguably contrary to New Zealand's Human Rights Act and Bill of Rights Act.
- The United States' system of citizenship-based taxation is fundamentally unjust.
- Reporting will result in "overreach", with particular concerns being expressed that the information of spouses that are not "US persons" will be provided.
- New Zealand is being "bullied" into accepting FATCA and the IGA, which are an impingement on New Zealand's sovereignty.

Officials will address each of these areas in turn.

Issue: Privacy concerns

(Anne Cargill, C Tobias, Caroline Hooper, Carrie Fisher, Centre for Freedom and Prosperity, Darlene Hall, Darryl Betham, Dr Nathaniel Janke-Gilman, Dr Stuart Jeanne Bramhall, Elliot Sawyer, Grant Kuppernick, Gwen D, Harold David Bonnett, Ian Fish, James George Jatras, James H Woods, Jason Spears, John Phillips, John Richardson, John Smith (key recommendation 3 and recommendation 9), Jonathan Baker, Kirsten Woods, Lea Turkington, Marvin Van Horn, Matthew Agnew, Rachael Fone, Rebecca Woodhouse, Richard Borain, Stephen John Schoenberg, Stephen Rowe – and implicit in other submissions)

New Zealand's Privacy Act is written in a way that contemplates it being over-ridden by express statutory authority. Officials consider that the scheme of this Act therefore anticipates that there may be over-riding public policy arguments for setting limits on privacy principles in carefully defined circumstances.

Officials accept that, under the IGA, information will be collected and shared which is not currently being collected or shared. In these cases, there is always a judgement about whether collecting that information is "appropriate" in a public policy sense, taking all circumstances into account. This is as true of information-sharing between New Zealand government departments as it is to sharing between governments.

The question therefore becomes: what is "appropriate"?

It seems obvious from submissions that many of the individuals concerned do not consider information-sharing in this case to be appropriate. However, government is in the position of having to make such judgements on a national, rather than individual, level. As set out in "Entering into an IGA" section of this report, officials consider that a sound public policy argument exists in this case that justifies New Zealand entering into an IGA – a necessary part of such an action being that the information collection and transmission contemplated in the IGA will occur. The privacy of the individuals concerned was a factor that officials examined in reaching this view, but it was, on balance, deemed to be outweighed by other public-interest considerations.

Issue: Discrimination

(Andrew Broadwell, Anne Cargill, C Tobias, Caroline Hooper, Carrie Fisher, Darryl Betham, Dr Nathaniel Janke-Gilman, Dr Stuart Jeanne Bramhall, Grant Kuppernick, Gwen D, Harold David Bonnett, Henry Velthuizen, Ian Fish, James George Jatras, John Richardson, John Smith (recommendation 1), Kent W Deitemeyer, Kirsten Woods, Lea Turkington, Marvin Van Horn, Matt Joynes, Matthew Provost, Richard Borain, Simon Titheridge – and implicit in other submissions)

Officials accept that, as a result of IGA information gathering and collecting, information on people that are "US persons" will be transmitted to the IRS, while the information of those that are not "US Persons" (or exhibit no "US indicia") will not. Officials also accept that there is an argument that this different treatment will take place because of the nationality of the person concerned, while noting that a "US person" for IGA purposes is not synonymous with "US Citizen".

Contrary to what is asserted in some submissions, officials wish to reassure the Committee that this bill was vetted for consistency with the New Zealand Bill of Rights Act by the Ministry of Justice, which was informed of the context of the changes.[3]

Issue: The US basis of taxation

(Anne Cargill, C Tobias, Carol Tapanila, Caroline Hooper, Carrie Fisher, Darlene Hall, Darryl Betham, Dean Tatro, Dr Nathaniel Janke-Gilman, Grant Kuppernick, Gwen D, Harold David Bonnett, John Richarsdon, John Smith, Kent W Deitemeyer, Kirsten Woods, Lea Turkington, Marvin Van Horn, Matt Joynes, Mr A, Rachael Fone, Richard Borain, Robert Fraser, Simon Titheridge, Stephen John Schoenberg, Stephen Rowe, Tiffany Love – and implicit in other submissions)

Officials acknowledge that the citizenship taxation model adopted by the United States is relatively unusual by international standards. However, it is not appropriate for Inland Revenue officials to comment on the merits or otherwise of tax policy decisions made by foreign governments.

As officials have noted in the "entering into an IGA section of this report, nothing in the IGA alters any substantive United States taxing rights.

It is generally recognised that, with the benefits of citizenship of any country comes an obligation to abide by the laws of that country. Officials would also add that:

- The United States does provide a mechanism whereby citizenship can be renounced. It is expected that a person that has renounced their US citizenship will be in a position to provide New Zealand financial institutions with sufficient evidence to prove that they are not a "US person" and so should not be the subject of reporting.

[3] http://www.justice.govt.nz/policy/constitutional-law-and-human-rights/human-rights/bill-of-rights/taxation-annual-rates-employee-allowances-and-remedial-matters-bill

- The United States model of taxation is not new, so it appears reasonable to assume that citizens of the United States are aware both of their citizenship rights and obligations.

Issue: Reporting "overreach"

(Anne Cargill, Carrie Fisher, Dean Tatro, Elliot Sawyer, Grant Kuppernick, Gwen D, John Richardson, Marvin Van Horn, Rebecca Woodhouse, Richard Borain, Simon Titheridge, Stephen Rowe – and implicit in other submissions)

It is important to note that the model IGA provides a set of "due diligence" requirements that a financial institution is required to carry out in order to determine whether or not an account holder is a "US person". Simply put, under these due diligence requirements, the institution is to collect or review existing data for what are known as "US indicia". Where no US indicia is found, the institution is not required to report on the account holder. Where US indicia is found, there is a working presumption that the account will be held by a US person. However, even when US indicia is found, the presumption that the person is a US person is rebuttable. There are mechanisms within the IGA that allow the person to provide evidence that they are not a "US person".

Submitters appear particularly concerned that information on the spouses of "US persons" (where those spouses are not "US persons") will be reported. Officials note that oral submissions from representatives of the financial services industry confirm that New Zealand financial institutions are intending to, and their systems are designed to accommodate, separating joint account holders where necessary and only reporting the personal details of the relevant "US person".

In addition, officials make the following observations:

- The United States has provided a "schema" setting out the information that it expects to receive as part of the IGA reporting. That schema provides for the name of the US person and the account number, but it does not contain a field for the account name. Given our understanding that each customer with a bank has a unique customer number, this significantly reduces the risk of the details of a non-US taxpayer being transmitted in error.
- Inland Revenue has established an IT working group with the financial services sector to ensure that only the necessary and correct information is transferred (noting that the first transfer of data to Inland Revenue is not due until about mid 2015).
- Inland Revenue's proposed technology solution for IGA information will result in data transferred from financial institutions being electronically screened to ensure it complies with minimum requirements. From the 2017 reporting period, one of the required data fields will be the US social security number (called a TIN for tax purposes and essentially an IRD number equivalent) of the relevant person. A person that is not a US taxpayer will not have a social security number. So, even if a financial institution did try to report on a non-US person, the data would be rejected by Inland Revenue systems as being incomplete.

The legislation before the Committee (clause 158, proposed section 185I) is also designed to reduce certain cases of "over-reporting". For example, the wording on "excluded choices" in clause 185 (proposed sections 185F(6) and (7)) is intended to prevent a financial institution from reporting on a US person if an account they have an interest in has a balance below the US$50,000 threshold set out in the model IGA. This is intended to ensure that financial institutions will not report on an account with a balance below that threshold even if they are held by a US person.

In addition, the draft legislation only authorises financial institutions to transmit data to Inland Revenue "…if that information and its providing and obtaining is described or contemplated in the agreement…". The model IGA does not contemplate the passing of information of anyone that is not a US person. Therefore, if a financial institution transmits data on any other person it will not be able to rely on the protections offered by the legislation if the relevant person made a complaint to the Privacy Commissioner under the Privacy Act.

Issue: Sovereignty issues

(Arielle Hiscox, Benjamin Popovich, C Tobias, Carrie Fisher, Centre for Freedom and Prosperity, Darlene Hall, Dr Nathaniel Janke-Gilman, Grant Kuppernick, Ian Fish, James George Jatras, James H Woods, Jason Spears, John Phillips, Stephen John Schoenberg, John Richardson, John Smith (recommendation 2) Stephen Rowe, Stephen Tamatoa Cairns, Kent W Deitemeyer, Kirsten Woods, Lynne Swanson, Marvin Van Horn, Matt Joynes, Matthew Agnew, Matthew Provost, Mr A, Paul Andrew Ross, Rachael Fone, Richard Borain, Robert Fraser, Julian Woodhouse – and implicit in other submissions)

From a tax policy perspective, the model IGA does not limit New Zealand's taxing rights in the same way as, for example, a double tax treaty might. Nor does it dilute the New Zealand Government's other regulatory capacity over financial institutions or individuals.

Officials consider there is scope to raise sovereignty issues in respect of any international agreement or convention. However, there is an underlying assumption that the government of the day will only enter into agreements that it considers to be in the best interests of New Zealand.

As set out in the "Entering into an IGA" section of this report, officials consider that entering into the IGA and enacting legislation that enables financial institutions to comply with its terms is in the best interests of New Zealand in this case. In saying this though, officials are aware that this is ultimately a decision for Ministers and Parliament.

The aim of the enabling legislation in this bill is simply to provide a legislative framework in which the proposed IGA, and any other similar agreements that may be entered into in the future, can operate. It is inherently limited in its scope to automatic exchange of information agreements, but is drafted in broadest way possible to accommodate these agreements, whatever form they may take.

Issue: Other matters raised

Submissions also raise the following points:

The IGA and enabling legislation will be detrimental to the New Zealand economy. (Elliot Sawyer, Kirsten Woods)

It is recognised that IGA information may result in previously unpaid US tax liabilities being discovered. However, as officials have noted in the "Entering into an IGA" section of this report, we consider that, from a New Zealand economy perspective, the most detrimental course of action would be not to negotiate and implement an IGA.

The changes are being introduced by "stealth" through an omnibus tax bill. (Marvin Van Horn, Grant Kuppernick, John Smith (recommendation 20)

Officials note that almost all amendments to the core tax legislation (particularly the Income Tax Act, the Tax Administration Act and the Goods and Services Tax Act) that take place outside the budget process are contained in omnibus tax bills. The complex nature of tax legislation makes this process of regular omnibus bills the most efficient way of progressing policy and remedial changes. This includes substantial changes and redrafting of entire parts of tax legislation.

The content of all tax bills is publicly available as soon as the bill is tabled in Parliament, as is the Commentary to the bill and any regulatory impact statements prepared for bill items. This bill has followed all of these standard processes.

No adequate cost/benefit analysis has been undertaken/the interests of US persons in New Zealand have not been properly canvassed. (Grant Kuppernick, C Tobias, Caroline Hooper, John Smith, (recommendations 3, 4, 5, 10, 16 and 19), Henry Velthuizen, Marvin Van Horn)

Officials note that it is not possible to accurately determine exactly how many "US persons" are likely to be reported on under the IGA. However, officials note that 2013 Census information records 21,462 people that are "usually resident" in New Zealand were born in the United States.

Despite these figures, the "Entering into an IGA" section of this report sets out why officials consider the IGA to be in the best interests of New Zealand. Officials also acknowledge the difficulty in putting a dollar value on either entering into an IGA or declining to do so. However, even in dollar terms it is expected that negotiating an IGA would be the preferable course of action – the non-monetary factors, such as reputational risk, are seen as adding weight to this conclusion.

Officials consider that public submissions on this bill, and the scrutiny that entails, is a good way of gauging public opinion. As noted above, this bill has followed all the usual procedures regarding publicity and dissemination of its content. The number of submissions received indicates to officials that this process is robust and Committee members have a fair view of how the changes are perceived.

The IGA will not in fact be reciprocal/the IGA will not be a "treaty" under US law. (James George Janras, John Smith (recommendations 12 and 14), Lea Turkington)

These issues appear to be predicated on an assumption that the United States will not have the legislative or regulatory framework in place that will cater for reciprocity – or that the United States may cancel the IGA. Again, this is not an issue that officials are able to comment on. International agreements are negotiated on a good faith understanding that each party will give effect to its terms and only break those terms, or cancel the agreement, when there are genuine reasons for doing so. The IGA is no different in this regard.

New Zealand should negotiate an amnesty under which US citizens in New Zealand would have a fast-track to renouncing that citizenship or negotiate other New Zealand-specific IGA concessions. (John Smith (recommendation 6))

Officials have addressed this point in the "Matters raised by the committee" section of this report.

New Zealand should insist on full reciprocity, being that New Zealand should only report on US "residents", not US citizens. (John Smith (key recommendations 2 and 13))

Officials consider this to be a sub-set of submissions opposed to the United States' method of taxation. As set out above, it is not considered appropriate for Inland Revenue officials to comment on these matters.

Experience in the UK suggests that the IGA will result in discrimination. (Jonathan Evans)

Officials consider that any choices taken by financial institutions in regard to their relationships with "US person" customers will be less likely to result in discrimination than would have been the case without an IGA.

The IGA should not be classified as a double tax agreement (DTA) simply to over-ride privacy concerns. (John Smith (recommendation 17)).

Officials consider that the classification of the IGA as a DTA does not itself over-ride the Privacy Act. The relevant privacy principles in the Privacy Act are capable of being over-ridden by any legislation that expressly contradicts them (section 7 of the Privacy Act 1993).

The legislation should be delayed until after the IGA is signed. (Caroline Hooper, John Smith)
The committee should assume that New Zealand will sign on terms identical to the Model 1A IGA. (John Smith (recommendation 11))

Officials accept that it would be preferable to have an IGA agreed in order to inform the debate. However, New Zealand financial institutions will have to deal with the effects of FATCA from 1 July 2014 irrespective of any action taken by the New Zealand Government. In this context, given this bill is the last legislative vehicle that will allow for a 1 July 2014 application date, officials consider that advancing this legislation in the current bill is the only viable option. In providing its guidance notes (referred to in greater detail later in this report), Inland Revenue is assuming that a Model 1A IGA will be agreed and this report is also drafted on that basis.

The IGA will only affect the law abiding. (Dan Sullivan, James H Woods)

The aim of FATCA and the IGA is to reduce tax evasion. Officials are not in a position to speculate as to the potential volumes of "dishonest Americans" (as one submitter puts it) that will be reported on.

The IGA itself should be subject to public scrutiny, as should any future amendments to that agreement. (Lea Turkington, John Smith (key recommendation 1 and recommendations 21 and 23)

Inland Revenue officials note that the decision as to whether or not the IGA is subject to Parliamentary Treaty Examination is made by the Minister of Foreign Affairs. This decision will be taken prior to any treaty action being taken by the Government.

FATCA will be repealed in any event/reciprocity is being challenged in US courts. (Centre for Freedom and Prosperity, John Smith, James George Jatras)

Officials acknowledge that, as with all countries, the United States has the right to amend its own laws. It is therefore possible that the FATCA rules may be repealed at some stage in the future. However, officials consider that ignoring current US law and instead relying on the current or a future United States government taking such a course of action would be irresponsible and would provide no benefit for New Zealand institutions and individuals who are, in the meantime, left to comply with the existing 1 July 2104 deadline.

Officials are aware that court proceedings in the United States are ongoing. However, a Federal Court has recently upheld the legal status of reciprocal reporting under IGAs.[4]

The Government must inform affected persons what the IGA means for them. (John Smith (recommendation 8)

As mentioned later in this report, Inland Revenue is providing extensive guidelines on how the IGA will operate in practice. This guidance is expected to be finalised after an IGA is agreed.

The New Zealand Government should not be funding FATCA.

As set out in the "Entering into an IGA" section of this report, the decision to enter into an IGA is at least in part an attempt to lower compliance costs that would be imposed on financial institutions in any event. It is anticipated that, by centralising some of these costs, the compliance costs on New Zealand as a whole will be reduced.

The legislation does not govern what information is exchanged (Paul Andrew Ross), is generally too broad (Victor Paul), is too open given the IGA has not yet been signed (John Philips)

Officials note that the actual information to be exchanged would be contained in the IGA. Given this legislation is designed to accommodate future similar agreements, officials consider the lack of specificity is appropriate.

---

[4] http://www.justice.gov/tax/2014/flabankersassoc.pdf

Officials reiterate that the proposed legislation is only the framework in which any IGA will operate – the two processes are separate. If an IGA is not signed for any reason, this legislation will exist without any operative effect.

Tax relief provided by the double tax agreement is inadequate (John Richardson), and this DTA should be reviewed. (John Smith (recommendation 7))

Officials acknowledge that the double tax agreement (DTA) with the United States does not apply to all forms of taxation. This is not unusual in such agreements. However, submitters appear to accept that it does apply to employment and investment income. Officials consider that, for the vast majority of people, this will cover the major forms of their income.

Information will be shared with other US government agencies. (Marvin Van Horn, Dr Stuart Jeanne Bramhall)

The actual information exchange in accordance with any IGA will take place under the existing DTA between the countries. Article 25 of the DTA sets out the terms under which information exchange will occur. This article will apply to IGA information. Article 25(2) provides:

> Any information received under this Article by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes referred to above, or the oversight of such functions. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

The enabling provisions and the IGA need to be read and considered together. (John Smith (recommendations 24 and 25))

Officials consider that the submission process to this bill has ensured that the Committee is aware of the potential impact of the IGA.

The practical implications of the IGA for family trusts have not been evaluated. (John Smith)

Officials reiterate (as set out in the response to a New Zealand Bankers' Association submission on "reasonableness" below) that Inland Revenue is currently undertaking a process whereby it is producing guidance notes for public consultation. Part of those guidance notes covers the IGA implications for trusts, including family trusts. Inland Revenue is happy to receive submissions on those draft guidance notes as part of its ongoing public consultation process.

A summary of submissions should be provided to Cabinet. (John Smith (recommendation 22))

Officials see no reason why the usual process by which the Committee reports to Parliament should be deviated from in this instance.

The OECD and FATCA models are different. (John Smith (recommendation 18))

Officials acknowledge that there are differences, but note that, in some respects, more reporting may take place under the draft OECD model because that model does not appear to have any low-value thresholds. Again, the real issue appears to be the citizenship basis of taxation adopted by the United States.

The due diligence requirements on New Zealand financial institutions need to be clarified. (John Smith)

Officials consider that preventing financial institutions reporting on low-value accounts (as set out in the bill) will address many of the privacy concerns expressed by individuals.

The effect of US tax policies on KiwiSaver funds needs to be clearly understood. (John Smith)

The submitter notes that the model IGA would treat KiwiSaver funds as “non-reporting”. In saying this, officials accept that this may not remove any underlying tax obligation a US taxpayer may have in respect of such funds. However, as the Committee will recall from recent changes to New Zealand’s foreign superannuation rules, a country exercising taxing rights over savings held in another country is not necessarily unusual.

The legislation constitutes an override of the DTA. (John Smith (recommendation 15))

Officials do not consider this legislation will override the existing DTA. As set out above, the information exchange will take place under the DTA but will not have an overriding effect.

Suggested alternatives

Many submissions also suggest alternative courses of action that the Government should consider in preference to entering into an IGA and enacting the legislation proposed. These include the Government taking no action and letting the financial institutions deal with FATCA within the existing legal framework.

Officials have addressed why Government inaction is not considered appropriate in the “Entering into an IGA” section of this report. Officials do not propose to comment on the various alternative courses of action suggested by submitters. The decision, at its simplest level, is to enter into an IGA or not. All alternative courses suggested by submitters are effectively a subset of the second option.

Recommendation

That the submissions be declined.

TECHNICAL MATTERS

Clauses 150 and 151

Issue: Criminal penalties

Submissions
(AMP, ANZ, BNZ, Ernst & Young, New Zealand Bankers' Association)

Failure to register should not be a criminal offence, if it is to be a criminal offence, it should not be an absolute liability offence or be subject to some "reasonableness" standard.

Comment

Officials accept that in some respects, IGA compliance will be "self-policing" because the potential of being labelled "non-participating" (effectively, non-compliant) by the United States could have a severe impact on the business of a financial institution. However, under the proposed IGA with the United States, it is expected that New Zealand will have obligations to remedy any serious non-compliance by New Zealand financial institutions. Therefore, in order to be in a position to comply with the IGA, officials consider it is necessary to have a domestic penalties regime in place.

The New Zealand tax rules divide penalties into two categories: civil and criminal. Criminal penalties are effectively already in place in existing legislation for what officials consider are the other likely forms of serious non-compliance: failing to collect IGA-relevant information; and failing to pass that information onto Inland Revenue when required to do so (under a notice issued under section 17 of the Tax Administration Act). The bill therefore proposes a criminal sanction for failing to register when required to do so.

Officials consider that it would be incoherent to have criminal penalties for some aspects of serious non-compliance and civil penalties for others. Such a system would be costly to administer and would seemingly place a priority on enforcing some non-compliant acts, when the IGA will require New Zealand to address all forms of significant non-compliance.

In addition, civil penalties are generally levied on the basis of tax owing. However, in the IGA context there is no tax owing on which to attach a penalty. Any civil penalty would therefore have to take the form of a fine of an arbitrary figure. Bearing in mind New Zealand's obligation to enforce compliance, it is considered that a civil penalty may not have the desired deterrent effect. This is because the penalty would have to be set at a level that would not financially cripple smaller institutions, but was nevertheless meaningful for larger institutions. Officials do not consider that a single civil penalty can achieve this result. By contrast the deterrent effect of criminal sanctions is universal.

Finally, officials note that Inland Revenue, if it were to pursue a prosecution for failure to comply with obligations under the IGA, is always subject to the Solicitor-General's Prosecution Guidelines.[5]

---

[5] http://www.crownlaw.govt.nz/uploads/prosecution_guidelines_2013.pdf.

These guidelines emphasise that a prosecution can only be brought if, amongst other things, the prosecution is "required in the public interest". Officials consider these guidelines set a high bar and the Committee and submitters can therefore be reassured that prosecution decisions will not be taken lightly and can only be taken when the public interest warrants that action. Officials consider it extremely unlikely that any form of inadvertent non-compliance (such as that described in submissions) that was immediately remedied by the financial institution could ever satisfy this test.

Recommendation

That the submission be declined.

Issue: Transition period

Clauses 150 and 151

Submission
(KPMG)

Given the tight timelines for IGA/FATCA compliance, there should be a transition period for the proposed penalties that apply to financial institutions.

Comment

Officials accept that timeframes are tight for financial institutions. However, although information collection is due to commence on 1 July 2014, there will not be any actual reporting requirements for financial institutions until around the middle of 2015. Officials consider that is the earliest point at which any non-compliance will be able to be detected. It is anticipated that this is enough time for financial institutions to prepare.

In any event, officials note that the 1 July deadline for information gathering has been publicly known for some time. Although the IGA and the related provisions in this bill provide the legal framework for FATCA reporting, financial institutions have long been aware that their obligations would commence on 1 July 2014 and the first filing obligation would be in 2015.

Recommendation

That the submission be declined.

Issue: Timeframes for reporting

Clause 158

Submissions
(ANZ, BNZ, Ernst & Young, New Zealand Bankers' Association, New Zealand Institute of Chartered Accountants)

The timeframe for providing information to Inland Revenue should be:

- Four months. *(ANZ, BNZ, New Zealand Bankers' Association)*
- Six months. *(Ernst & Young, New Zealand Institute of Chartered Accountants)*

Comment

The bill proposes that information be collected in respect of a New Zealand tax year, ending on 31 March. The IGA is likely to require that information be transmitted by Inland Revenue to the IRS by the end of September in the same year. As a result, there a six-month window between the end of the year and final date for information to be sent. Allowing financial institutions the full six months to report to Inland Revenue, as proposed by some submitters, is therefore unworkable.

The bill proposes that financial institutions proving information to Inland Revenue in accordance with the IGA must do so within two months. The reasons for this are:

- Inland Revenue will act as more than simply a "post-box" for IGA information. It is anticipated that Inland Revenue will also have a "gatekeeper" role to ensure that the data provided meets the minimum reporting standards. If a financial institution fails to provide complete data, this must be followed up to determine whether the data was sent in error or if more complete data is available to comply with minimum standards. In a worse-case scenario, this could mean that Inland Revenue would go through this process with every financial institution. The two month/four month split was therefore designed to allow some time for this checking to occur and also build in some inherent flexibility in reporting times (noting that there are no proposed legislative sanctions for late filing).

- The IGA itself contemplates that the reporting should generally occur on a calendar year basis. This reporting period would allow nine months between the end of the period and the due date for transmission to the United States. The bill's proposal to move this reporting period to a tax year was made because the industry preferred a reporting period that aligned with its tax reporting periods. On the assumption that Inland Revenue considered it needed four months to screen and collate the data, it seemed appropriate that the risk of the later reporting period be borne by the industry that requested it – rather than the Government.

- Two months is the timeframe in which financial institutions must provide their non-resident withholding tax information in respect of accounts held by non-residents. Given the potentially similar customer base between the two types of reporting, there appear to be sound reasons for having a consistent reporting period.

In saying this, officials also recognise that providing this information will be as new to financial institutions as it will be for Inland Revenue. We also understand that some of the timeframe allotted to Inland Revenue was to allow for the data to be accumulated before sending. This has now changed. Indications from the United States are that it will accept information on a more piecemeal basis, so information from a single financial institution can be sent as soon as it is verified as meeting minimum standards. This being the case, officials consider there is some scope to move the reporting deadline, but not to the extent requested by submissions. Given that (in practice) information is likely to be received on or near the final date, some time is still needed for Inland Revenue to verify incomplete records. Officials therefore consider that splitting the six-month period evenly between the financial institutions and Inland Revenue will provide a fairer outcome for both parties.

Recommendation

That the submissions be accepted in part, with the reporting period for financial institutions extended to three months.

Issue: Excluded choices

Clauses 158

Submissions
(AMP, ANZ, BNZ, New Zealand Bankers' Association, PricewaterhouseCoopers)

The concept of excluded choices should be limited so that financial institutions can still collect information from all new account holders, but only report on those where the value of the accounts exceeds the thresholds set out in the IGA. *(AMP, ANZ, BNZ, New Zealand Bankers' Association)*

Prohibiting reporting on low-value accounts will increase the FATCA compliance costs for financial institutions and is not justified on policy grounds. Financial institutions obliged to report should be able to do so in the most cost-effective manner, even if this requires additional data to be collected and/or reported. *(PricewaterhouseCoopers)*

Comment

The provision dealing with excluded choices is designed to prevent a possible area of over-reporting. As the volume of submissions attest to, unnecessary reporting to the IRS is a genuine concern both for US persons and those that hold joint accounts with such persons. The bill therefore proposes that financial institutions cannot ignore any low-value thresholds set out in the IGA. Without this provision, a financial institution could chose to report on a US person that, for example, had an account with a balance of $30,000, even though such reporting is not actually required by the IGA.

However, officials recognise that:

- It is unlikely to be possible for a financial institution to accurately assess on account-opening what a person's account balance is likely to be at the end of the tax year, when threshold tests are applied.

- For a financial institution, the best time to collect the relevant information is on account opening. Having to extract information from an existing customer at the end of the year in which account balances exceed certain thresholds may be expensive and relatively unfruitful.
- Although the provision of data is understandably a sensitive area, the real issue in this case appears to be the transmission of any data to the IRS, rather than the information being collected and retained by the financial institution.

Officials therefore agree with submitters that the legislation should be amended to allow data to be collected, but nevertheless prohibit over-reporting of that data.

Recommendation

That:

- The New Zealand Bankers' Association, AMP, ANZ and BNZ submissions be accepted.
- The PricewaterhouseCoopers submission be declined.

Issue: Permitted choices

Clause 158

Submission
(New Zealand Bankers' Association)

At present, the bill arguably requires a person to comply with all possible scenarios contemplated in a foreign account information-sharing agreement. The application of the "permitted choice" provision should be limited to the choice actually made.

Comment

Officials disagree with the interpretation of the relevant section adopted by the submitter. The submitter refers only to sections 185F(1) and (3). However, it is intended that proposed section 185F be read as a whole. Particularly relevant to this submission is the wording of proposed section 185F(2).

Section 185F(1) is designed as an application section. It sets out what a "permitted choice" is – effectively any choice described or contemplated by the agreement. Section 185F(2) then provides the rule that applies to those choices. It says that the person is authorised to make a permitted choice and carry that choice into effect.

An application provision, followed by a rule, is a common feature of tax legislation. Officials consider its use here is appropriate and, more importantly, provides the desired policy outcome. This outcome is, as the submitter notes, allowing financial institutions to make, and carry into effect, a choice contained in the relevant agreement. It is not intended to compel a financial institution to make all possible choices.

Recommendation

That the submission be declined.

Issue: The information required to be provided

Clause 158

Submission
(New Zealand Bankers' Association)

There should be a distinction between information that a person is required to provide to Inland Revenue and information they are authorised to provide.

Comment

Again, this is an issue where officials disagree with the interpretation adopted by the submitter. As the submitter notes in its previous submission, proposed section 185F(3) modifies a person's obligations to the extent necessary to give effect to a permitted choice. This modification also applies to the section at issue here: section 185I.

It is anticipated that the information that a person provides may, to some extent, depend on "permitted choices" they have made. The purpose of section 185I is to compel the person to provide whatever information is produced from the exercise of their choices. The provision of this information is not optional – however, the composition of this information will depend on choices made.

For example, suppose two financial institutions in the same position are permitted a choice under the relevant agreement to do X or Y. Institution 1 chooses X and is required to report on 100 customers. Institution 2 chooses Y and is required to report on 50 customers. The number of customers reported on will be directly affected by the choice, but each institution is nevertheless required to provide the information that it produces as a consequence of their respective choices.

The section is designed to neither force a financial institution to report on the maximum or minimum number of people (such an obligation would be impossible to enforce in any event because it may not be known at the time the choice is made what the exact consequences of that choice will be). An institution is simply required to follow the consequences of any choices made.

Recommendation

That the submission be declined

Issue: "Reasonableness" standard

Clause 158

Submissions
(New Zealand Bankers' Association)

Obligations under Part 11B should be subject to a "reasonableness" standard.

Comment

Officials agree that IGA compliance is a new and untested regime. However, this is similarly true of any new set of tax rules. There is invariably a "bedding in" period for any new set of rules. Although officials accept that underlying FATCA is a complicated set of US Treasury regulations, the IGA is intended to significantly reduce, and in some cases eliminate, the need to consult those regulations. Therefore, there does not appear to be anything unique about Part 11B in this regard.

However, officials note that, in order to address the concerns of the financial services sector, Inland Revenue is currently undertaking a process whereby it is producing guidance notes for public consultation. These guidance notes are effectively draft interpretations of the model IGA, and feedback on the interpretations taken are being sought with a view to providing a full set of guidance notes covering all key issues before 1 July. It is anticipated that this process will allow the Department's preliminary views of some of the more contentious issues to be tested and, ultimately, publicised so that the key affected parties are aware of these views.

Recommendation

That the submission be declined.

Issue: "Contemplated by the agreement" too broad

Clause 158

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

That the use of the phrase "contemplated by the agreement" in the draft legislation is too broad.

Comment

The expression "described or contemplated in the agreement" is designed to provide financial institutions with some degree of flexibility. Officials would be concerned if a financial institution felt it could not provide relevant information because that exact information was not strictly "described" in the IGA.

Recommendation

That the submission be declined.

Issue: Defining a "valid request"

Clause 158

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

The legislation, in proposed section 185J, needs to be clearer in setting out what a "valid" request from a foreign competent authority is. *(Ernst & Young, New Zealand Institute of Chartered Accountants)*

There should be legislative authority to decline a request that is not "valid". *(New Zealand Institute of Chartered Accountants)*

Comment

The IGA contemplates that information exchanges will generally occur between "competent authorities" (being special units within Inland Revenue in New Zealand and the IRS in the United States). However, it is expected that the IGA will also have a mechanism whereby, if the IRS discovers a minor or administrative error in information provided by a financial institution, it can approach the relevant financial institution directly to seek to address the matter rather than make all such requests through Inland Revenue. Proposed section 185J contemplates these exchanges and authorises New Zealand financial institutions to legally respond directly to such IRS requests without first having to respond to Inland Revenue.

Officials consider that a "valid" request will be one made in accordance with the terms of the IGA, where the IRS will be attempting to quickly resolve simple queries. It is accepted that there may be circumstances when it is unclear whether a request is strictly of a "minor or administrative" nature, or whether the request is actually more substantial. However, the competent authority at Inland Revenue will be available to assist financial institutions in making this judgement, if the need ever arises. Attempting to legislatively define "minor and administrative errors" could cause interpretation issues, and will detract from the broad nature of the legislation by introducing more terms that are potentially IGA-specific. In any event, the IRS has the option to contact Inland Revenue directly to seek its assistance in resolving any concerns they might have with the correct administration of the IGA.

Specific legislative authority is not needed to decline a request that is not valid. By definition, a request that exceeds the scope of the IGA's terms will not be "valid", so a financial institution will not be expected to respond to it.

Recommendation

That the submissions be declined.

Issue: Guidance for New Zealand financial institutions

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

Inland Revenue should educate New Zealand financial institutions on their anticipated obligations under the IGA.

Comment

As mentioned above, Inland Revenue is currently drafting comprehensive guidance notes on what are seen as the key interpretive issues in the model IGA. Priorities for this guidance have been set in consultation with the industry, so that maximum time is allowed for discussion and finalising the Department's views on contentious areas. In addition, the Department is also accepting and responding to ad hoc queries from interested parties on specific issues.

Recommendation

That the submission be noted.

Issue: Solicitors' trust accounts

Submission
(New Zealand Law Society)

The status of solicitors' trust accounts should be clarified by officials or specifically addressed in legislation.

Comment

Officials consider it would be contrary to the IGA to provide reporting exemptions in domestic legislation that are not provided for in the IGA itself. Such a course of action could see New Zealand breach the terms of the IGA by not providing information it has agreed to provide. However, officials acknowledge that the status of trusts is contentious – largely because "trusts" can range in complexity from simple family trusts through to widely held unit trusts.

For this reason, since submissions on this bill closed, the Department has released draft guidance on the IGA status of trusts, including solicitors' trust accounts. Dialogue on these guidance notes is the most appropriate way of clarifying the status of trust accounts.

Recommendation

That the submission recommending clarification by officials be noted, acknowledging that draft guidance has since been provided.

That the submission recommending the status of solicitor's trust accounts be addressed in legislation be declined.

Issue: Information provided and Privacy Act breaches

Clause 158

Submission
(New Zealand Law Society)

To cater for the possibility that information might have to be provided by account holders (including solicitors), the legislative protection against breaches of the Privacy Act should be extended to allow account holders to provide information when requested.

Comment

Officials consider that, if an account holder (such as a trustee) is asked to provide information on underlying beneficiaries, it will ideally ensure that it has the power to do so under the relevant trust deed or contract. It is anticipated that account holders will generally be protected by terms and conditions that allow them to comply with all legal information requests from financial institutions.

It is important to note that the proposed legislation is designed to ensure that financial institutions have all the tools available to collect and provide information to Inland Revenue in accordance with the IGA. It deliberately does not require account holders to provide the information when requested by financial institutions. This is because FATCA and the IGA are principally obligations on the Government and financial institutions, not the general public. If a person declines to provide relevant information, the default position may be that they are reported on as a suspected US person. The financial institution may also reserve the right in its terms and conditions to close such accounts. However, this is a choice and it is not considered appropriate to legislatively interfere with the relationship between financial institutions and their clients.

Recommendation

That the submission be declined.

Issue: Tax credits

Clause 37

Submission
(Ernst & Young)

It should be confirmed or clarified that New Zealand taxpayers may claim foreign tax credits for the full amount of (the 30%) FATCA withholdings in relation to income that is assessable here.

Comment

It is Inland Revenue's view that the 30% withholding penalty will not qualify for foreign tax credits. This is because it is not a foreign income tax – it is a penalty. The Department's conclusion on this point has been communicated to the financial services industry, including some instances when a credit could become available.

From a policy perspective, allowing a credit is not considered to be an appropriate outcome. It would permit a financial institution to effectively use the New Zealand tax base to offset a penalty that came about because that financial institution has failed to comply with the IGA. If a financial institution finds itself in a position where FATCA penalties are being imposed, the economic cost of that should be borne by that institution, not by the Government. This is consistent with how other similar penalties are treated for tax purposes.

Officials do not consider it is appropriate to legislate for this outcome because the current legislation already provides for it.

Recommendation

That the submission be declined.

MATTER RAISED BY THE COMMITTEE

The Committee has asked officials to consider whether there are any internal processes that New Zealand can undertake to allow dual New Zealand/United States citizens to renounce their US citizenship.

Officials note that the United States already has systems in place that provide for renunciation of citizenship. Officials consider that the New Zealand Government can only realistically control its own immigration laws, rather than those of another country. Granting New Zealand citizenship (or any other immigration status) to a US citizen does not have an immediate bearing on that person's US tax obligations. As a result, officials do not consider there is any unilateral action that New Zealand can take to alter a person's US tax obligations. However, as noted above, officials consider that the DTA between the two countries does provide relief from double taxation in many instances.

Deregistration of charities

OVERVIEW

Ten submissions were received on the proposed new tax rules for deregistered charities and were largely supportive of the underlying policy intention of the proposals. Submissions made a number of suggestions to improve the overall functioning of the new rules.

A major issue in submissions related to the new tax on net accumulated assets of a deregistered charity that retains its net assets 12 months after deregistration. A number of submissions opposed the new tax on the basis that it may result in unintended and inappropriate consequences. This includes, for example, the over-taxation of some deregistered charities, compared with what they would have paid had they always been subject to tax. Even so, we believe the policy underlying the new tax is appropriate. Although some minor technical modifications are being recommended by officials, these will leave the original proposal largely intact.

The Committee directed officials to consult with some Māori bodies to discuss the possible effects of the proposed rules for deregistered charities, particularly in the area of treaty settlements. As a result of this consultation, we have recommended amending the proposed requirements of the tax on net assets to exclude treaty settlements from the calculation of the tax. This change is consistent with previous government policy decisions to enable the transfer of settlement assets as part of a Treaty of Waitangi settlement to be effected without any tax impost.

END OF "TAX CHARITY" STATUS AND GRACE-PERIOD FOR COMPLIANT ENTITIES

Issue: Compliance with the relevant constitutional documents or other information supplied to the Charities Commission or Board at the time of applying for registration

Clause 27

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

The amendments to section CW 41 ensure that deregistered charities will continue to be tax-exempt until the date of "final decision", so long as they have acted in accordance with their constitution or other information supplied to Charities Services at the time of applying for charitable status. This effectively provides a "grace-period" for compliant entities starting from the date of registration with Charities Services to the earlier of two dates: namely, the day the entity is removed from the charities register or the day on which that entity exhausts all disputes and appeals to determine its charitable status.

The requirement to act in accordance with "information supplied … at the time of applying for charitable status" is unclear and not workable. This is because an entity's constitution may be amended over time, and the requirement to act in accordance with information supplied at the time of applying for registration will become increasingly anachronistic and irrelevant as time passes. We suggest changing this requirement to refer instead to the "constituting document" or the "entity's rules as filed on the charities register".

Comment

We support the submissions. The constitution or rules of a registered charity are required to be filed on the charities register and any changes to the constitution or rules of the entity are required to be notified and reviewed by Charities Services. The constitution or rules of the entity as they appear on the charities register are current. Therefore, we believe it is sufficient to refer to the entity's rules as they appear on the charities register.

Recommendation

That the submissions be accepted.

Issue: It is unclear why "day of final decision" should be used as an end point for the grace-period

Clause 27

Submission
(New Zealand Law Society)

As noted above, the grace-period effectively allows an entity to remain a tax charity, and to be protected from exposure to tax on a retrospective basis, until any appeals or proceedings "in relation to … charitable status", are finalised or exhausted.

It is unclear why this should be used as an appropriate end date.

If such appeals or proceedings are successful, the entity should not be removed from the register at all. It is also noted that that the Courts can make interim and final orders for an entity to be restored to the register from a specified date and to remain on the register (sections 60 and 61 of the Charities Act).

If such appeals or proceedings are unsuccessful, there does not seem to be any reason why the effective date of removal specified by the Charities Commission or Board, or effective date of removal as determined by the Court should not stand.

Comment

The protection afforded by the "grace-period" is based on whether a charity has been compliant with its constitution or rules. This is a significant departure from the current rules, which assess whether a charity is deriving income for charitable purposes.

We do not agree that the grace-period should end sooner for entities which do not successfully appeal their deregistrations. This is because these entities would have been acting in compliance with their constitutions or rules, and we feel comfortable that they should continue to be tax-exempt until the point that it is determined whether or not they will continue to be registered. The decision to deregister the entity might have come about as a result of a change in jurisprudential interpretation of whether a specific activity is in fact charitable in purpose. To subject the deregistered entity to tax while it is disputing the decision to deregister would impose unnecessary tax and compliance costs on an entity which has acted in good faith in compliance with a constitution it believed met the requirements for charitable status.

Recommendation

That the submission be declined.

Issue: Grace-period for compliant entities should be retrospective

Clause 27

Submission
(New Zealand Law Society)

The amendments should also apply with retrospective effect given that the amendments are taxpayer-friendly, and entities that have already been deregistered should be given the protection afforded by the amendments.

Comment

The amendments relating to the grace-period are intended to provide increased certainty that, for tax purposes, entities can rely on the decision made by Charities Services to recognise that entity as charitable in purpose. Other amendments, such as the new tax on accumulated net assets in new section HR 12, impose additional requirements on deregistered charities. Those requirements are intended to maintain the integrity of the tax concessions available to charities and improve overall public confidence in the charitable sector.

The grace-period is taxpayer-friendly, and will reduce the number of organisations which could face retrospective tax liabilities if they are deregistered. We understand the desire for certain taxpayer-friendly changes to have retrospective effect, but we note that they are designed as part of a package of changes, some of which would not be appropriate to apply retrospectively.

Recommendation

That the submission be declined.

TRANSITION FROM TAX-EXEMPT STATUS

Issue: The application of other income tax exemptions to deregistered charities

Clause 107

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

New section HR 11 clarifies how a deregistered charity should establish its initial tax base – such as the opening values of its assets and consideration for its financial arrangements. These tax base calculations are required to be undertaken on and after the date that a deregistered charity ceases to derive exempt income.

New section HR 11 does not take into account the possibility that a deregistered charity may be eligible for one of the other income tax exemptions in the Income Tax Act 2007 (for example, the exemption for local and regional promotion bodies, amateur sports promoters or scientific or industrial research entities) which would avoid the need to undertake the tax base calculations in new section HR 11.

The wording of new section HR 11 should be clarified to confirm that it will not apply if a deregistered charity is exempt under a provision other than section CW 41 or section CW 42.

Comment

We accept the submitters' points that an entity which is removed from the charities register may still be eligible for an income tax exemption under another provision of the Income Tax Act 2007. We did not consider it necessary to set out in legislation that other exemptions would still apply to these entities because it was clear that they would. Even so, given the concerns raised by submitters, this matter should be clarified in the legislation.

Recommendation

That the submissions be accepted.

Issue: Market value should be an option for valuation

Clause 107

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

New section HR 11 does not allow a market value option in the valuation of an entity's assets or financial arrangements. A market value option would be helpful in situations when historical cost information for valuing the entity's assets or financial arrangements is not available.

Comment

We accept that some deregistered charities may not have sufficient records on the actual historical cost of their assets and financial arrangements because either they were not required to keep those records, or have low administrative capability which is common in smaller charities. Consequently, it would be difficult for them to establish the tax costs of their property, plant, equipment and trading stock. In this regard, having an alternative means of establishing the cost values would be helpful. However, we have concerns with using market value as an alternative because it could lead to higher depreciation deductions and present a risk to the revenue base.

We note that there is a requirement under section 41 of the Charities Act 2005 for registered charities to furnish to the Charities Board an annual return containing financial information about the assets and liabilities of the charity. For charities that do not have historical cost records they will be able to use the cost data provided in their annual returns.

Recommendation

That the submission be declined.

Issue: The operation of new section HR 11(5) should be clarified

Clause 107

Submission
(Ernst & Young)

Clarification would be desirable that any prepayment or deferred employment payment deductions allowed under the proposed section HR 11(5) would still be subject to subsequent balance date add-backs under sections EA 3 and 4, CH 2 and 3 of any amounts then remaining unexpired.

Comment

We agree that the operation of new section HR 11(5) should be clarified in the *Tax Information Bulletin* following enactment of the bill.

Recommendation

That the submission be accepted.

Issue: Entities should be able to elect to be a Māori authority retrospectively

Submission

(Te Ohu Kai Moana Trust)

If a deregistered charity is eligible under section HF 2 to be a Māori authority, it should be able to elect to be a Māori authority with effect from the date at which the charitable exemption in section CW 41 ceases to apply to it.

Comment

Under the proposed amendments, a deregistered charity will be taxed in accordance with the general tax rules of the Income Tax Act 2007 from the point at which it ceases to be eligible for the charitable income tax exemption. In the absence of another income tax exemption applying, these entities will be subject to tax based on their legal form or the activities that they carry out. For example, a company will be taxed as a company and subject to tax on its income at the corporate tax rate of 28%, a trust will be taxed as a trust and subject to tax on its trustee income at the rate of 33%, and a Māori authority will be taxed at the rate of 17.5%.

An entity which is eligible may choose to become a Māori authority by notifying the Commissioner of Inland Revenue. The election then takes effect prospectively. The rules concerning elections to become a Māori authority do not contemplate a retrospective election.

If a deregistered charity that is eligible to be a Māori authority is removed from the charities register and has ceased to act in compliance with its constitution or rules, its election to become a Māori authority would only take effect prospectively. This will result in that entity being taxed at a higher rate for its retrospective tax obligations than its prospective tax obligations.

We consider that deregistered charities which are eligible to be Māori authorities should be able to make a retrospective election to become a Māori authority.

Recommendation

That the submission be accepted.

Issue: New sections CV 17 and HR 12 should not be introduced, pending a thorough review

Clauses 19 and 108

Submission
(New Zealand Law Society)

New sections CV 17 and HR 12 set out the requirements of the new tax on net assets. They provide that an entity has an amount of income equal to the greater of zero or the value of its net assets held at the time that is 12 months after the date of deregistration, subject to some adjustments.

These adjustments carve out certain assets, which reduce the net assets balance that will be subject to tax. The items carved out are:

- any assets distributed to charitable purposes in the 12 months after the entity is deregistered; and
- any assets (not including money gifted or left to the entity while it was deriving exempt income.

The New Zealand Law Society submits that these amendments should not be made, pending a thorough review of their potential consequences. It considers that the proposed tax treatment of net assets may have unintended and inappropriate consequences. Specific concerns include:

- The amendments do not attempt to "claw back" accurately or in a scientific way the benefits of tax-exempt status to the entity in relation to accumulating assets and income.
- Some deregistered charities may be prevented from distributing their accumulated assets for charitable purposes post-deregistration. This may arise if the entity's purposes as set out in its constitution or rules are determined to be non-charitable in purpose.
- Although the apparent simplicity of the proposed amendments may seem attractive, the potential application of the amendments to a wide range of deregistered charities needs to be carefully considered.

Comment

Officials do not support the general thrust of the submission. We believe the policy underlying the new requirements of the tax on net assets is appropriate.

Current tax law (legislation and case law) supports the ability of charities to accumulate their income for future use, and no symmetry is required between the income tax exemption and the payments towards charitable purpose, either in amount or timing. Although there is a requirement for deregistered charities which cease to operate to distribute their assets and income to charitable purposes, there is no such requirement when deregistered charities continue to operate.

The stated policy is that the assets and income of a charitable entity with tax-exempt status should always be destined for a charitable destination, irrespective of whether the entity ceases to exist or not. However, if a deregistered charity continues in existence, the value of the deregistered charity's net assets (assets minus liabilities) should be subject to income tax. The imposition of tax in this instance is consistent with the current policy intentions underlying the charities-related tax concessions. In other words, the tax concessions should only be available to *bona fide* charities and deregistered charities should be held to account for the assets and income they have built up while they enjoyed the benefit of the tax concessions.

The proposed adjustments to the net assets balance and the one-year transition period before the tax is imposed is intended to provide encouragement to deregistered charities to distribute their assets for charitable purposes.

We consider that the proposed tax on net assets with adjustments and the resulting calculations is a simple, low compliance-cost option but we acknowledge it may result in a tax impost for some deregistered charities that is higher than what they would have paid had they always been subject to tax.

We have some sympathy for the specific concern relating to deregistered charities that may not be able to distribute their assets for charitable purposes post-deregistration because they had been found not to have a charitable purpose. To remedy their specific issue we consider that the entity could be permitted to distribute its assets for the purposes set out in its constitution or rules.

Recommendation

That the submission be declined in general.

That new section HR 12 be amended to allow deregistered charities to distribute their assets in accordance with their constitution or rules.

Issue: The tax on net assets should be paid a year after the day of final decision, rather than a year after deregistration

Clauses 19 and 108

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

The tax liability should be calculated on net assets held by the deregistered charity on the "day of final decision" rather than the day the entity is removed from the Charities Register. The starting date for the calculation of the tax liability of the deregistered charity should be consistent with the date its tax-exempt status ceases under section CW 41. The proposed date of the day the entity is removed from the register does not take into account either the possibility of interim reinstatement to the charities register or the appeals process, which can be lengthy and carry on over a number of years. *(New Zealand Institute of Chartered Accountants, Sue Barker)*

Other provisions base the income tax consequences of deregistration on the date an entity's income ceases to be exempt under sections CW 41 or 42. Clause 27 proposes to amend section CW 41 so that organisations' income and "tax charity" status for those purposes would not necessarily end on removal from the Charities Register, but could continue until a later "day of final decision" as to their charitable status. We suggest that section HR 12 should also be based on the date of cessation as described in proposed section HR 11(1) for consistency. *(Ernst & Young)*

Comment

Submissions are correct in noting that the time at which the entity should have to pay tax on the net assets it has not distributed for charitable purposes should be one year after the date of final decision, rather than one year after the date of deregistration. It is entirely possible that a disputes process could take more than one year and so the amendments, as currently drafted, could lead to a requirement to distribute the net assets before a final decision is made on whether an entity does in fact have charitable purposes.

The definition of "day of final decision" determines this is the later point of two dates, namely the day the entity is removed from the charities register, and the day all appeals are exhausted. Consequently, entities which dispute the deregistration decision will have a longer period before the tax on net assets is required to be paid.

Recommendation

That the submission be accepted.

Issue: Gifts of money should be excluded from the net assets calculations

Clause 108

Submissions
(Ernst & Young, New Zealand Institute of Chartered Accountants, New Zealand Law Society, Sue Barker)

As noted above, new section HR 12 requires deregistered charities to pay tax on the value of their net assets, with adjustments for assets distributed for charitable purposes in a one-year period, and for any assets (other than money) gifted or left to the person while that person was deriving exempt income under sections CW 41 or 42.

Submissions considered that:

- It is not clear why money is excluded from the net assets calculation. The words "other than money" should be deleted from section HR 12(2)(b). *(Sue Barker)*
- Gifts of money, or at least certain gifts of money, should be excluded from the calculation, as tax incentives will not necessarily have been claimed by donors in relation to such gifts, and there are other items that should also be excluded from the calculation – for example, possibly capital gain amounts or assets acquired before becoming tax-exempt. *(New Zealand Law Society)*

- Instinctively, amounts gifted to an organisation in any form should be excluded on the basis they represent some form of capital contribution rather than any trading or business income. Given the fungibility of money, the proposed exclusion for gifts of money is likely to be impossible to measure in practice since organisations may have cash on hand from various sources, such as gifts, trading or other income and sale of capital assets (which themselves may have been acquired using funding from a mix of sources). *(Ernst & Young)*
- The exclusion of gifted money from the proposed adjustment introduces an arbitrary distinction between donations made in kind and monetary donations. Such a distinction would drive behaviour that is not beneficial to either the charitable sector or the public. The proposal to include as "income" money gifted or left to the deregistered charity when the deregistered charity was deriving exempt income is contradicted by the Commentary to the bill. The Commentary states that for reasons of fairness an adjustment should be permitted for any donated assets as these assets were not funded by non-taxed income or through a tax-preferred source. Money that is gifted to a deregistered charity also meets these criteria: monetary donations are not "income" of the deregistered charity; and in most cases a donor's monetary donation is from post-tax income. *(New Zealand Institute of Chartered Accountants)*

Comment

Officials note that new section HR 12 is intended to encourage deregistered charities to distribute their accumulated assets and income to charitable purposes within a reasonable time after they are deregistered.

One submission states that for a charity there is no fundamental difference from a tax perspective between a gift of a non-cash asset or of money. As noted in the Commentary on the bill, the distinction between cash and non-cash assets relates to the tax preference generally afforded to donors in relation to cash gifts.

Officials acknowledge that this tax could be viewed as severe. However, we believe it supports the Government's policy position that money a deregistered charity acquired when it had an exemption from income tax should always be destined for a charitable purpose. This policy position is intended to maintain the integrity of charitable giving tax incentives, as donors can have some confidence that that charitable donations are more likely to remain in the charitable sector.

The policy position is also consistent with the requirement on charitable organisations to distribute all their assets to charitable purposes on winding up.

Recommendation

That the submissions be declined.

Issue: The tax on net assets should not apply to entities which have retrospective income tax liabilities

Clause 108

Submission
(New Zealand Law Society)

The new tax on net assets should not apply to a deregistered entity that is exposed to tax on a retrospective basis, at least when the benefits of tax-exempt status are clawed back in that way.

Comment

The tax on net assets is intended to protect the integrity of the revenue base by ensuring the tax concessions that apply to charities are well-targeted and policy intentions are met. This includes, for example, ensuring that if an entity has claimed tax exemptions as a charity and has accumulated assets and income, these assets and income should always be destined for a charitable purpose.

The submission is opposed to applying the tax on net assets in situations when the deregistered charity had been non-compliant with its constitution or rules and has had to reconstruct its tax position retrospectively. In this situation, applying new section HR 12 could be viewed as penal, but it is intended to encourage the entity to distribute the assets for charitable purposes.

Excluding deregistered charities that have been non-compliant from the tax on net assets would mean that the tax would only apply to entities which have complied with their constitutions or rules. This policy outcome would be unfair.

We also note that the benefits of the tax exemption are not fully clawed back, as the entity has had use of the money over the period of the tax exemption, and has enjoyed the compounding benefits of this.

Recommendation

That the submission be declined.

Issue: Split application date should be reconsidered

Clause 108

Submission
(New Zealand Law Society)

The rationale for the proposed split application date for section HR 12 should be reviewed, as it would be preferable for there to be a single application date. In light of the potential significance of the proposed amendments, the deferred April 2015 application would seem preferable, and this would not necessarily result in a rush of voluntary deregistrations bearing in mind the other tax consequences of deregistration and the fact that voluntary deregistrations would presumably be tracked during the period.

Comment

Officials do not support an application date of 1 April 2015 for new section HR 12 for entities which choose to voluntarily deregister. The split application date is intended to prevent entities choosing to "opt out" of the new tax on net assets by simply voluntarily deregistering from the charities register.

This new tax on net assets is a response to the current ability of charitable entities to accumulate assets and income while tax-exempt, and the lack of any requirement to distribute these assets for charitable purposes once the entity deregisters if it continues to operate.

We accept the submitter's point that there would not necessarily be a rush of voluntary deregistrations but believe a delayed application date could lead to some entities with substantial asset bases deregistering to avoid the new tax.

Recommendation

That the submission be declined.

Issue: Section HR 12 should be limited to tax which would have been payable had the entity never been charitable

Clause 108

Submissions
(Ernst & Young, New Zealand Law Society, Te Ohu Kai Moana Trust)

We appreciate that it may be difficult to provide an appropriate basis for bringing any income accumulated during a tax-exempt period into account without some element of arbitrariness. It is not clear, however, that amounts received by an organisation would necessarily have been taxable income even if the body had never been registered as a charity. Amounts received from members might have been excluded under the mutuality concept or the organisation might have been eligible for some other income tax exemption. Any income tax arising under new section HR 12 should be limited to the tax which would otherwise have been payable had the entity never been charitable (assuming the organisation has sufficient records to support such calculation). *(Ernst & Young)*

Taxpayers should have an option to refine the calculation of "net assets" under section HR 12(2) to remove items that would not have been taxable to them (or resulted in tax to pay) if they were not applying the charitable income tax exemptions. As currently drafted, this provision will operate to tax a deregistered charity on assets they continue to hold 12 months after deregistration even when the assets would not have been taxable to them if they had not been applying the charitable exemption in sections CW 41 or 42.

Of particular relevance to organisations that Te Ohu Kai Moana represents are assets distributed to iwi organisations pursuant to a Treaty of Waitangi fisheries settlement. Receipt of these assets does not give rise to taxable income based on the application of general principles (that is, it is a capital receipt) irrespective of whether the recipient has charitable status. There are other settlements of a similar nature – for example, the forestry settlement (dealt with under the Central North Island Forests Iwi Collective Settlement Act 2008).

This issue is not limited to assets received pursuant to Treaty of Waitangi settlements. It is equally applicable to any other categories of income derived by the deregistered charity that would not otherwise have given rise to taxable income had it been derived by a taxpaying entity. For example, capital gains and unrealised revaluation gains on assets.

Taxpayers should be provided with an option to refine the calculation of “net assets” by removing certain items if they have sufficient information to do so. By making the refinement of the calculation optional, the proposed amendment will not impose a compliance cost on deregistered charities that choose to apply the simple definition of “net assets” (as currently defined). However, it also allows a more neutral (and equitable) outcome to be reached for taxpayers who choose to undertake a more detailed calculation of “net assets”. *(Te Ohu Kai Moana Trust)*

The provisions relating to the calculation of the amount of income to be recognised in section HR 12(2) and (3) need to be carefully reviewed and should be more closely aligned with the concept of clawing back the benefits of tax-exempt status. *(New Zealand Law Society)*

Comment

We acknowledge submitters’ points that if a deregistered charity chooses to retain its accumulated assets after deregistration, the tax imposed on those assets under new section HR 12 will not result in the same outcome as if the entity had never received the charitable exemption. This result is intentional.

Submitters are correct in noting that the formula could result in tax being applied to amounts that would not have been taxable if the entity had been subject to income tax when it received or derived those amounts.

We note that the calculation in proposed section HR 12 is intended to encourage the entity to choose to distribute those assets for charitable purposes, rather than to retain them. As noted in the Commentary to this bill, the Government believes that the assets of an entity with tax-exempt status should always be destined for a charitable purpose, irrespective of whether the entity ceases to exist or not.

We therefore do not support giving taxpayers an option to apply a refined version of the net assets formula.

We are recommending, however, that assets received pursuant to Treaty of Waitangi settlements should be excluded from the requirements of new section HR 12. This change recognises previous government policy decisions to enable the transfer of settlement assets as part of a Treaty of Waitangi settlement to be effected without tax impost.

Recommendation

That the submissions generally be declined.

That the submission on assets received pursuant to a Treaty of Waitangi settlement be accepted.

Issue: Clarifying the meaning of "liabilities"

Clause 108

Submission
(Matter raised by officials)

New section HR 12 should be clarified to explain what is meant by "liabilities".

Comment

This clarification can be set out in the *Tax Information Bulletin*. An example of a liability would be the amount of tax which an entity would be liable to pay in relation to past years if it ceased to comply with its constitution or rules at some point before deregistration. Similarly, an entity might have incurred legal costs in disputing the decision to deregister it but not yet paid those amounts.

Recommendation

That the submission be accepted.

Issue: New section HR 12 should not apply to entities which are re-registered before the 12-month period ends

Clause 108

Submission
(Matter raised by officials)

New section HR 12 should be clarified to explain that when an entity is reregistered before the end date after which new section HR 12 takes effect, the entity should not be required to distribute its net assets or pay tax on those assets.

Comment

New section HR 12 should not apply to entities which are still eligible for an income tax exemption, whether by virtue of another exemption or because they have been reregistered as a charity.

As discussed in item "Issue: The application of other income tax exemptions to deregistered charities", we have recommended that new section HR 12 be amended to clarify that if an exemption applies to an entity, the requirements in section HR 12 will not also apply.

Recommendation

That the submission be accepted.

EFFECT OF DEREGISTRATION ON FRINGE BENEFIT TAX AND DONEE ORGANISATION STATUS

Issue: Consequences for donors should be dealt with at an administrative, rather than legislative level

Clauses 110

Submission
(Sue Barker)

Loss of registered charitable status does not necessarily mean loss of donee status.

The consequences for donors of donations made to a charity that is subsequently deregistered would be better dealt with at an administrative, rather than legislative level.

Comment

Officials disagree with the submission.

The proposed amendment is intended to ensure that donors have a greater level of certainty that their donations tax relief will not ordinarily be reversed in circumstances when they have made a *bona fide* monetary gift and the entity they have donated to is later deregistered. We do not consider that the proposed intention can be achieved by continuing to deal with this matter at an administrative level.

If an entity is removed from the charities register, and before deregistration it ceased to comply with the requirements to be a donee organisation, then the donations relief claimed for donations made in the period after the date of non-compliance can be reversed by Inland Revenue. In practice, this requires Inland Revenue to approach each donor for evidence of the amount and circumstances of their gift, which can be onerous. We did not consider that this outcome was satisfactory for donors, and believed that it might discourage charitable giving if people were concerned that any donations tax relief could later be reversed.

Recommendation

That the submission be declined.

Issue: Extending donee status to all registered charities

Clause 110

Submission
(New Zealand Law Society, Sue Barker)

The proposed amendment to section LD 3 will allow registered charities to have donee status even if they carry out their charitable purposes wholly or mainly overseas. It will therefore allow donations to overseas-focussed charities to be eligible for donations tax credits. This will render schedule 32 of the Income Tax Act 2007, and the careful vetting process by which overseas charities are able to become listed on schedule 32, largely redundant. It is not clear if this result is intended.

Comment

The submissions are correct in noting that this drafting has resulted in an unintended change. Officials did not intend to extend the scope of the donations tax credit regime to all entities registered on the charities register. As the submitters note, the current drafting would make all entities that are registered on the charities register "donee organisations", and therefore make all donations of $5 or more eligible for donations tax relief.

Recommendation

That the submission be noted.

That new section LD 3(1)(ab) in clause 110 be redrafted to ensure that it achieves its policy intention.

Issue: No protection for donors in relation to gifts to approved donee organisations on Inland Revenue's website

Clause 110

Submission
(New Zealand Law Society)

The protection afforded by new section LD 3(1)(ab) should be extended to donors who have made donations to entities included on the list of approved donee organisations, which is maintained on Inland Revenue's website.

Comment

The submission raises a valid point but further work is required before a decision can be made to extend the protection for donors in this situation. This work can be carried out as part of the current tax review of donee organisations, which is on the Government's tax policy work programme.

Recommendation

That the submission be noted.

That the submission be considered further as part of the current tax review of donee organisations.

Issue: Use of the terms "ceased charities" and "date of cessation"

Clauses 19, 27, 104 and 107

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

The word "ceased" should not be used in the headings of new section CV 17 and new section CW 41(6), as the charity may not have ceased. Similarly, this term should not be used in new section HC 31(1B). In addition, section HR 11 should be amended to refer to "the date of the change in circumstances" rather than "the date of cessation".

Comment

The use of the term "ceased charity" was intended to denote that the entity's "tax charity" status had ceased, rather than the charity itself. Officials accept that this phrase could be confusing and that a different phrase would be more appropriate.

Recommendation

That the submission be accepted.

Issue: Use of the term "person"

Clauses 19, 27, 107, 108 and 123

Submission
(Sue Barker)

The provisions relating to deregistered charities should use the term "entity", as that term is defined in the Charities Act 2005, rather than "person".

Comment

Officials consider that the term "person" is more appropriate than "entity". The term "person" as used in the Income Tax Act 2007 encompasses a wider range of entity types than "entity" as defined in the Charities Act does. For example, an unincorporated body of people is a person, but would not necessarily be an entity.

Recommendation

That the submission be declined.

Issue: Use of the term "Charities Commissioner"

Clause 27

Submission
(Sue Barker)

There is a typographical error in proposed section CW 41(1)(aa)(i), it should say "Charities Commission", rather than "Charities Commissioner".

Comment

Officials agree that this is an error.

Recommendation

That the submission be accepted.

Issue: Use of undefined terms

Clause 27

Submission
(Sue Barker)

The term "Board" is not defined. A definition should be added to section YA 1.

Alternatively, a generic term, such as "charities regulator" should be used instead, and defined in section YA 1, as this could cover the Department of Internal Affairs as well as the Charities Registration Board.

Comment

We accept this submission. Statutory bodies, such as the Charities Commission, do not need to be defined in the Income Tax Act. The submission correctly noted that the Board is not defined in statute.

Recommendation

That the submission be accepted.

Issue: Eligibility to derive exempt income in section HR 12

Clause 108

Submission
(Sue Barker)

New section HR 12(2)(b) excludes assets which were gifted or left to the person while the person was deriving exempt income under sections CW 41 or CW 42. The adjustment should not turn on whether the entity was actually deriving exempt income under these sections, but rather on whether it was eligible to do so.

Comment

Officials accept this submission. In a small number of cases a deregistered charity may not have been actually deriving income, and so the use of an eligibility concept is appropriate.

Recommendation

That the submission be accepted.

Issue: Clarify what "distribution" means

Clause 108

Submissions
(Ernst & Young, New Zealand Law Society)

New section HR 12 requires net assets to be "distributed for charitable purposes". It should be confirmed that assets may be regarded as "distributed" for the purpose of section HR 12 if their legal or registered ownership has not changed but there has been a change in the capacity and purpose for which they are held. For example, if a deregistered charity has resolved that particular assets be held on trust for another organisation with appropriate charitable purposes. *(Ernst & Young)*

To provide flexibility it would seem appropriate to refer to assets "distributed or applied" for charitable purposes within the relevant 12-month period and possibly also to clarify that this would include the entity settling, or declaring that it holds, assets on trust for charitable purposes within the 12-month period. *(New Zealand Law Society)*

Comment

We consider the term "distribution" is likely to be wide enough to encompass assets whose equitable ownership has changed. Even so, and for the avoidance of doubt, this matter can be made clearer in new section HR 12.

Recommendation

That the submissions be accepted.

Issue: Clarify whether gifts are to be disregarded in section HR 12 regardless of their current form

Clause 108

Submission
(Ernst & Young)

Clarification is required to determine that amounts must be disregarded in relation to gifts of money. It is not clear whether new section HR 12(2)(b) is intended to ignore gifts of money (regardless of the form in which they may now be represented and held) or the amounts of gifts which are now represented and held as money, even though the original gifts may have been of other types of assets or investment.

Comment

Officials consider this matter should be clarified in the *Tax Information Bulletin*, not in the legislation. The requirements in new section HR 12 are based on assets held at a relevant date. If an asset, other than money, was gifted to an entity but has since been disposed of and is now represented in money, that money is not ignored under proposed section HR 12(2)(b) as it is not in itself an asset other than money.

Recommendation

That the submission be accepted.

Issue: Clarify the definition of "net assets"

Clause 108

Submission
(KPMG)

The definition of "net assets" in new section HR 12 should be clarified to make it clear that if an asset is disposed of for an amount less than market value, at the entity's "end date", it is the amount of the net proceeds from disposal which is treated as income.

Comment

Officials consider this matter should be clarified in the *Tax Information Bulletin*, not in the legislation. The requirements in new section HR 12 are based on assets held at a relevant date. If an asset has been disposed of before that date for less than market value, then it is the amount of disposal proceeds which section HR 12 will take into account.

Recommendation

That the submission be accepted.

Issue: Suggested alternate approach to the amendments to section CW 41

Clause 27

Submission
(New Zealand Law Society)

The drafting of proposed section CW 41 is complicated and confusing, attempting to achieve its effect by way of amendments to section CW 41(1) and (5), plus the addition of new subsection CW 41(6), and a confusing provision relating to the application of the amendments (clause 27(5)).

The intent of the proposed amendments is to clarify the point in time when a deregistered entity is a tax charity and to ensure that an entity is not exposed to tax on a retrospective basis when the entity has effectively relied upon registration under the Charities Act 2005 in taking the position that it was tax-exempt.

A simpler way to achieve the policy intention would be to amend section CW 41 by:

- amending the definition of "tax charity" to clarify the start and end dates for this status; and
- adding a new subsection (which could be new subsection (1A), (2A) or (6)), that clearly states the intended effect (that is, tax charity status until the day of final decision, provided that the entity has complied with its constitution).

Comment

Officials believe the drafting of new section CW 41 meets the intended policy outcome but it could be simplified to improve taxpayer certainty.

The issue of retrospectivity, requiring the validation of past mistakes, coupled with the requirement of fairness on a go-forward basis and the current pre-existing structural complexity of section CW 41, all contribute to the difficulty of the drafting. The New Zealand Law Society's suggestions, which are also complex, demonstrate the inherent drafting difficulties. Nevertheless, we believe the current drafting of section CW 41, enhanced by some minor clarifications suggested by the Law Society and other submitters, is "fit for purpose".

Recommendation

That the submission be noted.

That new section CW 41 be simplified to improve taxpayer certainty.

Issue: Clarify that non-compliance with the entity's constitution or rules does not necessarily mean it does not meet the requirements in new section CW 41(1)

Clause 27

Submission
(New Zealand Law Society)

It may be appropriate to state explicitly that a tax charity's non-compliance with its rules does not necessarily mean that it does not meet the requirements set out in new section CW 41(1).

Comment

The proposed amendments apply to entities which are removed from the charities register. If an entity's non-compliance with its constitution or rules does not lead to it being removed from the register, these rules will not apply to that entity.

Recommendation

That the submission be declined.

Issue: Drafting should recognise that the effective date of registration could be before the day an entity is registered

Clause 27

Submission
(New Zealand Law Society)

The drafting should recognise that under the Charities Act 2005 the effective date of registration may be either the time at which an entity actually becomes registered as a charitable entity or an earlier "effective registration time" (Section 20 of the Charities Act 2005 refers).

Comment

Section 20 of the Charities Act 2005 sets out that:

> "The Board may, if it thinks fit, direct the chief executive to register a notice in the register of charitable entities that specifies that an entity must be treated as having become registered as a charitable entity at a time (the **effective registration time**) that is before the time at which the entity actually became registered as a charitable entity.
>
> If the Board exercises its powers under subsection (1) in relation to an entity, the entity must be treated as having become registered as a charitable entity at the effective registration time for the purposes of this Act, the Income Tax Act 2007, and the Estate and Gift Duties Act 1968".

Officials believe therefore that the proposed wording in clause 27 is adequate.

Recommendation

That the submission be declined.

Issue: Use of the term "day of final decision"

Clause 123(8)

Submission
(New Zealand Law Society)

It would be simpler if the term "day of deregistration" or "day of effective deregistration" were used instead of "day of final decision". The reference in paragraph (a) of the definition of "day of final decision" to the day the entity "is removed from the register of charitable entities" is intended to refer to the effective date of removal specified by the Charities Commission or Board under section 31 of the Charities Act 2005, rather than the date the notice of removal is registered in the register under that section. This seems appropriate, provided that the effective date of deregistration cannot be set retrospectively. If the effective date of deregistration could be set retrospectively, then it may be appropriate to refer to the date the notice of removal is registered in the register under section 31 of the Charities Act 2005.

Comment

Officials intended this date to denote the effective date of deregistration, not the day on which the decision to remove the entity was actually noted in the register. As above, when referring to the effective date of registration, we believe that the current wording adequately achieves the policy intention.

Recommendation

That the submission be declined.

Issue: The drafting of section HC 31 should mirror that of section HR 11(1)

Clause 104

Submission
(New Zealand Law Society)

The proposed amendment to section HC 31 should mirror the drafting used in new section HR 11(1) in relation to the circumstances in which section HR 11 will apply – for example, instead of referring to a charitable trust "losing its charitable status", new section HC 31(1B) should refer to a charitable trust "ceasing to meet the requirements to derive exempt income under sections CW 41 or CW 42", or similar, or simply include a cross-reference to section HR 11.

Comment

The submitter raises a good point that the wording of new section HC 31(1B) should match that of new section HR 11 to ensure consistency between the two provisions.

Recommendation

That the submission be accepted.

Issue: Section CV 17 need not deal with the timing of derivation of the relevant income

Clause 19

Submission
(New Zealand Law Society)

New section CV 17 need not deal with the timing of derivation of the relevant income because this is dealt with in new section HR 12.

Comment

Officials see no harm in including this reference in both sections, as they will provide certainty for taxpayers about when this amount will be income.

Recommendation

That the submission be declined.

Issue: Proposed amendments in clauses 110 and 123(6) are potentially misleading

Clauses 110 and 123(6)

Submission
(New Zealand Law Society)

The proposed amendments in clauses 110 and 123(6) of the bill, which imply that there is a direct link between registration and deregistration under the Charities Act 2005 and the tax concessions relating to donee organisations and fringe benefit tax, are potentially misleading and inappropriate, and this may provide sufficient grounds for deleting both amendments, in their current form.

Comment

Officials do not believe these provisions imply a direct link between an entity being deregistered and an entity ceasing to meet the requirements to be a donee organisation or a charitable organisation for FBT purposes. We acknowledge that a deregistered charity might still apply its funds wholly or mainly to charitable, benevolent, philanthropic or cultural purposes within New Zealand and therefore qualify for these tax concessions.

The reason for including these amendments was to provide protection for entities and their donors when the entity is found to have ceased to meet the requirements at some time, but had nonetheless acted in compliance with their constitution or rules until deregistration. This is effectively a "grace-period", similar to the one contained in proposed new section CW 41.

Recommendation

That the submission be declined.

Issue: Drafting of donee organisation status

Clause 110(1)

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

The rationale of the proposed amendment to section LD 3(2) is to provide donors with a greater level of certainty that their donations tax relief will not ordinarily be reversed in circumstances when they have made a *bona fide* monetary gift and the entity they have donated to is later deregistered. In our view the current drafting of new section LD 3(2)(ab) does not reflect this.

A simpler approach to achieve the policy intent of the proposed amendment would be to provide specific protection for donors in relation to taking the position that an entity to which they have donated is a donee organisation. In this context, an entity's registration under the Charities Act 2005 or listing on Inland Revenue's donee organisation list could be specified as a sufficient or relevant grounds for concluding that an entity is a donee organisation.

Comment

Officials accept that the current drafting may not fully achieve the policy intention. This is explained in the item "Extending donee status to all registered charities". The amendment is intended to apply to registered charities who meet the current requirements of a donee organisation. There are a number of ways to achieve this result. New section LD 3(2)(ab) should refer to a registered charity whose funds are applied wholly or mainly to purposes (as set out in its rules) within New Zealand.

Recommendation

That the submission be noted.

That new section LD 3(2)(ab) be redrafted to better achieve its policy intention.

Issue: Extension of FBT status

Clause 123(6)

Submission
(New Zealand Law Society)

The proposed amendment to the definition of "charitable organisation" in section YA 1, by adding a new paragraph (ab) that refers to deregistered charities, is intended to be taxpayer-friendly, by protecting organisations that have relied upon registration under the Charities Act 2005 in taking the position that the limited exemption from FBT for charitable organisations can be utilised.

The general intent of the proposed amendment is supported but the way in which the amendment seeks to achieve that intent is confusing and needs to be revisited. A simpler approach to achieve the general intent of the proposed amendment would be to provide specific protection, under either the Income Tax Act 2007 or the Tax Administration Act 1994, for an entity that has taken the position, on reasonable grounds, that it is a "charitable organisation" and in this context provide that an entity's registration under the Charities Act 2005 or listing on Inland Revenue's donee organisation list is a sufficient ground for taking such a position.

Comment

Officials accept that the current drafting may not fully achieve the policy intention. This matter is discussed in the previous item "Drafting of donee organisation status".

Recommendation

That the submission be noted.

That new section LD 3(2)(ab) be redrafted to better reflect its policy intention.

Issue: Drafting of section HR 12

Clause 108

Submission
(New Zealand Law Society)

The exclusion of gifted assets, and potentially other items, should be dealt with as part of the "net assets" calculation, and the amount of income to be recognised under section HR 12 would then be the net assets value less the value of assets distributed for charitable purposes in the relevant 12-month period.

Comment

Officials believe the current drafting achieves the intended policy.

Recommendation

That the submission be declined.

OTHER MATTERS

Issue: Administrative guidance on meaning of "benevolent", "philanthropic", "cultural" and "charitable" should be provided

Submission
(Sue Barker)

We understand that Inland Revenue is currently working on guidelines on the various limbs of section LD 3 – that is, what constitutes "benevolent", "philanthropic", "cultural" or "charitable" purposes for the purposes of section LD 3 of the Income Tax Act 2007. These guidelines could be usefully expedited.

Comment

Officials understand that this work is expected to be completed mid-year.

Recommendation

That the submission be noted.

Issue: "Declined" charities

Submission
(Sue Barker)

The tax consequences for charities that have been declined registration, as opposed to deregistered, can be just as complicated, and should also be addressed as part of these reforms.

Comment

The submitter raises a valid point. However, further work is required to investigate the policy implications of extending the proposed reforms to declined registrations. This work should be considered in the context of the Government's tax policy work programme.

Recommendation

That the submission be noted.

That officials consider whether declined registrations should have the same treatment as deregistered charities as part of the Government's tax policy work programme.

Issue: Amendments should be made to the Charities Act 2005

Submission
(Sue Barker)

The approach being taken to the definition of "charitable purpose", and the Charities Act 2005 generally, by the charities regulator is too narrow, even "anti-charity", and needs to be amended. The narrow approach of the charities regulator is incorrect as a matter of law, and will ultimately be found to be so. The approach is also contrary to the original rationale for the establishment of the Charities Act in the first place, which was to monitor "bad" charities, not to deregister so many "good" charities on the basis of fine, black-letter, and by no means universally accepted legal distinctions. Given this, and if the promised review of the Charities Act is not to take place, the most helpful amendment that could be made would be to the process by which decisions of the charities regulator can be appealed.

Comment

Officials note that any changes to the Charities Act 2005 would be outside the scope of this bill.

Recommendation

That the submission be declined.

Issue: The rules should also apply to charities which are required to obtain approval from the Commissioner of Inland Revenue

Clauses 27 and 28

Submission
(New Zealand Law Society)

There does not appear to be any reason why the new rules for deregistered charities should apply to entities that register under the Charities Act 2005 to become tax charities but not apply to entities that are required to obtain approval from the Commissioner of Inland Revenue. Both types of tax charity ought to be covered by these proposals.

Comment

Officials do not support the submission. The amendments apply to charities that have been deregistered or removed from the charities register. They do not apply to periods before 1 July 2008, the date on which the charities income tax exemptions in sections CW 41 and 42 were linked to registration with Charities Services. As a result, the grace-period for compliant deregistered charities, during which an entity is not exposed to tax on a retrospective basis where the entity has effectively relied upon the decision of Charities Services that it is charitable, cannot apply to periods before 1 July 2008.

Before 1 July 2008, whether an entity was a charity or not, and therefore eligible for the charities-related income exemption, was a question of fact and there was no requirement for Inland Revenue to register or approve a charity. However, a practice had developed whereby entities would specifically seek Inland Revenue's confirmation that the entity met the requirements of the charities-related income tax exemption and Inland Revenue would in such cases issue a letter of confirmation.

We do not consider the grace-period afforded to compliant deregistered charities should apply to periods before 1 July 2008 for the following reasons:

- There was no registration system for charities – the proposed rules deal solely with the tax consequences for charities deregistered by Charities Services.
- The legislation before 1 July 2008 provided for charities to self-assess their eligibility for the charities-related tax exemptions. Notwithstanding the Inland Revenue practice of confirming charitable status, we cannot be assured that charities have complied with their rules in periods before 1 July 2008 as there was no formal registration or monitoring of charities.
- It would be very difficult to legislate for an administrative routine (the practice whereby Inland Revenue confirmed eligibility for the charitable tax exemption that existed before 1 July 2008), and to validate that routine with appropriate adjustments to take into account the current policy changes, at the same time.
- Inland Revenue should not be fettered in its ability to reassess non-compliant deregistered charities in periods before 1 July 2008. It is likely, however, that any such reassessment would occur only in the most egregious of cases, such as when fraud or tax avoidance, or serious mismanagement has been identified.

Recommendation

That the submission be declined.

Issue: An exemption from income tax should be given where an entity has a short break in registration

Clause 27

Submission
(New Zealand Law Society, KPMG)

New section CW 41 does not cover the position of an entity whose "tax charity" status, and therefore tax-exempt status, is affected by a short period of non-registration under the Charities Act 2005, even though the entity's assets and income may be held, or distributed exclusively for charitable purposes at all times. For example, it is not uncommon for entities to seek re-registration under the Charities Act 2005, rather than bearing the cost of disputing the Charities Commission or Board's decision to deregister an entity, but unless the effective date of re-registration precedes or matches the effective date of deregistration (for example, by way of backdating under section 31 of the Charities Act 2005), there will be a period of non-registration during which the entity is not a tax charity as defined in section CW 41, even under the amended definition of that term.

Consideration should be given to amending section CW 41 to provide for continuity of tax-exempt status in certain circumstances where an entity that is a tax charity is deregistered but then re-registers (for example, applies for and obtains a new registration) under the Charities Act.

Comment

Officials acknowledge that entities which undergo a short period of non-registration face a "broken period" for tax purposes, where they are subject to income tax for the period of non-registration. Under current tax law, the deregistered charity is required to file tax returns for any periods of non-registration.

We accept the submitters' points that it would reduce compliance if entities which are eventually reregistered were provided with continuity of tax-exempt status in the interim period. The problems that officials encounter with this suggestion are how to provide such continuity, and whether doing so would undermine the charities registration regime.

With the benefit of hindsight, it may be apparent that an entity has a period of non-registration. At the time the entity is deregistered though, there is no way of determining whether that entity will later be reregistered. The proposed rules extend the tax charity status of entities which are compliant with their constitutions to the "day of final decision". This means that if an entity is deregistered and disputes the deregistration decision it will not face a taxable period before re-registration.

Officials are also confident that the number of entities which encounter periods of non-registration should significantly decrease as a result of new administrative practices implemented by the Department of Internal Affairs. The most common reason for deregistration since the charities register opened has been the failure to file an annual return. Until recently, Charities Services automatically deregistered charities if they had failed to file one annual return. Under a new approach, registered charities will be given more opportunity to file their annual returns.

Officials note giving the Department of Internal Affairs the power to backdate an entity's re-registration could further reduce the number of entities which have to file tax returns during periods of non-registration. This would, of course, only alleviate the need to file a tax return if the entity applied for reregistration before its tax return was due. However, changes to the Charities Act 2005 are outside the scope of this bill. Officials do not believe the tax consequences for entities facing short broken periods (but which do not form a material breach of tax-exempt status requirements) will be significant. However, officials from the Department of Internal Affairs are investigating options for giving Charities Services the power to backdate an entity's registration as a charity in appropriate cases.

The issues raised in submissions were also covered in Inland Revenue's regulatory impact statement *New tax rules for deregistered charities*.

Recommendation

That the submission be declined.

Issue: New section HR 11 should be broadened to apply to other entities that cease to be eligible for a tax exemption

Clause 107

Submission
(New Zealand Law Society)

The provisions in new section HR 11 could be broadened to apply not only to deregistered charities but also to other entities that are eligible for a general exemption from income tax and then become ineligible because they no longer meet the requirements of that exemption.

Comment

The Income Tax Act 2007 does not provide guidance about what rules apply when an existing entity that is neither a trust nor a deregistered charity enters the tax base.

The submission raises a valid concern that could be considered in the context of the Government's tax policy work programme when it is next set.

Recommendation

That the submission be noted.

That the submission be considered in the context of the Government's tax policy work programme when it is next set.

Issue: Guidance should be given on how to establish the cost of prepayments

Clause 104

Submission
(New Zealand Institute of Chartered Accountants)

The amendment to section HC 31 should be expanded to include guidance to trustees, or other persons liable for the satisfaction of the income tax liability of the trustee, on how to establish the cost of prepayments. Including calculation rules for prepayments in section HC 31 will give greater certainty and coherency.

Comment

The submission raises a valid point that should be considered further. We suggest that this matter should be considered in the context of the Government's tax policy work programme when it is next set.

Recommendation

That the submission be noted.

That the submission be considered in the context of the Government's tax policy work programme when it is next set.

Issue: Mistakenly applying funds for a non-charitable purpose

Clause 27

Submission
(PricewaterhouseCoopers)

As drafted, the grace-period for charitable status in new section CW 41 can end when the entity fails to act in accordance with its constitution. As a practical matter, charitable entities can apply funding to a large number of projects and causes and there is scope for an individual outlay to, strictly speaking, not be for a charitable purpose.

We submit that consideration should be given to narrowing the scope under which an entity can fail to meet the definition of "tax charity" under the amendment. For example, the previously released issues paper on this topic referred to a failure arising because the entity wilfully failed to comply with its constitutional documents.

Comment

The proposed rules for deregistered charities are triggered by deregistration. Therefore, the matter raised in the submission is directly related to the Charities Services deregistration process.

Recommendation

That the submission be declined.

Issue: Consideration should be given to enacting more tax exemptions

Submission
(PricewaterhouseCoopers)

Entities which are deregistered may continue to apply money they receive in a manner which is beneficial to the community or public. If the entity does not operate a "business", arguably its revenue is not income under ordinary concepts. Difficulties can arise when determining to what extent expenses including grants and donations are deductible against that income.

In some cases, entities can act as "conduits", receiving funding or donations and distributing these amounts to other charitable entities. We are concerned that, in this situation, an amount of "income" could arise without a corresponding tax deduction.

Comment

The submission raises an interesting issue that should be considered further. This matter should be considered in the context of the Government's tax policy work programme when it is next set.

Recommendation

That the submission be declined.

That the submission be considered in the context of the Government's tax policy work programme when it is next set.

Issue: Exemption for amateur sport promoters

Submission
(Dr Michael Gousmett)

The bill should be amended to require the commercial activities of amateur sport promoters to be liable to income tax at a rate to be determined by the Committee.

Comment

Currently section CW 46 of the Income Tax Act 2007 exempts the income derived by a "club, society or association" established mainly to promote an amateur game or sport. The submission seems to be concerned that the exemption now applies to entities with large commercial operations and so the original intention of the exemption may no longer be valid. Although the submission raises a valid issue more time is needed to consider this matter. We recommend that this matter be considered in the context of the Government's tax policy work programme when it is next set.

Recommendation

That the submission be declined.

That the submission be considered in the context of the Government's tax policy work programme when it is next set.

Tax status of certain community housing entities

OVERVIEW

Ten submissions were received on the amendments relating to community housing entities and most of them supported the underlying policy intention of the amendments. However, the majority of these submitters (mainly from the community housing sector) were strongly opposed to the eligibility criteria and recommended significant changes. The sector's opposition centres on the proposed income and assets tests that would be applied to the intended recipient class.

The sector believes that the proposed tax exemption is unlikely to apply to community housing entities that they believe are most in need of it. This is because their current housing clients are unlikely to meet the proposed criteria for the intended recipient class. For example, Habitat for Humanity considers that the income and asset levels of some of its current housing clients would mean that it would not be eligible for the proposed tax exemption, should it no longer be eligible to be a registered charity.

Officials support the use of an income threshold to help determine the intended recipient class as it will ensure that the proposed exemption is effectively targeted. Furthermore, an income threshold is objective and can easily be applied in a self-assessment environment. Finally, we acknowledge that the way in which the regulation-making provision in new section 225D is drafted means Ministers can dispense with any one of the factors in determining the intended recipient class. Therefore, there is some flexibility for the responsible Ministers to make recommendations on the overall scope of the recipient class and to target the exemption accordingly.

SUPPORT FOR THE POLICY INTENT UNDERLYING THE COMMUNITY HOUSING ENTITY PROPOSALS

Clauses 28, 29, 110, 123 and 159

Submissions

(Accessible Properties, Community Housing Aotearoa, Ernst & Young, Marlborough Sustainable Housing Trust, New Zealand Institute of Chartered Accountants, Queenstown Lakes Community Housing Trust, Sue Barker)

The submissions support the policy intent of the amendments to confer a new income tax exemption for certain community housing entities and donee organisation status on these entities so that tax incentives can be claimed for donations to such entities.

However, the majority of these submitters (mainly from the community housing sector) were strongly opposed to the eligibility criteria and recommended significant changes. The sector's opposition centres on the proposed income and assets tests that would be applied to the intended recipient class. *(Accessible Properties, Community Housing Aotearoa, Marlborough Sustainable Housing Trust, Queenstown Lakes Community Housing Trust, Sue Barker)*

Broadly the amendments will increase certainty in the tax system and align tax policy with the Government's housing policy. *(New Zealand Institute of Chartered Accountants)*

Comment

The amendments are intended to address the current tax uncertainties relating to community housing entities who provide affordable home-ownership products to low-income households. These tax uncertainties arise because the charitable status for some of these entities is uncertain. Therefore, the amendments would be relevant only for those entities that lose their charitable status.

Specific concerns with the eligibility criteria are dealt with in the next items.

Recommendation

That the submissions be noted.

ELIGIBILITY CRITERIA

Issue: Recipient class defined by reference to an income threshold

Clause 29

Submissions

(Accessible Properties, Community Housing Aotearoa, Habitat for Humanity, Marlborough Sustainable Housing Trust, Queenstown Lakes Community Housing Trust)

The submissions are opposed to the income threshold being applied to determine the intended recipient class on the basis that they are too restrictive. They consider that the application of the current income threshold will exclude community housing entities that they believe are most in need of it. For example, Habitat for Humanity considers that the income threshold of some of its current clients would mean that they would exceed the income threshold based on the lower quartile of household income and therefore they would not be eligible for the proposed tax exemption.

The preferred approach put forward by these submissions is to apply tests on the community housing entity that would ensure its income, assets and profits are deployed solely towards the objects of its housing mission, and delivered through a non-profit structure. To enable pathways to independent living, this approach cannot require any further tests of income or assets of the class of recipient household for the purposes of confirming the tax-exempt status of the community housing entity.

If the proposed income threshold were retained, the tests should not be set by reference to the lower quartile of household income but rather 120 percent of the median household income, adjusted annually for inflation and set for each district or City Council jurisdiction throughout New Zealand.

A further related submission is concerned that community housing entities may lose their tax-exempt status if the assessment of the household income level must be observed even after the client has been initially considered eligible to receive housing assistance.

Comment

New section 225D of the Tax Administration Act 1994 permits the Governor-General to make regulations specifying people, or classes of people, who may be recipients of housing products or services offered by community housing entities.

The factors which may be used to determine a recipient may be any combination of the following:

- the person's geographic location in New Zealand;
- the composition of the household a person lives in;
- the income of the person or household relative to a maximum set by taking into account the lower quartile of household income based on household economic survey data published by Statistics New Zealand, and adjusted by an appropriate economic factor (for example, cost of living); or
- the person's assets relative to a maximum.

The Minister for Housing and the Minister of Revenue are jointly responsible for making recommendations on these factors.

Officials support the use of an income threshold to help determine the intended recipient class as it will ensure that the proposed exemption is effectively targeted. Furthermore, an income threshold is objective and can easily be applied in a self-assessment environment. We also acknowledge that an income threshold set by taking into account the lower quartile of household income may mean that some current community housing entities will not qualify for the proposed exemption.

The way in which the regulation-making provision in new section 225D is drafted means Ministers can dispense with any one of the factors in determining the intended recipient class. Therefore, there is some flexibility for Ministers to make recommendations on the overall scope of the recipient and to target the exemption accordingly.

In relation to the alternative proposal put forward by submissions, we note that 120 percent of the median household income nationwide in 2013 was $82,000.

We also note that the income threshold (and the asset test) is intended to be measured at the point a community housing entity is considering providing the housing assistance to a recipient, rather than continually measured over time. We can clarify this point in the regulation.

Recommendation

That the submissions be noted.

Issue: Provision of new housing criterion

Clause 29

Submissions
(Accessible Properties, Community Housing Aotearoa, Habitat for Humanity, Marlborough Sustainable Housing Trust)

The criterion that the proposed exemption applies to community housing entities that provide new houses is too narrow. The problem that the amendments are resolving relate to both existing community housing entities with portfolios of families living in shared ownership homes, as well as entities who are currently under contract for delivering shared ownership.

Comment

We agree that the criterion is too narrow. The amendments should apply to both existing and new housing products so long as the activities of the entity includes the provision of home-ownership products and services to low-income households and meet the other criteria.

Recommendation

That the submissions be accepted.

Issue: Reinvestment of profits criterion

Clause 29

Submissions
(Accessible Properties, Community Housing Aotearoa, Habitat for Humanity, Marlborough Sustainable Housing Trust, New Zealand Law Society, Queenstown Lakes Community Housing Trust)

The New Zealand Law Society queries whether the requirement that "all profit of the business is reinvested into the business" might preclude the distribution or application of the profit for community housing purposes that should be permitted – for example, a distribution or application of such profit to or for the benefit of a parent or beneficiary/client community housing entity. *(New Zealand Law Society)*

The criterion that requires housing profits to be reinvested in the housing activity of the community housing entity should be extended to allow distribution of housing profits to a parent entity that is itself a charitable organisation. *(Accessible Properties, Community Housing Aotearoa, Habitat for Humanity, Marlborough Sustainable Housing Trust, Queenstown Lakes Community Housing Trust)*

Comment

We support the submissions. Community housing entities should be able to distribute housing profits to a parent entity that is itself a charitable organisation on the basis that the profits would be used to further the charitable purposes of the parent entity. Additionally, community housing entities should be permitted to distribute profits to other related community housing entities as this is consistent with the requirement in new section CW 42B(1)(a).

Recommendation

That the submissions be accepted.

Issue: Registration with the new Regulatory Housing Authority criterion

Clause 29

Submissions
(Accessible Properties, Community Housing Aotearoa, Habitat for Humanity, Marlborough Sustainable Housing Trust, Queenstown Lakes Community Housing Trust)

The proposed amendments and the proposed registration framework for community housing entities should be properly aligned to ensure consistency. For example, currently there is a discrepancy between the definition of "community housing provider" for registration purposes and the proposed exemption criterion relating to the provision of new housing.

Comment

Officials agree with the submissions and the suggested change relating to "Issue: Provision of new housing criterion" should address the submission. We also note that all community housing providers are required to provide social rental products to be eligible to register with the new Regulatory Housing Authority.

Recommendation

That the submissions be accepted.

REGULATION-MAKING POWER

Clause 159

Submission
(New Zealand Law Society)

The regulation-making power in new section 225D of the Tax Administration Act 1994 should be "framed" by a purpose provision that makes it clear that the factors referred to in section 225D (3) are to be used to ensure that the operations of tax-exempt community housing entities are targeted at the provision of new housing for the benefit of individuals and families who are on relatively low incomes and who could not otherwise afford to buy a house without government assistance.

Comment

Officials do not agree with the submission. A purpose provision is not necessary as new section 225D already provides sufficient explanation about how the regulation is to be promulgated and what it may contain.

Recommendation

That the submission be declined.

OTHER MATTERS

Issue: Use of the term “business”

Clause 29

Submissions

(Ernst & Young, New Zealand Law Society, Russell McVeagh)

For the purposes of the Income Tax Act 2007, a “business” includes any profession, trade, or undertaking carried on for profit. The reference to “business” in new section CW 42B may cause uncertainty and confusion in this context. We suggest references to activities or purposes should be sufficient to cover the intended entities, without having to consider whether or not there is any “profit” element. *(Ernst & Young)*

The term “business” may not be an appropriate term to cover the full range of community housing activity undertaken by the target community housing entities and it may be more appropriate to use wider or more neutral terms, such as “enterprise” or “activity”. *(New Zealand Law Society)*

The proposed exemption is aimed at community housing entities that operate under a non-profit model, but this aim may not be achieved because use of the term “business” suggests that the target community housing entity must have an intention to make a profit. The lack of intention to make a profit should not exclude a community housing entity from the proposed exemption. *(Russell McVeagh)*

Comment

We agree the use of the term “business” is confusing and may lead to unintended consequences. We support amending section CW 42B in line with the suggestions raised in submissions.

Recommendation

That the submissions be accepted.

Issue: Use of the terms “beneficiaries” and “clients”

Clause 29

Submissions

(New Zealand Law Society, Russell McVeagh)

New section CW 42B refers to “beneficiaries of the trust” or “clients of the company”. It may be preferable for section CW 42B to refer to “the only beneficiaries or clients of the entity, as the case may be …”. This is because trusts and companies may have either beneficiaries or clients. *(New Zealand Law Society)*

Limiting the beneficiaries of any trust and the clients of any company to classes of persons specified in new section CW 42B is too restrictive and uncertain. References to "beneficiaries of the trust" and "clients of the company" should be deleted. *(Russell McVeagh)*

Comment

We agree with the submission of the New Zealand Law Society, as it is consistent with the intended policy outcome. However, we disagree with the submission put forward by Russell McVeagh as it would remove an important design feature of the new exemption that ensures it is effectively targeted.

Recommendation

That the submission to amend new section CW 42B to refer to "the only beneficiaries or clients of the entity, as the case may be …" be accepted.

That the submission for Russell McVeagh be declined.

Issue: Scope of the exemption provision

Clause 29

Submissions
(New Zealand Law Society, Russell McVeagh)

New section CW 42B is limited to the income of a community housing entity from its housing business. This limitation might create some uncertainty as to the scope of the exemption in relation to income from other sources – for example, interest or dividends. *(New Zealand Law Society)*

The reference in new section CW 42B to income from a business may unintentionally limit the scope of the exemption or (in some cases) cause it not to apply at all. *(Russell McVeagh)*

Comment

We agree that new section CW 42B should exempt all income derived by the community housing entity, and not be limited to income from an entity's housing activity.

Recommendation

That the submissions be accepted.

Issue: Scope of the donee status provision

Clause 29

Submission
(New Zealand Law Society)

As currently drafted, new section LD 3(2)(ac) would apply only if "the gift is made in a tax year that the entity derives exempt income under section CW 42B". It may be preferable for the provision to refer to the donee as being an entity that is "eligible to derive" exempt income under new section CW 42B.

Comment

We agree with the submission as it will ensure that new section LD 3(2)(ac) achieves the intended policy.

Recommendation

That the submission be accepted.

Issue: Continuation of the tax-exempt status for already deregistered charities

Clause 29

Submissions
(New Zealand Law Society, Queenstown Lakes Community Housing Trust)

The amendments relating to community housing entities and deregistered charities do not address the specific issue of continuity of tax-exempt status for an entity if there has been a period of non-registration under the Charities Act 2005 (and no other general income tax exemption applies to the entity). Consideration should be given to including amendments in the bill to provide for continuity of tax-exempt status for community housing entities if continuity of tax-exempt status would otherwise be affected by deregistration under the Charities Act 2005. *(New Zealand Law Society)*

In a related submission, the Queenstown Lakes Community Housing Trust submitted that the Trust is the only community housing entity deregistered by Charities Services. The Trust commented that the proposed exemption for community housing entities will not restore tax exemption for the Trust and its activities and that it had received an assurance from the Minister for Housing that it would be covered by the proposed exemption. This matter was noted by the Committee. *(Queenstown Lakes Community Housing Trust)*

Comment

We do not agree with the submissions. The proposed exemption is intended to target those community housing entities that meet the proposed criteria. The exemption is not intended to cover all community housing entities.

Furthermore, we note that the Queenstown Lakes Community Housing Trust advised the Committee on 19 February 2014 that it was in discussions with the Government about its current tax liability.

Recommendation

That the submissions be declined.

Other policy matters

LAND-RELATED LEASE PAYMENTS

Clauses 8, 9, 53, 56 and 123

Issue: Support for aspects of the reform

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

We generally welcome the narrower/targeted focus of the rules aimed at taxing payments to transfer a lease paid in substitution for taxable lease premiums and lease surrender payments, rather than the original proposed broad reform which would have treated all land-related lease payments as being on revenue account. *(Corporate Taxpayers Group, Ernst & Young, KPMG, New Zealand Law Society)*

We support the amendment treating consecutive leases as a single lease for depreciation purposes. *(New Zealand Institute of Chartered Accountants)*

The amendment to clarify that retirement villages' occupation rights should be excepted financial arrangements to align their treatment with leases of land under the financial arrangement rules, is supported. *(New Zealand Institute of Chartered Accountants)*

Comment

Officials welcome this support and note that it illustrates the benefits of the generic tax policy process.

Recommendation

That the submissions be noted.

Issue: Glasgow-type leases are akin to freehold estates

Submission
(Parininihi ki Waitotara Incorporation, West Coast Settlement Reserve Lessees Association (Inc))

Payments made in respect of Glasgow-type leases (with the usual term of 7, 12 or 21 years), which are renewable in perpetuity, should not be taxable to the recipient, and deductible to the payer. The reason is that Glasgow-type leases are more akin to freehold estates, and are different from ordinary commercial leases with a defined term. The payments for Glasgow-type leases can include a payment made on the transfer of a lease or on the surrender of the lease. The fact that the payments can occur between associated parties, for commercial reasons, should not change the non-taxable and non-deductible nature of the payments.

Therefore, the transfer of Glasgow leases should be excluded from the ambit of proposed new section CC 1B. The lease surrender provisions in section CC 1C should also be amended to exclude payments for the surrender of Glasgow leases.

Comment

Officials agree with the position that Glasgow leases are more akin to freehold estates because, in principle, the tenant has the right to use the land in perpetuity.

Officials recommend that proposed section CC 1B of the bill, and section CC 1C of the Income Tax Act 2007, be amended to exclude payments made for the transfer or surrender of Glasgow leases. The amendment to section CC 1C should apply from the commencement of that section.

Recommendation

That the submission be accepted.

Issue: Glasgow-type leases should be depreciable property

Submission
(New Zealand Institute of Chartered Accountants)

Glasgow leases should remain depreciable property. Glasgow lease payments are made for a fixed period and at the end of this period, if the lease is not renewed, the lessee's rights are extinguished. A Glasgow lease is not like freehold land and an interest in such a lease should continue to be depreciable. This would ensure symmetry of tax treatment, and the recipient remains taxable on the payments under section CC 1.

The definition of "fixed-life intangible property" should also be amended to include Glasgow leases in order for a deduction to be spread over the initial lease term.

Comment

Officials consider that Glasgow leases are more akin to freehold estates because, in principle, the tenant has the right to use the land in perpetuity. Therefore, it is the correct policy that these leases are not depreciable property.

A tenant under a Glasgow lease may not claim depreciation deductions during the term of the lease (for premiums paid on the grant of the lease) because this type of lease has a perpetually renewable lease period. The tenant may be able to claim a depreciation loss when the perpetually renewable lease is sold for less that its adjusted tax value if the lease meets the definition of "depreciable property" in section EE 6 of the Income Tax Act 2007 – that is, in normal circumstances, the lease might reasonably be expected to decline in value. Officials consider it is likely that Glasgow leases are not depreciable under the current law.

Officials therefore consider that this amendment only clarifies the existing position.

Recommendation

That the submission be declined.

Issue: Application date of Glasgow lease amendment

Submission
(KPMG, New Zealand Institute of Chartered Accountants)

The amendment would capture Glasgow leases that have been in effect for many years. These leases would have been negotiated on the basis of lease premiums paid being depreciable property, and the deduction arising on termination/transfer of the lease. These decisions should not be affected by these changes. The proposed amendment should only apply to Glasgow leases entered into on or after 1 April 2015. *(KPMG)*

The amendment to section EE 7, which will apply from 1 April 2015, will change the tax treatment of a number of Glasgow leases part-way through the lease term. This will create uncertainty for taxpayers and involve some element of retrospectivity which is not justified. The proposed amendment should not apply to existing leases which were negotiated on the basis of the tax treatment in force at the time the leases were entered into. *(New Zealand Institute of Chartered Accountants)*

Comment

The amendment excluding Glasgow leases from being depreciable property currently has an application date of 1 April 2015. This is consistent with the application dates for all other land-related lease payments amendments in the bill. As noted above, it is likely that Glasgow leases are not depreciable under the current law. Given that the amendment is of a clarifying nature only, officials consider that the application date of 1 April 2015 is appropriate.

Recommendation

That the submission be declined.

Issue: Premium paid on grant of Glasgow leases

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

Treatment of payments for perpetually renewable leases should be consistent for payer and recipient. Payments to landowners for the grant of a perpetually renewable lease should be excluded from section CC 1, so that the treatment for the landlord and the tenant is consistent. Otherwise the effect of the proposal would be to treat a perpetually renewable leasehold interest as akin to a freehold interest to the lessee (such that the lessee would have no deduction for the expenditure) but like any other leasehold interest for the landowner (such that the landowner would be taxed on the receipt). This would be inconsistent from a policy perspective, and contrary to symmetrical tax treatments, which have been a significant driver on recently enacted and currently proposed reforms to the tax treatment of lease-related payments.

Comment

There is no universal principle of tax symmetry in the income tax system. Tax asymmetry is inherent and inevitable in a system that distinguishes between capital and revenue items. For example, lease transfer payments are generally non-taxable to the recipient but depreciable to the payer.

Lease premiums paid on the grant of a Glasgow lease should continue to be taxable to the owner of the land under section CC 1, which has been the tax treatment since 1915.

Recommendation

That the submission be declined.

Issue: Lease transfer payments amendment is not necessary

Submission
(KPMG)

In practice, in commercial settings, payments to assign commercial leases will have different drivers to lease premiums and lease surrender payments. These payments are therefore unlikely to be substitutable, without some degree of artificiality and a high degree of structuring. This also introduces additional legislative complexity. *(KPMG)*

Comment

Officials note that during extensive consultation on the examples of certain lease transfer payments being substitutable for taxable lease surrender payments and lease premiums, the validity of these examples was not disputed. Officials consider the examples remain valid and that there is a risk to the tax base if such lease transfer payments are not made taxable.

Recommendation

That the submission be declined.

Issue: Drafting of the lease transfer payments provision

Submission
(New Zealand Institute of Chartered Accountants)

Drafting of new section CC 1B(3) requires improvement as it uses double negatives which make the provision difficult to understand.

Comment

Officials have considered the points raised in the submission, but have decided that the current drafting is sufficiently clear. Re-drafting of the provision so that the current exceptions in section CC 1B(3) are included in the opening subsection would make the drafting significantly more complex.

Recommendation

That the submission be declined.

Issue: Scope of lease transfer payments amendment

Submission
(Corporate Taxpayers Group, Russell McVeagh)

If a landlord, as part of a broader commercial relationship, provides funds to a new tenant, part of which is to be applied in an arm's-length transaction for a lease transfer payment, this should not be taxable. Any transfer payment in this case is not a substitute for a lease premium or lease termination payment paid to or by a landlord. So the tax treatment should not be dependent on the source of the lease transfer payment funds, and section CC 1B(3)(c) should be more appropriately targeted. *(Corporate Taxpayers Group)*

Proposed section CC 1B(3)(c) could result in lease transfer payments being taxable to the outgoing tenant who may have no knowledge or control over the arrangement. For example, if the landlord makes a loan to the incoming tenant to enable the new tenant to purchase the outgoing tenant's business (including the lease), the lease transfer payment made by the incoming tenant as part of the business sale would be taxable. By contrast, if the incoming tenant borrowed from a bank rather than from the landlord, the lease transfer payment would not be taxable. *(Russell McVeagh)*

Comment

Officials agree that the scope of section CC 1B(3)(c), which taxes payments sourced directly or indirectly from funds provided by the landlord, is too wide. Officials agree that situations involving an arm's-length transaction between the landlord and the incoming tenant should not be caught, and the provision should be amended accordingly.

Recommendation

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

Issue: Aligning section DB 20B with new section CC 1B

Submissions

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

Current section DB 20B provides a deduction for the existing section CC 1B where the payer is the person who owns the land right, the estate from which the land right is granted and the payment is to the person who is obtaining the land right. New section CC 1B(1) will apply if there is a transfer of the land right from the holder of the land right to another person. This should be clarified to ensure that the person who pays the amount is entitled to a deduction. Section DB 20B requires a corresponding amendment to provide a matching deduction. *(New Zealand Institute of Chartered Accountants)*

As currently drafted, proposed section CC 1B may cause mismatches between the income and deductibility treatment of some lease inducement payments. The bill should harmonise the income and deductibility treatment of lease inducement payments for the transfer of land rights. This could be done by amending the criteria in section DB 20B to reflect more closely the exemption criteria in proposed new section CC 1B. *(New Zealand Law Society)*

Comment

Officials consider it is not necessary to expand the deductibility criteria in section DB 20B(1)(a) to refer to payments for the transfer of land rights from the holder of the land to another person. This is because the transferee of the land right (the incoming tenant) would receive a deduction for the payment under the depreciation rules, being a payment for the right to use land under schedule 14 of the Income Tax Act 2007.

Officials consider that a deduction would not be denied to the owner of the land in a case where the owner uses an agent to make a lease inducement payment to the prospective tenant. This is because section YB 21 of the Income Tax Act 2007 treats anything done by a nominee of a person as being done by that person. Therefore, the owner of the land would still be treated as the payer under section DB 20B(1)(b), and be entitled to a deduction.

Recommendation

That the submissions be declined.

Issue: Residential premises exemption needs amendment

Submissions

(Ernst & Young)

Section CC 1B should be amended to remove the "natural person" requirement from the section CC 1B(4)(a) residential premises exemption. If necessary, the reference in that provision to residential premises should be amended to ensure the exclusion relates to premises in the nature of dwellings occupied, intended or available for occupation by individuals as residencies.

Transfers of shares in cross-leased properties could fall within the proposed provisions. A large number of cross-leased family units may be owned as family trusts, the executors or trustees of deceased estates, or companies that may or may not be charging rentals. Transfers of such properties to associates may occur.

There is no reason why the structural nature of an owner of any such residential premises should be critical in determining whether amounts derived or deemed (when subparts FB or FC apply) for their assignment or transfer would be taxable. If expenditure on acquiring such leased or licensed residential premises would not meet the general permission criteria for deductibility for the transferor, application of the proposed section CC 1B should be excluded, regardless of the nature of the transferor.

Comment

Officials consider that the current "natural person" requirement in the exception for residential situations is necessary to maintain the integrity of this exception. The "natural person" requirement in new section CC 1B is consistent with the residential exceptions in current sections CC 1B and CC 1C.

The submission refers to transfers of residential property by the executors or trustees of deceased estates. Such transfers do not involve the payment of consideration and would therefore be outside the ambit of section CC 1B(1), which requires a transfer in exchange for the payment of an amount of consideration.

Recommendation

That the submission be declined.

Issue: Wash-up of deductions if the lease is terminated early

Submission
(KPMG)

This issue is in relation to section EI 4B, enacted by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013. Section EI 4B allows spreading of income and deductions for the lease inducement payment over the term of the relevant lease. An exception to this is when a person ceases to hold the lease or land from which the lease is granted, before the end of the lease term. However, section EI 4B(5) does not provide a wash-up of deductions for landlords if a lease is terminated early (for example, for reasons of insolvency); the landlord is still required to spread deductions over the original term of the lease. This outcome is inconsistent with the policy rationale for having the wash-up mechanism. For consistency, a wash-up mechanism for lease inducement deductions for landlords (that is, lessors and sub-lessors) should be provided in section EI 4B(5).

Comment

Officials agree it would be consistent with the policy of the wash-up provision in section EI 4B(5) to allow a landlord to receive the balance of deductions for a lease inducement payment, if the lease is terminated early. This would be consistent with the treatment of a lessee who is taxed on the balance of income from a lease inducement payment if the lease is terminated early.

Recommendation

That the submission be accepted.

Issue: Permanent easement exclusion

Submission
(Matter raised by officials)

Comment

Clause 8 of the bill excludes all payments for permanent easements from being taxable to landowners. It should be clarified that the exclusion does not apply to ongoing periodical payments for a permanent easement, as such payments should be on revenue account.

Recommendation

That the submission be accepted.

FINANCIAL ARRANGEMENTS – AGREEMENTS FOR THE SALE AND PURCHASE OF PROPERTY OR SERVICES IN FOREIGN CURRENCY

Issue: Support for proposed changes

Clauses 60 to 67, 82 and 123

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

The submitters support changes to simplify the spreading methods used by taxpayers for the agreements. They particularly note the appropriateness of the changes for IFRS taxpayers while also noting that some further improvements could be included for non-IFRS taxpayers. The latter submissions are discussed below.

Recommendation

That the submissions be noted.

Issue: Lowest price clauses and interest explicitly included in agreements for non-IFRS taxpayers

Clauses 65 and 123

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

The elimination for tax of the lowest price clause mechanism to value the property or services in agreements and thereby not implicitly agree the amount of interest (if any) is not appropriate for non-IFRS taxpayers.

The imputation of interest into "12-month ASAPs" is also inappropriate when non-IFRS parties have not explicitly agreed interest.

Comment

The current rules for agreements for sale and purchase of property or services (ASAPs) is to value them at the lowest price the parties would have agreed, on the date the agreement was entered into, if payment had been required in full at the time the first right in the property was transferred or the services provided. This tax rule has resulted in the long-established practice of including "lowest price" clauses in commercial contracts for the sale and purchase of property or services in New Zealand. The lowest price tax mechanism also establishes if there is any interest in the agreement for tax, being the difference between the lowest price and the total consideration paid for the property or services. However, when the objective facts indicate that interest is disguised or capitalised, Inland Revenue may challenge the lowest price stated by the parties (*Tax Information Bulletin* Vol 3, No 3, October 1991 p8 sets out Inland Revenue's position).

The submissions focus on the long established practice of including lowest price clauses in commercial contracts when there is no interest explicitly agreed in the contracts. They submit that this practice has worked well and has become widely accepted. Officials acknowledge these points but consider that the practice is not relevant when New Zealand taxpayers enter into contracts with non-residents.

However, officials consider that the genuine explicit agreement of interest in commercial contracts should not be overturned through the application (or non-application) of a tax rule. This will address the issues regarding lowest price clauses raised in the submissions.

Officials also consider that the imputation of interest for tax purposes is appropriate for "12-month ASAPs", as included in the bill, in the absence of an explicit agreement of interest in commercial contracts.

Recommendation

That the submissions be accepted in part, subject of officials' comments.

Issue: Definition of 12-month ASAP

Clause 123

Submission
(New Zealand Law Society)

The definition of "12-month ASAP" (applicable for non-IFRS taxpayers) should be amended to exclude ASAPs which incorporate certain deferral features (for example, an earn-out) but do not have the underlying features of a loan.

Comment

The concern is that an ASAP may become a 12-month ASAP because an "earn-out" payment (expressed as an adjustment to the purchase price) is made 12 months after completion of the transaction. The deferral of payment in such a case occurs because of uncertainty regarding the value of the business, not because there is some imputed interest component between the parties that ought to be recognised for tax purposes. Similar issues may arise with warranty payments that are expressed as an adjustment to the purchase price, or working capital adjustments that take more than 12 months to determine.

Officials agree that these payments should not result in interest income or expenditure when there is no interest explicitly agreed between the parties. Officials recommend that the definition of "12-month ASAP" in the bill be amended to exclude agreements which include these types of payments made more than 12 months after the rights date.

Recommendation

That the submission be accepted.

Issue: Definition of "foreign ASAP"

Clause 123

Submission
(New Zealand Law Society)

The definition of "foreign ASAP" should be clarified to confirm whether an ASAP will be a foreign ASAP when some part (but not all) of the consideration is denominated in a foreign currency.

Comment

Officials agree with the submission and recommend that the definition of "foreign ASAP" in the bill be amended to apply to foreign ASAPs where 50 percent or more of the consideration (measured at the time the ASAP is entered into) is in foreign currency. This rule will be based on using spot foreign currency rates at the time the ASAP is entered into.

Recommendation

That the submission be accepted.

Issue: Revenue account property/trading stock

Clause 66

Submission
(Ernst & Young)

Proposed section EW 33B should be amended to refer consistently to revenue account property for all taxpayers and foreign ASAP situations, rather than using that term in section EW 33B(1)(a)(i) but referring to trading stock in section EW 33B(2)(a).

Comment

The use of trading stock (along with depreciable property) in proposed section EW 33B(2)(a) for non-IFRS taxpayers was considered to be appropriate as those taxpayers would usually be hedging those types of sales and purchases in foreign currency. It was also considered appropriate to constrain the ability to use foreign currency hedging for tax for non-IFRS taxpayers to the most common transactions. It was considered that IFRS taxpayers would be hedging all types of revenue account property (including trading stock) and that the use of the IFRS accounting rules for tax for all those transactions was appropriate.

On reflection officials agree that the proposed section for non-IFRS taxpayers should apply to all revenue account property. We also consider that the section should also apply to services (as it already does for IFRS taxpayers). However, use of the hedging provisions by non-IFRS taxpayers should continue to be subject to a once only irrevocable election (in writing) to apply the section. This is appropriate for non-IFRS taxpayers because, unlike IFRS taxpayers, they

will not usually be using a proscribed hedging treatment in the financial accounts for these transactions. Because of the vast range of small to medium-sized taxpayers in this category, it is appropriate they be required to make a conscious act to be able to use the hedging rules.

Recommendation

That the submission be accepted.

Issue: Transitional provisions

Clause 82

Submission
(Ernst & Young)

The requirement that taxpayers should have filed returns in accordance with the proposed sections EZ 70 or EZ 71 as the case may be, for "every earlier income year" as well as for the 2013–14 income year, should be deleted.

Comment

The submission says, given the uncertainty, confusion and numerous amendments which have been made to the financial arrangement rules, it is unreasonable to restrict application of the proposed transitional provisions to taxpayers who may have filed all previous year returns in accordance with provisions which are only now in the process of being articulated and enacted.

The proposed changes to the tax rules for foreign ASAPs are the first changes to these rules since they were enacted in 1999. There have been changes to other parts of the tax rules for financial arrangements since then. The proposed changes will simplify the current treatment of these financial arrangements considerably and are generally welcomed by taxpayers.

During consultation with taxpayers and their advisers over the past few years over possible changes to the rules for these arrangements, it became clear there is a substantial degree of non-compliance with the technicalities of the rules. It is considered necessary to retrospectively endorse this technical non-compliance when it has been in accordance with what the new rules require. We understand from discussions with a number of taxpayers and their advisers that the proposals in the bill for endorsing the past years are appropriate.

However, it is necessary to apply this to every year of the term of a financial arrangement as the technically incorrect methods applied should have been applied for all years. It is not appropriate to retrospectively endorse positions when taxpayers have switched between various (technically non-compliant) methods for the same financial arrangements during their terms.

It is appropriate to amend the proposed sections to endorse positions taken when the treatment was originally technically non-compliant but has been changed to technically compliant. This will apply to the treatment of all a taxpayer's foreign ASAPs for the relevant years.

Recommendation

That the submission be accepted in part.

Issue: Deposits/payments for progress made

Clause 123

Submission
(Ernst & Young)

Clarification is needed as to when deposits or other instalments would not be regarded as "payments for progress made" and thus excluded from treatment as prepayments in the definition of "12-month ASAP".

Comment

The submission is concerned about relatively small deposits paid at or very close to the commencement of a contract which may not be regarded as "payments for progress made". These contracts may have payments for progress made subsequent to any initial deposit.

Officials agree there is good reason to exclude small deposits paid at the beginning of contracts from creating a 12-month ASAP under the proposed rules. Officials recommend that the bill be amended to exclude deposits aggregating no more than 10 percent of the total consideration to be paid for the property or services and paid within the first three months of entering into the contract from being treated as prepayments for the definition of a 12-month ASAP.

Recommendation

That the submission be accepted.

Issue: Sale and purchase of services

Clause 123

Submission
(Ernst & Young)

The proposed definitions of "12-month ASAP" and "rights date" should be clarified in relation to agreements for sale and purchase of services.

Comment

The submitter is concerned the proposed definition (of "rights date") is not appropriate in relation to the provision of services, particularly if they are provided on many dates or over a continuous period.

The proposed definition uses the same words used in an existing definition of "right" which has been part of the financial arrangements rules since they were introduced. Officials have not been provided with any actual examples of issues regarding the valuation of services using the existing definition of "right".

In the absence of known widespread problems, and given that the words used in the definition of "rights date" (and therefore also in "12-month ASAP") are already used in the legislation, officials consider no action should be necessary at this time.

Recommendation

That the submission be declined.

Issue: Consistency requirements

Clause 60

Submission
(KPMG, New Zealand Institute of Chartered Accountants)

The consistency requirements in subpart EW require taxpayers to use the same spreading method every income year for financial arrangements that are the same or similar. The bill does not amend the consistency requirement to allow taxpayers to use the IFRS method for new foreign currency ASAPs if they are currently applying Determination G29 to other "same or similar" ASAPs entered into before the application of these new rules.

Comment

Officials agree that the consistency rules should be amended as submitted, to allow for the proposed changes.

Recommendation

That the submission be accepted.

Issue: Interest-free loans

Clause 60

Submission
(KPMG)

Another bill contains an amendment to the IFRS spreading method in section EW 15D to ensure that holders of interest-free or low interest loans cannot claim deductions for interest imputed under IFRS that has not been economically incurred. It is not clear whether a foreign currency ASAP could also fall within the scope of the low-interest loan proposals. The policy intention should be clarified. This could be achieved by defining the terms "interest-free loan" and "low-interest loan" so that they exclude foreign currency ASAPs (if this is the intention).

Comment

The submission is correct that it is not the intention that interest-free and low-interest loans are included in the proposals for foreign currency ASAPs. The two proposals are separate. Officials consider that the proposals for interest-free and low-interest loans stand alone and need no further clarification. The term "interest-free loan" is used in various other parts of income tax legislation and is not defined for any of those purposes. As a result, it is not considered necessary to add further text to income tax legislation. The point will be noted in the *Tax Information Bulletin* which will follow enactment of the legislation.

Recommendation

That the submission be declined.

Issue: Appropriate spreading methods for foreign currency ASAPs

Clauses 60 to 67, 82 and 123

Submission
(KPMG)

The Act and the bill should be reviewed and appropriate amendments made to ensure that taxpayers have appropriate spreading methods to apply.

Comment

The submission suggests that when a foreign currency ASAP does not meet the application criteria for the yield-to-maturity method it is difficult to apply a spreading method that meets the purpose of the financial arrangements rules. This results in the allocation of an inappropriate amount of income/expenditure to each income year.

While officials appreciate that sometimes it is difficult to achieve an appropriate allocation of income or expenditure in some situations, it is not an issue of major significance to warrant an immediate review of the Act. Officials are also aware of various disputes and discussions with taxpayers where it has been relatively easy to apply an appropriate spreading method using existing legislation and the underlying purposes of the financial arrangements rules.

Recommendation

That the submission be declined.

Issue: Use of spot rates to convert foreign currency payments

Clause 66

Submission
(Deloitte)

The use of spot rates to convert foreign currency amounts to New Zealand currency in proposed section EW 33C needs to be clarified. Also, proposed subsections EW 32(2C) and (2D) include redundant wording being, "section EW 33C applies if the consideration is in a foreign currency", as the provisions only apply to foreign currency transactions in the first instance.

Comment

Officials accept that the use of spot rates could be clarified. The intention is to allow some flexibility in the use of spot rates to cater for a variety of factual circumstances which can apply. Officials recommend that the use of spot rates be amended to make it clear that spot rates to be used are the spot rates on the dates payments are made during an income year. When payments are made after the end of an income year, the spot rates used can be the actual spot rates for payments made within 93 days of the end of the income year or the spot rate at the end of the income year.

The redundant words in proposed section EW 33C will be addressed.

Recommendation

That the submission be accepted.

Issue: Elections by non-IFRS taxpayers to use foreign currency hedging

Clause 66

Submission
(New Zealand Institute of Chartered Accountants)

Separate elections should not be required (by non-IFRS taxpayers) to include in the value of property certain forward foreign exchange contracts which hedge the foreign currency arrangements.

Comment

The bill proposes that a once only irrevocable election is made in writing to apply the proposed section to all financial arrangements for the property. The form and timing of the election is considered quite clear from the wording of the proposed section.

It is considered appropriate to include this requirement for non-IFRS taxpayers to enable them to use hedging for foreign currency ASAPs because they will not usually be using hedging for accounting purposes. IFRS taxpayers can only apply hedging to foreign currency ASAPs which are subject to designated hedging under IFRS accounting. The application of designated hedge accounting under IFRS is a rigorous exercise and its use will be compulsory for tax. It is considered appropriate that non-IFRS taxpayers be required to consciously elect to use hedging for tax and to be on a similar footing to IFRS taxpayers.

Recommendation

That the submission be declined.

Issue: Future and discounted valuing

Clause 65

Submission
(Deloitte)

Proposed section EW 32(2C) requires a non-IFRS taxpayer to determine in respect of a foreign ASAP that is more than 12 months: "the future value, or the discounted value, or a combination of both the future and discounted values, on the rights date". What is required is uncertain. This wording should be clarified and clear, worked examples should be provided in a commentary.

Comment

The words in proposed section EW 32(2C) are the same as those used in an existing subsection of section EW 32. There are examples of the use of the future value, or the discounted value, or a combination of both the future and discounted values in existing determinations. These existing provisions and examples will be referred to in a *Tax Information Bulletin* following enactment.

Recommendation

That the submission be noted.

Issue: Life financial reinsurance contracts which may be foreign ASAPs

Clause 60

Submission

(Matter raised by officials)

Life financial reinsurance contracts are subject to specific provisions in the Income Tax Act 2007. Where such contracts come within the definition of foreign ASAPs it is proposed that section EW 15D (the IFRS financial reporting method) is not able to be applied and the existing section EW 15I spreading method continues to apply.

Comment

Officials consider that the current and proposed IFRS accounting treatment may result in the spreading of income and expenditure on these contracts which does not reflect the underlying purposes of the financial arrangement rules. As a result, it is considered that the existing spreading treatment of such contracts under section EW 15I should be retained.

Recommendation

That the submission be accepted.

ACQUISITION DATE OF LAND

Clause 7

Issue: The amendment is not needed

Submission
(Corporate Taxpayers Group, Deloitte, Ernst & Young)

The legislative amendment is not necessary, and the Commissioner of Inland Revenue should revisit her interpretation of when land is acquired to ensure it is consistent with case law. This would make clause 7 unnecessary.

Comment

The Commentary on the bill (page 100) and the officials' issues paper *Clarifying the acquisition date of land*,[6] explains the uncertainty regarding section CB 6 of the Income Tax Act 2007 is caused by the timing of when the taxpayer's intention or purpose should be determined. The Courts have held that the relevant time for determining a taxpayer's purpose or intention is at the time the taxpayer acquired the land.[7]

There is minimal case law to provide sufficient guidance on when acquisition actually occurs, in particular when an agreement for the sale and purchase of land is initially conditional. A 1973 tax decision in the High Court held that land is acquired when the parties to an agreement become bound by the contract to purchase and to sell – that is, when the contract becomes unconditional and an order for specific performance of the land transfer is available.[8]

However, in a subsequent non-tax case, the Court of Appeal held that under the general law, a purchaser acquires an equitable interest in land if specific performance in its wider sense (that is, any form of equitable remedy) is available to protect the purchaser's rights under the contract.[9] In other words, it is a question of whether a purchaser can, by injunction or otherwise, prevent the vendor from dealing with the property in a way that is inconsistent with the contract of sale.

The interpretation of these two cases (and those that followed) has resulted in a number of differing views over when land is acquired.

Further confusion is caused because the definition of "land" in the Income Tax Act 2007 includes estates and interests in land. In a typical sale and purchase situation, the purchaser acquires different interests and estates in "land" over time which is then merged when the title is registered. Neither the legislation nor common law has provided sufficient clarity over which interest in "land" the date of acquisition should apply to.

---

[6] This issues paper is available at: http://taxpolicy.ird.govt.nz/publications/2013-ip-acquisition-date-land/overview.
[7] *AnzamcoLtd (in liq) v CIR* (1983) 6 NZTC 61,522 (HC).
[8] *Beetham v CIR* [1973] 1 NZLR 575 (HC). See also *West v Commissioner of Inland Revenue* (1976) 2 NZTC 61,114 (HC), Case Y3 (2007) 23 NZTC 13,028, and *Annalong Pty Ltd v FCT* 72 ATC 4141.
[9] *Bevan v Smith* [1994] 3 NZLR 648 (CA).

Within Inland Revenue, the Crown Law Office and the private sector, there are diverse views on what is the most accurate interpretation of the law and date of acquisition. The diversity of views is exacerbated when there is a significant period of time between entering into an agreement to purchase land and the registration of the land transfer title. Officials consider a clear legislative test is the best way of dealing with the current uncertainty.

Recommendation

That the submission be declined.

Issue: The drafting of section CB 15B

Submission
(Corporate Taxpayers Group, Deloitte, KPMG, New Zealand Institute of Chartered Accountants, Russell McVeagh)

The drafting of proposed section CB 15B is circular and could be improved to better convey how the test applies.

Comment

Proposed section CB 15B (1) current states:

> "*General rule*
> "(1) For the purposes of subpart CB, a person acquires ***land*** on the date that ***begins a period*** in which the person ***has an estate or interest in the land***, alone or jointly or in common with another person."
> [emphasis added]

Officials consider the wording of this proposed section is not circular even though the definition of "land" in the Income Tax Act includes estates and interests. The crucial aspect of the wording of section CB 15B (1) is that the "land" that is being acquired is identified and the "estate or interest" is in that "land".

Furthermore, section CB 15B (1) will only be applied retrospectively, so the emphasis is in looking back to when the person had the first estate or interest. Once the taxpayer determines the point in time that they had the first estate or interest, the beginning of this period is considered to be the acquisition date for the purposes of subpart CB.

Recommendation

That the submission be declined.

Issue: The timing of the test of a person's intention and purpose

Submission
(Corporate Taxpayers Group, Deloitte, KPMG, New Zealand Institute of Chartered Accountants, Russell McVeagh)

The drafting of proposed section CB 15B should refer explicitly to the time at which a person's purpose or intention is to be determined (that is, when the person enters into a binding agreement for the sale and purchase of land), as opposed to when land is acquired.

Comment

The policy intent of proposed section CB 15B is to clarify the timing of when land is acquired as the Court has held that this is when a person's purpose or intention should be tested.[10]

Officials consider that focusing the proposed section on the timing of the person's intention or purpose will narrow the application of proposed section CB 15B just to section CB 6. This will not resolve when the date of acquisition is for the rest of the land provisions, as the date of acquisition is important for:

- section CB 15 – which determines when land is acquired by associated persons for most of the land provisions in subpart CB;
- sections CB 7, CB 9, CB 10 and CB 14 – which determine when the 10-year period begins for a business dealing in land (including land development, subdivisions and change of land under the Resource Management Act 1991); and
- sections CB 18 and CB 19 – which determine when land is acquired for the purposes of the residential and business exemption.

Furthermore, if the legislation referred more explicitly to the date the person enters into a sale and purchase agreement, the inclusion of the word "agreement" would create a proxy and would narrow the scope of the provision even further, as any other form of acquisition (outside of an agreement) will fall outside the scope of proposed section CB 15 B and section CB 6. Officials are of the view that this could create a revenue risk.

Recommendation

That the submission be declined.

---

[10] See footnote 2.

Issue: Proposed section CB 15B should be deleted or reconsidered more substantially

Submission
(Ernst & Young)

Proposed section CB 15B should be deleted or reconsidered more substantially; in particular, further clarification is needed on:

- identification of the "land";
- changes in the nature of a person's interest or holding in the land;
- a need to deal explicitly with options, nominee and trust situations; and
- amending provisions allowing for deductions for the cost of acquiring property which is or becomes "revenue account property" under the Land Sale Provisions.

Comment

The clarification sought by proposed section CB 15B has highlighted a number of technical problems and other related areas of ambiguity with the current application of section CB 6, the definition of land and the relationship between section CB 6 and other land sale provisions.

Although proposed section CB 15B will address the main problem of when the taxpayer's intention or purpose should be tested, further detailed analysis to address the technical issues raised by the submitter is needed. Officials consider that if further amendments are proposed to address the issues raised, this may create further ambiguities without the benefit of full consideration.

Given the time constraints for the bill, and the number of issues that would need to be worked through (and consulted on), the current bill is not the best vehicle to address the various technical issues raised. A number of these issues could be best addressed in a published statement on the interpretation and application of proposed section CB 15B given there is a range of case law that covers some of the issues raised.

For example, there are a number of cases on whose intention or purpose should be tested:

- *Harkness v CIR*[11] – where the purpose is the purpose of the owner of the land;
- *Tilley v FCT*[12] – the agent's purpose will be imputed to the principal;
- *Boanas v CIR*[13] – the intention is of the partnership and not the partners; and
- *CIR v National Distributors*[14] – the company's purpose is the purpose of the persons who control the decisions of the company.

Officials disagree that an explicit provision covering these circumstances should be included in the bill but further guidance in a public statement would provide further clarity.

---

[11] (1975) 2 NZTC 61,017.
[12] 77 ACT 4027.
[13] (2008) 23 NZTC 22,046.
[14] (1989) 11 NZTC 6,346.

Officials also do not agree that proposed section CB 15B be removed from the bill for the reasons noted above (the diverse views between Inland Revenue, the Crown Law Office, taxpayers and their agents). A number of other submitters are supportive of the legislative clarity.

Recommendation

That the submission be declined, subject to Inland Revenue publishing a statement on the interpretation and application on proposed section CB 15B.

Issue: Purpose and intention of the subsequent nominee, nominated transferee or assignee

Submission
(Ernst & Young)

Outside of the circumstances of section YB 21, proposed section CB 15B would not be effective in relation to the subsequent nominee, nominated transferee or assignee. For example, in the absence of any specific deeming provision, we do not understand how a subsequently incorporated company could acquire any interest in land before the company came into existence, let alone have the purpose or intentions of another legal person at that pre-existence time.

Comment

Officials agree that in the circumstance when a subsequent nominee, transferee or assignee does not yet exist it is impossible for this subsequent nominee, transferee or assignee to have any requisite purpose or intention to test under proposed section CB 15B.

Officials therefore recommend that a provision be included in the bill that clarifies the circumstance when a subsequent nominee, transferee or assignee is yet to exist, that the purpose and intention of the person who controls the nominee, transferee or assignee, be imputed onto the subsequent person once this subsequent person comes into existence. The provision is only likely to be needed in a company situation, as this is a clear example of where a "person" does not yet exist but can be created.

Recommendation

That the submission be accepted.

Issue: Definition of "interest in land"

Submission

(New Zealand Law Society)

The Income Tax Act 2007 does not define what an "interest in land" is for this purpose and there is the potential for uncertainty where "land" acquired is different from the "land" being disposed of, therefore the ambit of "land" should be clarified.

Comment

Subpart YA 1 provides a definition of "interest" in relation to land so no separate definition of "interest" for the purposes of section CB 6 is needed. A wider review of the ambit of "land" is outside the scope of the proposed amendment.

Officials also consider that the effect of section CB 6(3) is that the "land" acquired and the "land" sold need not be the same "land". Subsection CB 6(3) states:

> *Land partially sold or sold with other land*
>
> (3) This section and sections CB 7 to CB 23 apply whether the land disposed of—
>
> - (a) is part only of the land to which the relevant section applies:
> - (b) is the whole of the land to which the relevant section applies:
> - (c) is the whole of the land to which the relevant section applies, together with other land

As explained in the officials' issues paper, the introduction of subsection CB 6(3) was to cover situations where land that is disposed of constitutes the whole or part of any land. According to an Inland Revenue Head Office Circular, this subsection was introduced to circumvent the Australian case *Moruben Gardens*,[15] where the Australian High Court held that it was necessary for there to be a clear "identity" between the estate or the interest acquired, and the estate or interest disposed of.

It also follows that in a typical sale and purchase agreement for the acquisition of land, all the estates and interests in land merge into the one legal title, therefore there is always a link between what "land" is disposed of and what "land" is acquired.

Recommendation

That the submission be declined.

---

[15] *Moruben Gardens Pty Ltd v Commissioner of Taxation (Cth)* (1972) 46 ALJR 559; 3 ATR 225; 72 ATC 4147 (HC).

Issue: Alignment with the definition of "land"

Submission
(Matter raised by officials)

Proposed section CB 15B should include options to acquire land, or an estate or interest in land.

Comment

The definition of "land" in the Income Tax Act includes "an option to acquire land, or an estate or interest in land". Currently proposed section CB 15B only refers to estates or interests in land. Officials recommend that proposed section CB 15 B include an "option" to acquire land to align with the definition of "land".

Recommendation

That the submission be accepted.

Issue: Previous interests and estates in land with an option

Submission
(Matter raised by officials, Ernst & Young)

The policy intent should be clarified where taxpayers hold an interest in one type of land (such as a leasehold interest) but then acquire another interest in that land (such as the estate in fee simple), which is later all or partly disposed of.

Comment

The policy intent of proposed section CB 15B is to test the person's intention or purpose when they first acquire an interest or estate in the land. The submitter raised the issue that clarification is needed where a taxpayer holds an interest of one type of land in a particular block of land, such as a leasehold interest, then acquires the freehold, which is later all or partly disposed of. As currently drafted, the taxpayer's intention or purpose would only be tested when they acquired the leasehold interest.

Officials agree that in the circumstance outlined by the submitter, this situation is only likely to occur where there is an option to exercise a right to acquire another estate or interest in land.

For example:

- Brian has an unregistered leasehold in land, with a "first right" option to acquire the fee simple estate if it is disposed of by the lessor April.
- April decides to sell the estate in fee simple, and offers the land to Brian as per the terms of the lease agreement.
- Brian agrees to exercise the option to acquire the estate in fee simple.

In this example Brian has a number of interests and estates – the leasehold land, the option and once the option is exercised, a contingent equitable interest in the land that eventually merges into an estate in fee simple. Under the current drafting of proposed section CB 15B, Brian's intention or purpose is only tested when he acquires the unregistered leasehold interest. However because an unregistered leasehold interest does not merge into the legal estate in fee simple, if Brian had the intention to acquire the estate in fee simple to dispose of it, and Brian disposes of the estate in fee simple, any gain Brian makes from this disposal falls outside the ambit of section CB 6. This is because when Brian acquired (the leasehold) he did not have the intention to dispose of the leasehold, despite making another active decision to exercise the option and acquire the estate that is eventually disposed of.

Officials consider that this outcome is not consistent with the underlying policy intent of section CB 6 or the first interest principle, as Brian has made another active decision to enter into an agreement to acquire the estate in fee simple. Officials consider that this subsequent acquisition should be treated as separate acquisition of land, and Brian's intention or purpose should be tested at this time (when he exercises the option). As per the officials' issues paper:

> …the policy intent of section CB 6 is to capture property speculators, arguably the most appropriate time to assess a taxpayer's intention and purpose should be when a person decides to enter into a sale and purchase agreement. **It is the initial decision-making that informs how a person intends to use the property.** It would be unusual for a property speculator to enter into a sale and purchase agreement unless they thought it very likely that the purchase and its subsequent disposal would be profitable.

Officials recommend that a new provision be included in the bill that provides where a person has a previous (first) interest in land, and exercises an option that is related to that land, the person has entered into a new acquisition and the section CB 6 and proposed section CB 15B should be applied, as if the previous interest did not exist.

The example above is distinct from the situation where a person just has an option to acquire land but no other previous interest in land. As per the officials' issues paper, the appropriate time to test their intention or purpose in relation to the option is when the option is granted.

Recommendation

That the submission be accepted.

Issue: Timing in subpart FB and FC

Submission

(New Zealand Institute of Chartered Accountants)

The new section should only apply when subpart FB or FC provide a different timing of a transaction to that provided under the new section.

Comment

Proposed subsection CB 15B (2) provides that the timing of when land is acquired is overridden by any timing set out in subpart FB (transfers of relationship property) and FC (distribution, transmission, and gifts of property).

Under the current wording, proposed subsection CB 15B (1) is only overridden if there is a timing set out in subpart FB and FC. Therefore when there is no timing specified in subpart FB or FC, the timing of subpart CB 15B (1) will apply.

Recommendation

That the submission be declined.

Issue: Section 225 of the Resource Management Act 1991

Submission
(Deloitte)

Clause 7 should contemplate arrangements subject to section 225 of the Resource Management Act 1991 and confirm land is acquired when a binding agreement is entered into regardless of any conditions.

Comment

Section 225 of the Resource Management Act 1991 (RMA) deems that an agreement to sell land or any building that constitutes a subdivision and is made before the appropriate survey plan is approved is conditional on the survey plan being deposited. A purchaser can therefore cancel or rescind the agreement if there are delays in the title separation.

The policy underlying the preferred date to test the taxpayer's purpose or intention is founded on the "first interest" approach, where the date to test a person's purpose or intention is the date when the first interest (equitable or legal) in land arises under an agreement for the sale and purchase of land (the "first interest" interpretation).

Therefore, an explicit provision for agreements subject to section 225 of the RMA is not needed, as the parties intend to be bound by the agreement and the Court has the ability to enforce the purchaser's right in the agreement by ordering specific performance in the sense of requiring the vendor to submit a survey plan.

Recommendation

That the submission be declined.

Issue: Proposed section CB 15B should not apply to other land-related provisions

Submission
(Corporate Taxpayers Group)

The rule should not apply to other land-related provisions in subpart CB, but could apply for sections CB 7, CB 18 and CB 19.

Comment

As noted above, in general the timing of the acquisition date of land affects most of the land-related provisions in subpart CB:

- section CB 15 – determines when land is acquired by associated persons for most of the land provisions in subpart CB;
- sections CB 7, CB 9, CB 10 and CB 14 – determine when the 10-year period begins for a business dealing in land (including land development, subdivisions and change of land under the Resource Management Act 1991); and
- sections CB 18 and CB 19 – determine when land is acquired for the purposes of the residential and business exemption.

Officials do not agree with limiting the rule to just section CB 6 as the issue of when land is acquired for the remaining land-related provisions would be unclear. Officials consider that one rule for all the land-related provisions is the more appropriate policy approach.

Recommendation

That the submission be declined.

Issue: Correction of the application date of new section CB 15B

Clause 2(20)

Submission
(Matter raised by officials)

Comment

Clause 2(20) provides that the application date for proposed section CB 15B is from the date of the introduction of the bill whereas it has always been intended (as reflected in the bill Commentary) that proposed section CB 15B applies to *disposals of land* from the date the bill is introduced.

Officials recommend that the application date be corrected.

Recommendation

That the submission be accepted.

Issue: Clarify that the application date can be retrospective

Clause 2(20)

Submission
(Deloitte, Corporate Taxpayers Group)

It should be made clearer that proposed section CB 15B has a retrospective effect to determining the acquisition date or Inland Revenue should indicate it will immediately cease advancing the new interpretation of the existing law.

Comment

If the Committee agrees the application date should be corrected to apply to disposals of land from the date the bill is introduced, it will be made clear that proposed section CB 15B can apply to land that has been acquired before the date the bill is introduced, and is therefore retrospective where land has not yet been disposed of.

Although the officials' issues paper acknowledged that the "first interest" interpretation is the preferred tax policy interpretation, the current interpretation used by Inland Revenue (that is, the disposal interpretation – where the date of acquisition is determined by the "land" that is disposed of) is not a totally unreasonable interpretation. We consider it unwarranted for the Commissioner to "unwind" previous positions taken by both the taxpayer and Inland Revenue when the land has already been disposed.

Recommendation

That the submission be accepted, subject to the Committee agreeing to the correction of the application date.

Issue: Deferral or limitation of the application date

Clause 2(20)

Submission
(Ernst & Young, Matter raised by officials)

There does not appear to be any reason for urgency in bringing in any change of rules, therefore the commencement and scope of application of any such new provision should be:

- deferred at least until enactment of the legislation; and
- limited in application to land acquired after that date.

Comment

In the officials' issues paper, it was suggested:

> "For ease of administration and in the interests of fairness, if the Government does decide to clarify the date of acquisition following feedback on the options presented here, we suggest that the date of application for any legislative option (that is, for new acquisitions as opposed to new disposals) be prospective from the date of Royal assent of the relevant tax bill."

Submissions received on the application date in the officials' issues paper were not supportive of the prospective application date. Two application dates were suggested by two submitters during consultation:

1. "Retrospective to allow for the reversal of previous decisions/ interpretations that are inconsistent with what is now acknowledged to be the correct interpretation."

2. "Retrospective for all disposals where income tax has not been assessed prior to the date the preferred changes are publicly announced. This will help minimise issues with uncertainty and will ensure that neither taxpayers nor Inland Revenue need to continue protracted disputes. Applying a clarified definition only to land purchased after enactment will leave uncertainty for those taxpayers subject to the 10-year rule in the other land provisions, potentially up to 10 years after the enactment of the legislation."

Officials considered that the current interpretation applied by Inland Revenue is not a totally unreasonable interpretation that it warrants a fully retrospective application date as suggested in the first submission.

However officials did agree with submitter 2, that the impact on the other land provisions was not ideal, and that the application date in the officials' issues paper needed to be reconsidered. Hence the application date suggested in the bill Commentary, which we have recommended the Committee correct in the bill.

Recommendation

That the submission be declined.

REPEAL OF THE SUBSTITUTING DEBENTURE RULE

Clauses 38, 40, 51, 83, 84, 105 and 123(13) and (40)

Issue: Support for the proposal

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

The submitters support the repeal of the substituting debenture rule.

Recommendation

That the submission be noted.

Issue: Transitional provision and application dates

Clause 83

Submission
(Ernst & Young)

The application date based on income years should be clarified and revised. Parties to the same debenture may have different balance dates. This could cause uncertainty where, for example, the issuer has a 30 June balance date and pays a "dividend" in April. Because the substituting debenture is still treated as a share from the issuer's perspective, the payment is treated as a dividend and may be imputed. If the holder has a 31 March balance date, then the new regime will apply, the debenture will be treated as debt and the payment by the issuer will be treated as interest. There is uncertainty over whether the holder can use the imputation credit.

Comment

Officials considered two ways of dealing with the transition date:

- an "income year approach" where all instruments transition from equity to debt at the end of each affected taxpayer's 2014–15 income year (the exact date of transition will therefore vary depending on the taxpayer's specific balance date). This is the approach currently in the bill. The rationale for the income year approach is to make the transition as clean as possible for taxpayers and to prevent the need for potentially complicated part-year adjustments that may be required if a single date (such as 31 March 2015) was chosen. Under the income year approach, a taxpayer who is party to a substituting debenture will have an equity investment for the whole of the 2014–15 income year and a new debt investment for the whole of the 2015–16 and later income years. The income year approach does, however, have the disadvantage identified by Ernst & Young where the balance dates of the parties to the substituting debenture are different and there is a payment under the debenture (or some other event such as a remission/cancellation or repayment) in the period between their balance dates; or

- a “tax year approach” where all instruments transition from equity to debt at the end of the 2014–15 tax year – 31 March 2015. The tax year approach has the benefit of setting a single transition date for all taxpayers who are parties to substituting debentures and eliminates the potential for mismatches in debt/equity treatment between parties to the same arrangement. However, it does mean that some taxpayers may have a transition part-way through their income year which may increase compliance costs associated with what is intended to be a taxpayer-friendly measure.

Ernst & Young has not identified a preferred solution to the problem it has identified. One way of dealing with the submitter’s concern would be to include provisions specifying how payments (or other actions/events) under the substituting debenture should be treated where the parties’ balance dates do not align. This would add significant complexity to the legislation. The alternative would be to adopt the tax year approach.

Ernst & Young considers that the complexity and compliance costs of doing a part-year adjustment should be minimal (given people already have to calculate their outstanding principal at year-end). Accordingly, adopting the tax year approach should not make any taxpayers worse off and would solve a potential problem for parties to substituting debentures with non-aligned balance dates. This approach is also consistent with the goal of eliminating any potential tax treatment mismatches generally.

Officials therefore support adopting a tax year approach to the repeal of the substitution debenture rule and the transitional provision. This means that the substituting debenture rule will be repealed on 1 April 2015 for all taxpayers and the transitional provision will apply to deem a redemption of shares on 31 March 2015 and the advance of a new loan on 1 April 2015.

Recommendation

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

Issue: Transitional provision – clarifications

Clause 83

Submissions
(Ernst & Young)

The “outstanding principal” concept in the transitional provision should be clarified to explicitly include any accrued but unpaid interest.

The transitional provision should clarify that the deemed repayment and re-issue of the debenture applies to both the issuer and the holder of the debenture.

Comment

Officials agree that these clarifications would be useful.

Recommendation

That the submissions be accepted.

Issue: Transitional provision – effect on shareholder continuity

Clause 83

Submission
(Ernst & Young)

Some debentures carry voting rights. When these debentures cease to be treated as shares for tax purposes, taxpayers could potentially suffer a shareholder continuity breach, thus forfeiting tax losses and/or imputation credits. Specific "savings" provisions are needed in relation to the measurement of voting interest in determining continuity for losses and imputation credits to ensure no adverse tax consequences arise.

Comment

Officials estimate it would be fairly unusual to have voting debentures that were originally held in proportion to equity, but have ceased to be so held such that their subsequent redemption could affect shareholder continuity. However, the repeal of the substituting debenture rule was not intended to have any adverse tax consequences, therefore a savings provision is appropriate.

Recommendation

That the submission be accepted.

Issue: Tailoring the transitional provision

Clause 83

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

Corporate Taxpayers Group supports the transitional provision, however notes that there may need to be some amendments to ensure individual taxpayers are not adversely affected. Corporate Taxpayers Group expects affected taxpayers would submit separately on this matter.

New Zealand Institute of Chartered Accountants submits that the transitional provision should be tailored to ensure individual taxpayers are not adversely affected (for example, in relation to available subscribed capital (ASC)). New Zealand Institute of Chartered Accountants advises that officials are aware of how taxpayers could be negatively affected.

Comment

Officials note the submissions. Other submitters have drawn officials' attention to the specific amendments needed to transitional provisions to ensure taxpayers are not adversely affected and these have been separately considered.

There have not been any submissions on how ASC may be affected. Officials considered the effect of the transitional provision on ASC in drafting the transitional provision. The transitional provision is intended to ensure that the deemed redemption – an "off-market cancellation" – of the "share" has the same tax consequences as the redemption of a non-participating redeemable share that is:

(a) no dividend arises to the "shareholder" to the extent the redemption payment does not exceed ASC; and
(b) the company's ASC is reduced by the amount of the principal repayment (being a component of "returns" in the ASC formula in section CD 43(2)).

The original subscription for the "share" should have generated ASC equal to the loan principal and this should be sufficient to shelter the dividend arising on redemption. Assuming the full loan balance is outstanding at the transition date, the original ASC should be equal to redemption proceeds/principal repayment, and there should be no dividend and (appropriately) there should be a reduction in the ASC equal to redemption proceeds/principal repayment.

If the outstanding principal on the transition date is less than the amount originally lent (because some of the principal has been paid down), we would expect the ASC to have been reduced by previous loan repayments (that is, the ASC would have been used to shelter "dividends" arising from previous repayments). So, for example, if one hundred $1 debentures were originally issued, this would have generated $100 of ASC. If $30 has been repaid to date (treated as a cancellation of thirty $1 debentures), this repayment will not have been a dividend to the extent covered by ASC and, consequently, the ASC should have been reduced by $30. This means when the deemed repayment of $70 occurs on the transition date, the remaining ASC of $70 should shelter the dividend. The ASC will also be reduced by $70. If there was only a single debenture issued for $100, the previous $30 repayment cannot have been sheltered by ASC (because the debenture was not cancelled). This means that the $30 repayment would have been a dividend and ASC would not have been reduced by $30. On the transition date, because the debenture is cancelled, the $70 repayment is sheltered by ASC of $70 and this leaves the company with $30 ASC (which may only be applied in future to amounts paid in respect of shares of the same class).

Recommendation

That the submissions be noted.

Issue: Grandparenting of existing transactions

Submission
(KPMG, New Zealand Law Society, PricewaterhouseCoopers)

Some taxpayers may have deliberately issued substituting debentures and changing the tax treatment/classification of the debentures part-way through their life could have adverse consequences for issuers and investors. Some of these taxpayers may have sought binding rulings. While tax law is always subject to change, holders and issuers may have taken long-term positions based on the tax treatment at the date they entered into the transaction. A savings provision is therefore warranted to preserve the existing tax treatment (as equity) if the taxpayer so desires.

Comment

The substituting debenture rule is an anti-avoidance provision. It is slightly unusual for a taxpayer to structure into an anti-avoidance rule. However, the repeal is intended to be a taxpayer-favourable reform and was not intended to have any adverse consequences.

Accordingly, officials support the elective grandparenting of existing transactions on the following basis:

- The transaction must have been entered into before the introduction of the bill.
- The transaction must have been subject to a binding ruling which would continue to apply in the absence of the repeal of the substituting debenture rule (that is, the facts disclosed in the binding ruling continue to be correct for the entire term of the transaction and all ruling conditions met).
- An electing party must notify the Commissioner by 31 July 2014 that it elects to continue to treat the debentures as shares.

Recommendation

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

WITHHOLDING TAX AND INFLATION-INDEXED BONDS

Submission
(Corporate Taxpayers Group)

We generally support the proposals in the bill to deal with technical issues in relation to the application of the RWT and NRWT rules to inflation-indexed instruments. However the Government should consider how workable rules could be introduced in other areas where there is a mismatch between income arising and cash flows.

Comment

Officials note that this submission raises an issue that would require further analysis and needs to be prioritised against other work on the Government's tax policy work programme. Officials propose to discuss the priority of this work with the submitter.

Recommendation

That the submission be noted.

CLASSIFICATION OF MINING PERMITS AS REAL PROPERTY FOR TAX PURPOSES

Clause 123(35)

Issue: Whether the amendment creates uncertainty

Submission
(PricewaterhouseCoopers)

Including mining permits in a definition of "real property" in the Income Tax Act 2007 may result in unforeseen ambiguity. It raises the question of whether mining permits are akin to other forms of real property and, in particular, akin to land. For example, section CT 7 of the Income Tax Act 2007 defines a "petroleum mining asset" as including a petroleum permit, but excluding "land".

One solution is to limit the extended definition of "real property" (which includes mining permits) to the application of New Zealand's double tax agreements (DTAs).

Comment

The amendment changes the definition of "real property", which is a different definition (and concept) from "land" (although land is a subset of real property).

There should be no ambiguity with respect to the definition of "petroleum mining asset" in section CT 7 because the term "real property" is not used in that section; the relevant term used is "land" (the definition of which does not refer to "real property"). Accordingly, the proposed amendment has no legislative effect on section CT 7. Additionally, CT 7 is very explicit about how "petroleum mining asset" is defined – that is, petroleum mining assets include a "petroleum permit" (which is one kind of real property), but does not include "land" (which is another kind of real property). So the proposed change is not inconsistent with the definition in section CT 7.

Limiting application of the amended definition to the application of New Zealand's DTAs would mean that the amendment does not adequately address the problem identified because New Zealand's DTAs refer to domestic law definitions to determine source-country taxing rights. Therefore, the definition would be somewhat circular (and potentially ambiguous) if the domestic law definition was only for the purpose of DTAs.

Recommendation

That the submission be declined.

Issue: Classification of mining permits as real property for goods and services tax purposes

Submission

(New Zealand Institute of Chartered Accountants)

Consideration should be given to introducing a similar clarification to the definition of "land" for GST purposes.

Comment

The amendment is to the definition of "real property", which is a different definition (and concept) from "land". In addition, the change to the definition of "real property" is for income tax purposes and the policy rationale does not necessarily translate to goods and services tax where "land" has a meaning tailored to that tax type.

Officials will further consider and engage with the submitter on this issue.

Recommendation

That the submission be declined.

EMPLOYEE SHARE SCHEMES AND PAYE

Submission

(Corporate Taxpayers Group)

Reforms should be included in the bill that would allow employers to elect to treat benefits under share purchase agreements (commonly referred to as "employee share schemes" (ESS)) as subject to PAYE, when it is practical to do so.

Inland Revenue's recent published position is that employee share scheme income is not subject to PAYE, and employees with such income must file IR 3 income tax returns.

Employee share schemes have a productivity benefit to New Zealand by providing employees with a stake in the companies that they work for. When there is a tax consequence, the compliance obligations for employees should be minimised.

Requiring employees to file IR 3 returns is not the most desirable outcome from a policy perspective as employees will often have no other tax filing requirement. The current law therefore brings more taxpayers into the filing system despite Inland Revenue actively trying to remove the need for individuals to file tax returns in many circumstances.

Further, overall compliance with tax laws is likely to be reduced if employees are required to file IR 3 returns, as many are likely to be unaware of their tax obligations (and others may simply not comply). Greater compliance is assured when employers are able to deduct PAYE in relation to employee share scheme awards and the Government is assured of receiving the correct amount of tax.

The Group is happy to work with officials to develop a policy response to this issue, noting that any such response should also ensure that past positions adopted by taxpayers are protected.

Comment

Officials agree in principle with the concerns raised by the Corporate Taxpayers Group. However, given the large number of taxpayers potentially affected by this change, it is more appropriate for any reforms to be included in a future tax bill to ensure the proposed solution is subject to full consultation in accordance with the generic tax policy process. If the suggested amendment was included in the bill at this stage, some taxpayers would not have the opportunity to consider the proposed solution and comment on it.

Accordingly, officials recommend that the submission be declined for this tax bill, but that work commence on a solution for a future tax bill.

Officials have discussed this approach with the submitter who is comfortable with it.

Recommendation

That the submission be declined.

ASSOCIATED PERSONS AND PERSON WITH A POWER OF APPOINTMENT OR REMOVAL

Submission
(New Zealand Institute of Chartered Accountants)

A person with a power of appointment or of removal of a trustee should be exempt from association with the trustee under section YB 11 (Trustee and person with power of appointment or removal) if they are subject to the professional code of conduct and disciplinary processes of an approved organisation.

Section YB 11(1) of the Income Tax Act 2007 prescribes that a trustee of a trust and a person with the power of appointment or removal of trustees in relation to the same trust are associated for tax purposes.

An exclusion to this associated persons test was enacted by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013.

Among other requirements, the exemption applies to a person who is a "member of an approved organisation". To be an approved organisation, the organisation's natural person members must be subject to a professional code of conduct and to disciplinary processes in accordance with that code (among other requirements).

There are circumstances in which this exemption does not operate as intended.

Using the New Zealand Institute of Chartered Accountants (NZICA) as an example of an approved organisation, chartered accountancy practices can have partners who are members of NZICA and partners who are not members. A partner in a CA practice who is not a member of NZICA is still subject to NZICA's code of ethics and disciplinary processes because they are part of a member firm. However, because they are not a member of NZICA themselves, they are not currently covered by the exclusion in section YB 11(2).

It appears contrary to the policy for the exclusion that a partner who is not a member of NZICA but receives a power of appointment or removal of a trustee in their professional capacity is not covered by the exclusion.

Comment

Officials agree that the policy intention was to exclude from the association test those trustees acting in a professional capacity. The membership of a professional body was seen as an appropriate test as it ensured that those eligible for the exclusion would be limited and that a high standard would have to be met before the exclusion was available. Members of professional bodies such as the New Zealand Law Society and NZICA are the most likely trustees to be acting in a professional capacity. A non-member of NZICA working in a chartered accounting firm is as likely as an NZICA member to be a trustee in their professional capacity and should not be treated any differently for the purpose of the associated persons test. Therefore, the exemption should be extended to include not only members of an approved organisation, but also persons who are subject to the approved organisation's code of ethics and disciplinary processes (provided the other requirements of the exclusion in section YB 11(2) are also met).

Recommendation

That the submission be accepted.

EXTENDING THE TAX EXEMPTION FOR NON-RESIDENT OFFSHORE OIL RIG AND SEISMIC VESSEL OPERATORS

Issue: Extending the exemption to other vessels

Clause 30

Submission
(Ernst & Young)

The exemption should be extended to also cover vessels that operate electromagnetic surveying, not just seismic survey vessels.

Comment

The exemption, as drafted, applies to non-resident companies "… operating a ship to provide seismic survey readings…".

The submission suggests that the reference to seismic surveys does not adequately cover new forms of technology that provide a comparable or substitutable function – in particular, electromagnetic surveying.

Officials agree that it is generally desirable for substitutable products to be given the same or similar tax treatment whenever possible. Officials also agree with the submitter that electromagnetic and seismic surveying are two techniques that achieve broadly the same result for the same purpose. The policy justifications for extending the exemption for seismic vessels appear to be equally applicable to electromagnetic vessels.

Recommendation

That the submission be accepted.

Issue: Modular rigs

Submission
(Petroleum Exploration and Production Association of New Zealand)

The exclusion for modular drilling rigs should only apply if the rig is in New Zealand for 183 days after December 2014.

Comment

The bill proposes to remove from the scope of the exemption modular drilling rigs, on the basis that these smaller rigs (that are designed to be installed on an existing platform) do not have the same high mobilisation and demobilisation costs associated with other rigs in operation. These were never intended to be covered by the exemption.

For these rigs, the exemption will expire on 31 December 2014. Officials consider this expiry date to be appropriate. Operators of these rigs have had plenty of notice of the intended change. Given they were never intended to be within the exemption, effectively extending the exemption for a further 183 days appears unnecessarily concessionary.

Recommendation

That the submission be declined.

Issue: Prospecting activities

Submission
(Petroleum Exploration and Production Association of New Zealand)

Section CW 57 should be redrafted to explicitly cover "prospecting" with seismic vessels.

Comment

Officials consider that the words "identifying and developing" are appropriate. These words have always been used to define the scope of the exemption and to change them now may cause unnecessary confusion. Subject to the earlier recommended changes regarding electromagnetic surveying vessels and modular rigs, the policy is to roll over the exemption – not to change the relevant activities it applies to.

Recommendation

That the submission be declined.

Issue: Extended exemption

Submissions
(Corporate Taxpayers Group, Deloitte, Petroleum Exploration and Production Association of New Zealand, PricewaterhouseCoopers)

The extension of the exemption is supported. *(Corporate Taxpayers Group, PricewaterhouseCoopers, Deloitte).*

The extension should be made permanent. *(Corporate Taxpayers Group, Deloitte, Petroleum Exploration and Production Association of New Zealand)*

Comment

Officials consider that the extension of the exemption will provide the industry with a considerable degree of certainty in the medium term. The appropriateness or otherwise of a permanent exemption can be revisited at the expiry of the proposed extension.

Recommendation

That the submissions be noted.

UNDERGROUND GAS STORAGE

Clauses 17, 18 and 36

Issue: Scope of the proposed provision

Submissions

(New Zealand Institute of Chartered Accountants, Petroleum Exploration and Production Association of New Zealand)

The legislation should make it clear that the proposed rules do not apply to the storage of unprocessed gas. *(New Zealand Institute of Chartered Accountants)*; or instances where gas is reinjected as part of field management or depletion. *(Petroleum Exploration and Production Association of New Zealand)*

The appropriate reference is to "royalty paid gas under a mining permit that has been issued or amended under the Crown Minerals Act 1991 for the purposes of underground gas storage." *(Petroleum Exploration and Production Association of New Zealand)*

Comment

Inland Revenue officials have discussed this matter with officials from Resource Markets at the Ministry of Business, Innovation and Employment, who consider the definition of "underground gas storage facility" as defined in section 2 of the Crown Minerals Act (as currently used in the draft bill) is appropriate and there should not be any confusion in practice by what is covered by the proposed provision.

Recommendation

That the submissions be declined.

Issue: Grandparenting existing arrangements

Submission

(Deloitte, New Zealand Institute of Chartered Accountants, Petroleum Exploration and Production Association of New Zealand)

Allowing owners of existing facilities to continue present treatment would reduce compliance costs. *(New Zealand Institute of Chartered Accountants)*

Grandparenting arrangements in the proposed legislation are appropriate. *(Petroleum Exploration and Production Association of New Zealand, Deloitte)*

Recommendation

That the submission be noted.

OVER-CREDITING OF IMPUTATION CREDITS IN EXCESS OF FIF INCOME

Submission
(BDO Wellington Ltd)

Section CV 19 of the Income Tax Act 2007 should not include imputation credits already taxed under the FIF rules. Alternatively, section CV 19 should not be enacted at all.

Comment

Section CV 19 was recently enacted by the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014. It was part of the amendments designed to address a mismatch arising under the tax rules in relation to imputed dividends paid by Australian companies under the trans-Tasman imputation rules. This mismatch arose because imputation credits were calculated on the basis of the dividend paid but income tax arises only on the foreign investment fund (FIF) income.

Officials agree there is double-counting of imputation credits when the comparative value or deemed rate of return FIF calculation methods are used. Officials agree that section CV 19 should be amended to prevent the double-counting of imputation credits in these cases.

Recommendation

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

WHETHER A TRUSTEE OF A HEAD-TRUST IS A SETTLOR OF A SUB-TRUST

Submission
(PricewaterhouseCoopers)

Section HC 28 of the Income Tax Act 2007 lists a number of activities of a person that result in that person being treated as a settlor of a trust for tax purposes. A person is treated as a settlor of a sub-trust if they are a settlor of a head-trust and a trustee of that head-trust settles property on the sub-trust.

However, by virtue of section HC 27(2) of the Act, the trustee of the head-trust may be treated as a settlor of the sub-trust.

It is therefore arguable that the trustee of a head-trust could be treated as a settlor of the sub-trust, as they are transferring value to the sub-trust.

Section HC 27(2) should be amended so that it does not apply to treat a trustee as a settlor in circumstances where the trustee transfers value to a sub-trust as a result of a settlor of a head-trust settling a new trust.

Comment

Officials note that this issue is primarily related to foreign trusts. A trust is a foreign trust in relation to a distribution if no settlor is resident in New Zealand. Foreign trusts are not taxed on their foreign-sourced trustee income. The review of the tax treatment of foreign trusts will be included in the Government's tax policy work programme as part of the work on base erosion and profit shifting.

Recommendation

That the submission be declined.

TAXATION OF LIFE INSURANCE BUSINESS – MATCHING EXPENDITURE TO INCOME

Submissions
(Partners Life)

Partners Life is seeking a legislative change to restore its tax position to what it was before the enactment of an amendment to the financial arrangement rules made by the Taxation (Livestock Valuation, Asset Expenditure, and Remedial Matters) Act 2013.

The submitter has proposed two ways of achieving this outcome (discussed below).

Comment

Changes made to the financial arrangement rules by the Taxation (Livestock Valuation, Asset Expenditure, and Remedial Matters) Act 2013 were directed at countering arrangements that sought to re-characterise capital expenditure as revenue expenditure using a compliance cost-savings measure in those rules. The change prevented taxpayers from making an election that an "excepted financial arrangement" is a "financial arrangement" for short-term agreements for the sale and purchase of property.

Officials had not anticipated (and could not reasonably be expected to anticipate) that the change would have an impact on taxpayers seeking to spread expenditure that would ordinarily be classified as being on revenue account, such as commission expenses incurred in relation to the sale of life insurance policies. Practice in the life insurance industry is that such expenditure is deducted in full (that is, not spread) when the expenditure is "incurred" for tax purposes. Inland Revenue accepts this practice.

Partners Life has adopted an alternative interpretation and spreads life insurance brokerage commission expenses against future premium income to better match expenditure and income for taxation purposes. A benefit of slowing the recognition of expenditure is that the taxpayer does not generate a large volume of tax losses (created when deductions exceed taxable income), when in fact in commercial and accounting terms it is profitable. This outcome is of concern when the losses could be lost through the operation of the loss continuity rules given that Partners Life is a start-up company and undertaking on-going capital-raising.

Partners Life submits that there are two options to restore its tax interpretation; either:

- restore the drafting of the relevant provision previously relied on by Partners Life to match its deduction against income – section EW 8 of the Income Tax Act 2007; or
- provide a new set of rules in the Income Tax Act 2007 that would allow, at the insurer's election, commissions to be spread.

Officials have considered the implications of both options.

The first option is within the scope of the bill as it already contains changes to the financial arrangement rules. Given the impact the change to section EW 8 of the Income Tax Act 2007 has had on Partners Life and the fact that it was unanticipated, officials consider there is a case for restoring in some limited form the scope and application of the election permitted under section EW 8 (before it is was amended by the Taxation (Livestock Valuation, Asset Expenditure, and Remedial Matters) Act 2013), subject to some modification to deal with the base integrity concerns that officials had with the original section.

Officials recommend that section EW 8 be amended, with retrospective effect, to restore an election allowing taxpayers to treat certain “excepted financial arrangements” as “financial arrangements” on the condition that the expenditure was on revenue account (that is, it does not rely on the election allowed by section EW 8 to deem the expenditure as on revenue account). This condition is intended to address the policy concern behind the amendment made by the Taxation (Livestock Valuation, Asset Expenditure, and Remedial Matters) Act 2013.

The proposal is designed to restore Partners Life to the situation before the change. This should not be taken as a comment on the interpretation taken by Partners Life, which is a function of the application of the law to the taxpayer’s specific fact situation. The change allows Partners Life to prepare tax returns on the same basis and relying on the same statutory provisions that it used before the amendment of section EW 8 of the Income Tax Act 2007. This would be consistent with Partners Life’s financial reporting. For tax purposes, spreading brokerage commission expense is out of step with industry practice, but of itself is not objectionable from a policy perspective.

Officials have consulted with the submitter about the proposal. Partners Life agrees that the suggested solution meets the concerns raised in its submission.

There are no direct fiscal consequences arising from accepting the submission.

Officials have also considered Partners Life’s second option, which involves adding a new set of rules to the Income Tax Act 2007 to facilitate spreading life insurance brokerage commissions. Officials consider that this option, while conceptually correct, has wider implications for the life insurance industry and, in our view, is not a change that should be made without further or more considered consultation with the industry using the generic tax policy process.

Recommendation

That the submission be accepted. The amendment to section EW 8 made by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 be repealed and the election permitted under section EW 8 of the Income Tax Act 2007 be restored, provided that the expenditure to be spread is on revenue account (that is, it does not rely on the election allowed by section EW 8 to deem the expenditure as on revenue account).

Remedial matters

Issue: Retirement villages and rest homes

Clause 161

Submission
(The Selwyn Foundation, KPMG)

The amendment to the “dwelling” and “commercial dwelling” definitions in conjunction with the proposed “wash-up rule” will require retirement villages and rest homes to refund input tax deductions claimed on acquiring properties during the period between 1 April 2011 and 31 March 2015. These deductions were claimed in good faith owing to a previous change to the dwelling definition in 2011. It is recommended an amendment be made that would either apply the dwelling amendments to:

- supplies of goods and services on properties acquired/constructed/developed from 1 April 2015; or
- goods and services supplied from 1 April 2015, and input tax deductions claimed on construction costs incurred before 1 April 2015 should not be repaid under the current apportionment, or wash-up adjustment; or
- goods and services supplied from 1 April 2015, and a “savings” provision should be introduced whereby output tax previously paid is taken into account when performing the wash-up adjustment.

Comment

This issue arises due to the interaction of two separate legislative changes in the bill:

- The first change is an amendment to the “dwelling” and “commercial dwelling” definitions which is intended to restore the pre-1 April 2011 GST-exempt treatment of residential units in retirement villages and rest homes. Officials understand the majority of the retirement village industry is supportive of this change as exemption was always the intended outcome.
- The second change is a “wash-up” rule which will require taxpayers who have applied the apportionment rules to account for any unclaimed input tax or pay output tax when the use of the asset changes exclusively either to taxable or non-taxable use.

The submitters have pointed out that the amendment to restore the exempt treatment of residential units in retirement villages and rest homes will trigger the wash-up rule. This would only arise for those taxpayers that have been treating the supply of these residential units as taxable from 1 April 2011. Officials understand it is only likely to affect a small number of taxpayers.

For these taxpayers the application of the GST apportionment rules and the proposed “wash-up rule” will primarily negatively affect them by requiring them to repay input tax deductions claimed after 1 April 2011 on GST incurred in acquiring residential units and related expenditure.

Considering these taxpayers claimed these deductions and made commercial decisions during this period based on a legitimate interpretation of the law, it seems appropriate to provide some form of relief.

Officials recommend giving affected taxpayers[16] the choice whether to continue to treat the supply of residential units in retirement villages and rest homes as taxable.

This approach recognises that affected taxpayers have made long-term commercial decisions on the basis that the supply of these residential units would be taxable. However, we recommend that taxable treatment would only apply to residential units acquired before 1 April 2015; the supply of residential units acquired after that date would be exempt.

Alternatively, affected taxpayers could decide to return to exempt treatment. For these taxpayers, officials recommend the introduction of a "savings" provision that would turn off the application of the proposed wash-up. These taxpayers would not be required to return input tax deductions in one lump-sum payment. Instead, the regular apportionment rules would apply to take into account the change of use brought about by the dwelling amendment, thereby allowing the payments to be spread.

For taxpayers that have been treating the supply of residential units as taxable during the period between 1 April 2011 and 31 March 2015, output tax paid would not be refunded and input tax deduction claimed and expensed during that period would not need to be returned. These proposals relate solely to supplies made during that period.

Recommendation

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

Issue: Dwelling definition

Clause 161

Submission

(New Zealand Institute of Chartered Accountants, KPMG)

Amendments to the "dwelling" and "commercial dwelling" definitions deal only with the uncertainty surrounding the GST treatment of residential units in retirement villages and rest homes. However, uncertainty still exists in respect of the GST treatment of similar types of independent living units such as student accommodation and accommodation for people with intellectual or physical disabilities. This should be rectified in the current bill or the next tax bill.

Comment

Officials do not agree with the submissions. Similar submissions were made, specifically related to student accommodation, when the definitions of "dwelling" and "commercial dwelling" were amended in 2011. It was considered preferable for the dwelling definitions to describe the nature of the accommodation rather than the types of occupant of the premises.

[16] Taxpayers that have been treating the supply of residential units as taxable for GST purposes from 1 April 2011.

This approach better achieves the policy objective which is to prescribe exempt treatment to the provision of accommodation that is an economic equivalent to owner-occupied homes.

Officials still consider this argument to be valid and that the amendment suggested by submitters would be an undesirable departure from the current approach.

Recommendation

That the submission be declined.

Issue: Requirement to be registered

Clause 169

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

The scope of the amendment to section 21HB of the Goods and Services Tax Act (GST) should be extended to include those who are already GST-registered.

The amendment allows suppliers affected by the 1 April 2011 changes to the "dwelling" definition the option of not including a commercial dwelling as part of their broader taxable activity. The amendment as proposed will only apply to taxpayers who are not GST-registered, but the issue more commonly arises for those individuals who are already registered in relation to other activities. These taxpayers are less able to structure their affairs to limit the impact of the previous law change.

However, taxpayers whose newly defined commercial dwelling would constitute a "taxable activity" in its own right should not be given relief. Accordingly, an exclusion would be appropriate when the rental income exceeds the GST registration threshold.

Comment

Officials agree that the suggested amendment to section 21HB, as currently drafted, would have limited application as it would only apply when the change in definition caused a person to exceed the $60,000 GST registration threshold.

We agree with the submission that the scope should be broadened so that it applies to persons who are already GST-registered. These people would not be required to account for GST on their newly defined commercial dwellings so long as their rental income from those dwellings is below the $60,000 threshold.

Recommendation

That the submission be accepted.

Issue: Wash-up rule – definition of actual deduction

Clause 168

Submission
(Tax Team)

The definition of "actual deduction" in the proposed "wash-up" rule should refer to adjustments made up until the end of the adjustment period when taxpayers are required to perform the wash-up calculation.

Comment

The proposed "wash-up" rule would require taxpayers who have applied the apportionment rules to account for any unclaimed input tax or pay output tax when the use of the asset changes exclusively to either taxable or non-taxable. To qualify for the "wash-up", taxpayers need to sustain the 100 percent change-of-use from the adjustment period in which the use changes and the following adjustment period (up to two years).

Officials agree with the suggested amendment. Currently, the definition of "actual deduction" only includes adjustments made up to the date on which the use was changed. However, taxpayers would be required to make adjustments up until the date the wash-up was required to be carried out, which could be up to two taxable periods after the change of use.

To achieve an accurate wash-up calculation, the actual deductions made after the date the use changed should also be taken into account.

Recommendation

That the submission be accepted.

Issue: Wash-up rule – registration after acquiring goods and services

Clause 168

Submission
(KPMG)

If a person, or partnership, becomes registered after acquiring goods and services, the taxpayer must wait until the first adjustment period in order to claim change-of-use calculations. This method of calculation would result in a timing delay for the taxpayer and is inconsistent with the position for a taxpayer who is already registered.

It is recommended that the adjustment should be made when the taxpayer is registered and first uses goods or services to make taxable supplies.

Comment

Officials disagree with the submission. To qualify for the "wash-up", taxpayers need to sustain the 100 percent change-of-use from the adjustment period in which the use changes and the following adjustment period (up to two years).

This time period is required to demonstrate a genuine change of use and must be demonstrated whether or not the taxpayer has just registered for GST, or has always been registered.

Recommendation

That the submission be declined.

Issue: Procurement of a lease

Clause 165

Submission
(Real Estate Institute of New Zealand, PricewaterhouseCoopers)

The bill amends section 11(8D) so that a payment to procure a lease is subject to the GST zero-rating of land provisions. The application of this amendment should be clarified, specifically whether the amendment is intended to capture payments in relation to a new commercial lease agreement in the absence of any transfer of business.

Comment

The proposed addition to section 11(8D) is intended to apply only to situations when a third party has paid to procure an existing lease (such as in a business sale). Officials agree that a further amendment should be made to section 11(8D) to clarify this policy intent.

Recommendation

That the submission be accepted.

Issue: Section 11(8D) – drafting suggestions

Clause 165

Submission
(New Zealand Institute of Chartered Accountants)

There should be no "if" at the start of section 11(8D)(b)(ii) and the circular wording of section 11(8D)(c) should be removed.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Surrenders and assignments of land

Clause 165

Submission
(PricewaterhouseCoopers)

The proposed amendment to the zero-rating of land rules should be designed to ensure that only surrenders and assignments of interests of land are subject to the zero-rating of land rules. Any other surrender and assignment (for example, contractual releases) that do not involve transfer or disposals of interests in land should be governed by ordinary GST principles.

Comment

Officials agree with the policy approach outlined in this submission but we consider the draft legislation is sufficiently clear to achieve the correct policy outcome. Further guidance will be provided in the *Tax Information Bulletin* to be published after enactment.

Recommendation

That the submission be noted.

Issue: Surrender of an interest in land

Clause 165

Submission
(KPMG)

The scope of what is a "surrender of an interest in land" contained in section 11(8D) is unclear. A surrender of an interest in land should include:

- payments from a tenant to a landlord to obtain the landlord's consent for the tenant's surrender of the lease; and
- payments from a landlord to a tenant for surrender of the tenant's interest in the land.

The phrase "surrender of an interest in land" should be defined to ensure both of the above examples can be zero-rated.

Comment

Officials agree with the submission in part. The policy intent of section 11(8D) is to capture both types of surrender payments as described by the submitter. Officials will consider whether the current wording of section 11(8D) achieves this and recommend an amendment in a later tax bill if required.

Recommendation

That the submission be declined subject to officials' comments.

Issue: Other rights and obligations in respect of land

Submission
(New Zealand Institute of Chartered Accountants)

Consideration should be given to providing further guidance on the treatment of certain other rights and obligations where their classification as "land" is unclear. Examples include mining permits and transferable fishing quota.

Comment

The submission does not specifically relate to an amendment in the bill. However, officials will further consider and engage with the submitter on this issue.

Recommendation

That the submission be noted.

Issue: Deemed supply of land on disposal

Clause 163

Submission
(PricewaterhouseCoopers, Offen Advisors Ltd, New Zealand Institute of Chartered Accountants, Deloitte)

A number of submissions have been received on the amendment to section 5(16) (Deemed taxable supply of land on disposal). These include:

- The amendment is not necessary as the current law is adequate.
- The amendment would have the effect of a capital gains tax.

- Taxpayers should not be required to account for output tax when selling a private asset.
- The output tax payable should be capped to the input tax claimed.
- GST-registered persons should have the option to choose not to claim input tax on land in order to avoid the payment of output tax when the land is sold. This option should also be available under the equivalent rules for mixed-use assets.
- The meaning of "course and furtherance" should be clarified.
- The relationship between the amendment to sections 5(16) and 14(1)(d) (exempt supply of a dwelling), 11(1)(mb) (zero-rating of land), and 21FB (the proposed new wash-up rule) should be clarified.

Comment

The purpose of the amendment to section 5(16) is to address an avoidance concern where taxpayers can change the use of an asset before sale to avoid the application of output tax. The amendment would require taxpayers to pay output tax on the sale of land when any input tax deduction had been claimed in respect of the acquisition of the land.

Submitters have raised valid concerns over the practical application of the proposed amendment, particularly the GST implications of selling essentially private land where a relatively small input tax deduction had been claimed in the past.

Officials consider the new wash-up rule and the general anti-avoidance provision will address many of the concerns underlying the amendment to section 5(16). Therefore, officials recommend the amendment to section 5(16) be removed from the bill at this time.

Officials will further engage with taxpayers about how we could address the avoidance concern while also taking into account the practical concerns raised by submitters. At the same time we will also consider whether similar issues arise under the recently enacted mixed-use asset GST rules.

Recommendation

That the submission be accepted subject to officials' comments.

Issue: Zero-rated services supplied to non-residents

Clause 166

Submissions
(New Zealand Institute of Chartered Accountants, KPMG)

In the proposed section 11A(3B) the words "not directly connected with" should be replaced with "not directly in connection with". The phrase "not directly in connection with" is better understood in law. *(New Zealand Institute of Chartered Accountants)*

Guidance should also be given as to when a presence is not directly connected with the supply. *(New Zealand Institute of Chartered Accountants)*

The term "directly connected with the supply" needs to be defined to prevent uncertainty over the application of this measure. *(KPMG)*

Comment

Officials agree with the submission that the wording of proposed section 11A(3B) should be amended to the better understood phrase "not directly in connection with".

Officials understand that, in practice, it could be unclear whether a non-resident's presence in New Zealand would be regarded as not directly connected with the supply. However, we do not think the term should be defined; instead such a determination would depend largely on the facts of each case.

The policy rationale behind the amendment is to deal with situations when it is unreasonable for the supplier to be aware that the non-resident is in New Zealand during the time the services are performed, and therefore, whether the services should be zero-rated.

Further guidance will be provided in a *Tax Information Bulletin* if the proposed amendment is enacted.

Recommendation

That the submissions be accepted in part.

Issue: Scope of the hire purchase definition

Clauses 123 and 180

Submission
(New Zealand Institute of Chartered Accountants)

The proposed amendment to the definition of "hire purchase agreement" is more than a mere clarification; it broadens the definition to include those agreements where a purchase is considered but not "expressly contemplated".

Comment

Officials agree that for some taxpayers the amendment may require them to change GST systems and procedures. However, the amendment is required to address a drafting error which arguably means a person's upfront agreement to purchase the goods is required in order for an arrangement to be a hire purchase agreement. This interpretation is inconsistent with the original policy intent so an amendment is necessary to ensure the law achieves the correct policy outcome.

Recommendation

That the submission be noted.

Issue: Apportionment rules

Submissions
(BDO Wellington Ltd)

The various threshold rules in the GST apportionment rules should provide for the aggregation of the costs of goods and services.

Secondly, if the GST transitional rules require the "old apportionment rules" to still be used for goods and services, the "old apportionment rules" should also continue to be applied to further costs incurred in relation to the same goods and services.

Comment

These submissions do not relate to any provision in the bill. However, officials will further consider and engage with the submitter on these matters.

Recommendation

That the submissions be declined.

Issue: Agency rules

Submission
(Deloitte)

An amendment to the agency rules should be made to ensure there is consistency between when an agent acts for the seller and an agent acts for the purchaser.

Comment

The submission does not relate to any provision in the bill. However, officials will consider this issue for inclusion in a future GST omnibus consultation paper.

Recommendation

That the submission be declined.

Issue: Credit and debit notes

Submission
(Matter raised by officials)

A remedial amendment is required to fix a drafting oversight in the credit and debit note provision in relation to land which has been incorrectly standard-rated when it should have been zero-rated.

Comment

Section 25 relates to the issuing of a credit or debit note when GST has been accounted for incorrectly.

A remedial amendment is required to section 25(4) to ensure that when the supply of land has been incorrectly standard-rated when it should have been zero-rated, the recipient of the supply must correct any input tax claim in relation to that supply.

Recommendation

That the submission be accepted.

Issue: Zero-rating tooling costs

Submission
(Matter raised by officials)

A remedial amendment is required to ensure services that are carried out on tools can be zero-rated when the tools are used in New Zealand solely to manufacture goods that will be exported.

Comment

The Taxation (Livestock Valuation, Asset Expenditure, and Remedial Matters) Act 2013 extended the application of the zero-rating rules to tools used in New Zealand solely to manufacture goods that will be for export and supplied to a recipient who is a non-resident and not GST-registered.

A remedial amendment is required to ensure that when services are carried out on tools that are to be zero-rated under the new provision, the services can also be zero-rated. This is consistent with the treatment of services in relation to exports more generally and the policy intent of GST neutrality in cross-border trade.

Recommendation

That the submission be accepted.

Issue: Non-resident registration rules

Submission

(Matter raised by officials)

The Taxation (Livestock Valuation, Asset Expenditure, and Remedial Matters) Act 2013 introduced rules under which non-resident businesses can register for New Zealand GST and claim input tax deductions for GST incurred. This ensures that GST is neutral for these businesses in the same way as it is for domestic businesses. The new rules take effect from 1 April 2014.

Officials have identified a potential fiscal risk with the design of these new non-resident registration rules: The new rules may enable registered non-residents to sell high-value goods to New Zealand private consumers without the net imposition of GST.

This could be achieved by the non-resident treating themselves as the "importer" of the goods so that the GST liability falls on the non-resident rather than on the final consumer. The non-resident is then able to claim an input tax deduction for the GST incurred on importation. Because the goods were offshore at the time of supply, GST would not be required to be returned on the sale, therefore no net GST will be collected despite a final consumer receiving the imported good.

Comment

Officials recommend an amendment be made to prevent GST-registered non-residents from claiming input tax deductions in relation to GST levied by the New Zealand Customs Service. Instead, when the non-resident acts as an "importer", the recipient of the good will be treated as if they had paid the GST and will be entitled to an input tax credit for the GST if they are GST-registered and receiving the goods as part of their taxable activity.

It is recommended that the amendment applies from 1 April 2014, the same date the new registration rules come into effect.

Recommendation

That the submission be accepted.

Issue: Wash-up rule

Clause 168

Submission
(Matter raised by officials)

An amendment to the proposed "wash-up" rule is required to ensure the timing of the wash-up occurs at the end of the second adjustment period after the use has changed.

Comment

The proposed "wash-up" rule requires taxpayers who have applied the apportionment rules to account for any unclaimed input tax or pay output tax when the use of the asset changes exclusively to either taxable or non-taxable use. To qualify for the "wash-up", taxpayers need to sustain the 100 percent change of use from the adjustment period in which the use changes and the following adjustment period (up to two years).

As currently drafted, taxpayers are required to carry out the wash-up calculation at the end of the third adjustment period following the change of use. This was not the intended policy outcome; instead, taxpayers should be required to carry out the wash-up calculation at the end of the second adjustment period following the change of use.

Officials recommend an amendment be made to ensure the correct policy outcome is achieved.

Recommendation

That the submission be accepted.

Issue: Foreign exchange gains and losses on liabilities

Clause 74

Submissions

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

In many cases a company's accounts will report foreign exchange gains and losses relating to both assets and liabilities. To reduce compliance costs, the bill includes an amendment which allows taxpayers to use an aggregate figure when applying the active business test.

As currently drafted, the amendment applies more broadly than intended. It would capture other types of gains and losses such as gains and losses on derecognition of a liability and changes in the reported value of liabilities. It should be limited to foreign exchange gains or losses.

Comment

Officials agree that the amendment that allows taxpayers to include gains and losses on liabilities in the active business test should be limited to foreign exchange gains and losses.

Recommendation

That the submission be accepted.

Issue: CFCs with offshore branches should be able to join test groups

Submission

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

The CFC rules allow taxpayers to group multiple CFCs together for the purposes of calculating the active business test. There are rules which limit the CFCs that can be included in the group, one of which says that each CFC must have a "taxed CFC connection" with the same country or territory.

The "taxed CFC connection" essentially requires that the CFC is taxed and resident in the country it is based in and not taxed or resident in any other country. This has the effect of barring any CFC that has an offshore branch from being included in a test group.

The issue is whether this has a disproportionate effect on CFCs that have minor business presences in other countries. The submission proposes allowing these CFCs to form test groups despite the presence of offshore branches. Any active income earned by the offshore branch would be disregarded in the active income test.

Comment

It is not unusual for the operating company to have an offshore branch in another jurisdiction which may, for example, comprise a small sales team. The rules determining whether a branch exists are not clear cut, and can vary from country to country, so it is possible that a CFC may unintentionally establish an offshore branch and unexpectedly fall outside of the test group rules.

Officials agree that this may have a disproportionate effect on the taxpayer's position and the proposed amendment should include two additional safeguards to prevent abuse.

First, the CFC with the offshore branch must be a non-attributing active CFC in its own right. This eliminates the possibility of passive income earned through a branch being sheltered by active income earned in the country the CFC is based in.

Secondly, the anti-abuse provisions in sections GB 15B and 15C may need to be amended so that they also cover arrangements/supplies between offshore branches and head offices that have been entered into/made with the intent of gaining the active exemption.

Recommendation

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

Issue: Application date for relocation of apportioned funding income

Clause 70

Submission
(Ernst & Young)

The bill relocates an existing adjustment for apportioned funding income from sections EX 20C to 20B. This amendment should not apply retrospectively as it could affect a taxpayer's active business test results.

Comment

Applying the amendment retrospectively could potentially mean that a CFC may now pass an active business test that it would have previously failed. Because taxpayers do not have to pay tax on profits from a CFC which passes an active business test, this will usually be taxpayer-friendly. In other words, if the amendment applied prospectively it would be more likely to disadvantage taxpayers.

Recommendation

That the submission be declined.

Issue: Section DB 55 should not be repealed

Clause 43

Submission

(Deloitte, PricewaterhouseCoopers, New Zealand Institute of Chartered Accountants)

Section DB 55 should not be repealed as the repeal will not have a material fiscal impact but would lead to uncertainty and compliance costs from having to apportion expenses between exempt and assessable income.

Some submitters have also suggested that the repeal could create "black hole" expenditure which is contrary to the Government's recent work on reducing "black hole" expenditure.

Comment

As a general principle, expenses can only be deducted for tax purposes if they are incurred in earning taxable income. In other words, if the expenses relate to income which is exempt from tax, no deduction can be claimed.

When a New Zealand company receives a dividend from a foreign company, the dividend is exempt from income tax. Section DB 55 allows deductions despite the fact that the dividends are exempt from income tax.

The rationale for this, is that before 2009, the dividends were subject to a special levy, known as "foreign dividend payment" or "FDP" which was equivalent to income tax.

In 2009 there was a major reform of New Zealand's international tax rules. This reform was designed to reduce tax barriers on New Zealand businesses that expand offshore. It did this by exempting most types of income that businesses earned through foreign subsidiaries. As part of this reform all tax on foreign dividends paid to New Zealand companies, including FDP was removed.

In the course of implementing the 2009 reforms, the need to repeal section DB 55 was overlooked. We are now seeking to repeal it as part of the current bill.

Maintaining section DB 55 in the absence of FDP would be contrary to general tax principles of not allowing deductions which relate to exempt income (now that the dividends are truly exempt). It would effectively be a tax concession or subsidy.

There would be fiscal risks associated with providing deductions in cases where the resulting income will not be taxed, as these could be used as building blocks for tax planning arrangements which shift income offshore or which generate artificial losses to shelter other forms of income.

The repeal of section DB 55 does not prevent deductions for head office expenses that relate to subsidiaries. These could still be claimed if they satisfy the "general permission" in section DA 1, which applies for all other types of expenses.

It is a common commercial practice for head offices to charge their subsidiaries for head office expenses and, in such cases, a deduction should be available under the general permission.

In other cases, apportionment of expenses between exempt and taxable income may be necessary. However, the compliance costs associated with apportionment are unlikely to be significant as taxpayers already have discretion to make fair and reasonable apportionments. Taxpayers are frequently required to apportion expenses in many other situations, such as when they relate to receiving an exempt government grant, or an untaxed capital gain.

There is no generally agreed definition of "black hole" expenditure. However it usually refers to expenses incurred in an activity that was expected to generate taxable income, but which cannot be claimed (either immediately or as a depreciable asset) as the activity fails to produce any income. This is not the case with section DB 55 as this provision specifically relates to expenses incurred in deriving exempt income.

Recommendation

That the submission be declined.

Issue: Repeal of section DB 55 application date

Clause 43

Submission
(New Zealand Institute of Chartered Accountants)

The application date of the repeal of section DB 55 should be the date of introduction of the bill to Parliament in order to preserve tax positions taken by taxpayers who have relied on the provision.

Comment

As currently drafted, the repeal of section DB 55 includes a "savings" provision which means it does not apply to tax positions taken in tax returns filed before the date the bill was introduced to Parliament (22 November 2013). This savings provision deals with the concern raised by the submitter.

Recommendation

That the submission be declined.

Issue: Repeal of DB 55 savings provision

Clause 43

Submission
(The Whyte Group)

The repeal of section DB 55 has a "savings" provision whereby it does not affect tax positions taken in tax returns that have been filed before the date the bill was introduced to Parliament.

This savings provision fails to accommodate taxpayers who have applied section DB 55 during their 2013 or 2014 income years, but had not yet filed their returns for these years as these returns are not due until after November 2013. This means the repeal could have a retrospective effect of denying deductions that have already been taken for these income years in cases when the relevant tax return has not yet been filed.

Comment

Officials agree that the savings provision should be extended to deal with the concern raised by the submitter.

Recommendation

That the submission be accepted.

Issue: Nexus requirement under section DB 55

Clause 43

Submission
(The Whyte Group)

The current nexus test provided by section DB 55 is too narrow as it only allows deductions that are directly incurred in deriving the exempt dividends.

This creates uncertainty over whether management fees could be deducted under this section.

In contrast, the general permission for deductions in section DA 1 has two limbs. It allows deductions for expenditure incurred in earning income and expenditure incurred in carrying on a business of deriving income.

Section DB 55 should be broadened so that it matches both limbs of the test provided by the general permission in section DA 1.

Comment

Section DB 55 was introduced in 2004 because at that time, foreign dividends were subject to a special levy, known as a "foreign dividend payment" or "FDP", which was equivalent to income tax.

The 2004 Official's report on the Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Bill[17] which introduced the amendment explained that the policy intention was to allow a deduction for expenditure incurred by a company in deriving the foreign dividend, to the extent to which it was subject to FDP.

We note that FDP only arises when a dividend is actually received. This suggests that a relatively narrow nexus could have been intended. In contrast, management fees may be charged irrespective of whether a dividend is received (for example, the management fee may relate to making an investment in a company that never pays dividends).

Because the existing nexus requirement in section DB 55 appears to achieve the original policy objective, officials do not think there is a strong case for retrospectively broadening the nexus test. This is particularly true with respect to periods after 2009, after which FDP no longer applied to the dividends. This meant the original rationale for allowing deductions under section DB 55 was no longer required.

Recommendation

That the submission be declined.

Issue: Removing Australian unit trusts from the Australian exemption

Clauses 75 and 76

Submission
(KPMG)

The amendment to remove Australian unit trusts from the CFC and FIF exemptions in sections EX 22 and EX 35 is not a remedial item. It should be omitted from the bill and be subject to a proper consultation process.

Comment

The exemptions from the CFC and FIF rules in sections EX 22 and EX 35 are based on the assumption that Australian companies generally face similar tax rules and a similar level of tax to New Zealand companies.

Australian unit trusts are not taxed as companies in Australia, and investments made through an Australian unit trusts often face a lower rate of tax than Australian companies.

---

[17] http://taxpolicy.ird.govt.nz/publications/2004-or-arvcmp/overview.

For this reason, the policy intention at the time of the 2009 international tax reforms was that Australian unit trusts should not be able to qualify for the Australian exemption. The policy of excluding Australian unit trusts was explicitly expressed, on page 49 of the 2009 Official's Report on the Taxation (International Tax, Life Insurance, and Remedial Matters) Bill which introduced the Australian exemption.

The change in the current bill ensures that the law achieves the original policy intent.

Recommendation

That the submission be declined.

Issue: Application date for removing Australian unit trusts from the Australian exemption

Clauses 75 and 76

Submissions
(Vital Healthcare Property Limited, The Whyte Group)

As currently drafted, the removal of Australian unit trusts from the Australian exemption applies from the 2014–15 income year. This could have a retrospective effect for some taxpayers who will have begun their 2014–15 year before the bill is enacted.

To prevent this retrospective effect, a savings provision should be provided for taxpayers who have applied for a binding ruling before the date the bill was introduced (22 November 2013).

The application date for taxpayers who did not apply for a binding ruling should be deferred by one year, until the start of the 2015–16 income year. *(Vital Healthcare Property Limited)*

The application date should be for income years beginning on or after 1 July 2014:

- Previous amendments to section EX 22 have been by reference to this 1 July date.
- The Australian unit trusts which are affected by the provision typically have a 30 June balance date.
- Other proposed amendments to the CFC rules contained in the bill also have application dates that refer to 1 July.

(The Whyte Group)

Comment

We agree that the application date should be amended to apply to income years beginning on or after 1 July 2014. Because the bill is expected to be enacted before July, this should reduce the possibility of a retrospective effect, while still providing taxpayers with certainty about when the amendment will take effect.

Recommendation

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

Issue: Further guidance material on CFC remedials

Submission
(PricewaterhouseCoopers)

Inland Revenue should publish examples of the application of the CFC remedial changes in a *Tax Information Bulletin*.

Comment

Officials agree that the remedial changes are complex and that further guidance material, including examples, will be provided in a *Tax Information Bulletin* following enactment.

Recommendation

That the submission be accepted.

Issue: Indirect interests in FIFs

Clauses 78 and 80

Submission
(New Zealand Institute of Chartered Accountants)

The bill attempts to clarify the rules that apply to interests in FIFs that are held indirectly through another FIF or CFC.

However, as currently drafted, the proposed amendments will not entirely resolve the uncertainty and the proposed drafting needs further consideration and refinement.

In addition, if the indirect interest in a FIF is minor or immaterial it should be disregarded for the purposes of these rules.

Comment

Officials consider that the current drafting achieves the intended policy result. We will, however, discuss the specific drafting suggestions with the bill's drafters.

With regard to the submission on disregarding indirect interests in FIFs when these are minor or immaterial, we note that this would have wider policy implications which would need to be further considered and consulted on. For these reasons it would not be appropriate to advance this suggestion in the current bill but we will consider this issue as part of our future policy work on CFCs and FIFs.

Recommendation

That the submissions be declined.

Issue: Extending the on-lending concessions and exemptions for group funding

Submission
(Matter raised by officials)

The CFC rules should be amended so that the on-lending concession and exemptions that apply to certain interest payments also apply to those dividends that are taxed like interest payments.

Comment

The CFC rules generally treat dividends from certain types of shares (deductible and fixed-rate shares) in the same way as interest on debt. This is because these shares have debt-like characteristics and are highly substitutable for debt.

Taxpayers have identified two areas where the rules for these shares are less favourable than the equivalent rules that apply to debt. This can lead to the same income being taxed twice.

Under the current CFC rules, a CFC that borrows money and then lends that money on to an associated CFC is able to claim a full deduction of any expenses incurred (the on-lending concession). There is also an exemption for interest income that a CFC receives from lending money to an associated active CFC that is located in the same country.

Officials recommend that this on-lending concession and exemption be extended so they also apply to deductible and fixed-rate shares.

Because this amendment is taxpayer-friendly and consistent with the over-arching policy treatment of the affected shares, we recommend the amendments apply retrospectively to the date these rules were first introduced.

Recommendation

That the submission be accepted.

MIXED-USE ASSET REMEDIALS

Issue: Support for remedial amendments

Clauses 47 to 49

Submission
(New Zealand Institute of Chartered Accountants)

New Zealand Institute of Chartered Accountants supports the proposed remedial amendments contained in clauses 47 to 49 of the bill.

Comment

Officials note the support for the amendments which ensure the mixed-use asset rules operate in accordance with the policy intention and correct minor errors in legislative examples.

Recommendation

That the submission be noted.

Issue: Minor technical issues with remedial amendments

Submission
(New Zealand Institute of Chartered Accountants)

The drafting of the amendment to section DG 6 should be amended to make it clear that paragraph (b) is a continuation of the section.

Comment

The drafting convention is to leave the section as originally drafted – including paragraphs (a) and (b) – so the history of the provision is clear; accordingly the section in the principal Act will read:

> "Despite section YB 3(1), for the purposes of this subpart, a company and a person other than a company are associated persons if—
> (a) *repealed*; or
> (b) the person's share in the company gives them a right to use the asset."

Recommendation

That the submission be declined.

Submission
(Ernst & Young)

Repealing and replacing section DZ 21(2) arguably repeals the example, it should be clarified that the example remains.

Comment

An example in the legislation is not part of the legislation, it is an interpretation aid. Therefore, replacing a subsection does not repeal the following example as it is a stand-alone item and not "attached" to the particular subsection.

Recommendation

That the submission be declined.

Issue: Further mixed-use asset amendments

Submission
(New Zealand Institute of Chartered Accountants)

The legislation was rushed and is in need of further remedial attention.

Comment

Officials note NZICA's concern and will continue to work with NZICA (and other stakeholders) to address remedial issues with the rules.

Recommendation

That the submission be noted.

Issue: In certain circumstances, the asset value is too high for land

Submission
(New Zealand Institute of Chartered Accountants)

Leased assets

Where a mixed-use asset is leased, the valuation of that mixed-use asset should reflect the degree of ownership interest in the asset.

Where a close company seeks to claim interest deductions in respect of a mixed-use asset, the company must first determine the amount of its debt value and its asset value to determine the amount of interest it is allowed to claim.

The “asset value” for land, including an improvement to land, is the amount given by the later of either its most recent capital value or annual value (as set by the relevant local authority), or its cost on acquisition (or market value, if the transaction involves an associated person).

If a crib/batch is on leased land, the capital value greatly overstates the value to the lessee as the lessee does not own the land. Therefore, there is a greater likelihood that the asset value will result in either:

- a denial of an interest deduction to the company; and
- a denial of an interest deduction to a shareholder.

The quarantining provisions in section DG 16(1), which apply to all taxpayers, also require amendment for valuation purposes when an asset is a leased asset.

Two new rules are required for leased assets:

1. a rule that applies if there is a lease between associated persons and prevents “gaming” of the rules in such situations; and
2. a valuation rule for leased assets where the parties are not associated.

Two activities on a single title

The legislation also requires amendment to provide for apportionment when a single legal property title covers two separate activities and the mixed-use asset rules applies to only one of those activities.

The situation envisaged is when a taxpayer owns a beach house which is on a piece of land with two houses. The capital value on the legal title will give the value for both houses and the whole of the land area. Where the mixed-use activity is being carried on by only one of the owners, it would be very difficult for that owner to reach the quarantining threshold because of the presence of the two houses.

This is similar to a situation where a farmer sets up a house on the farm as a farmstay. The house is on the farm land, and is used to derive rental income, but is also used by the farmer’s children and their friends when they come home. If the land value cannot be apportioned, then the farmer would never be able to claim any expenditure associated with the farmstay, as the income would never reach 2 percent of the value of the total farm.

Comment

Officials agree, that in certain circumstances, using the capital value or annual value (as set by the relevant local authority) could overstate the assets’ value for the purposes of subpart DG. In the lease example raised by the submitter, it is arguable that a leasehold estate is an asset separate from the freehold estate and therefore does not have a capital/annual value itself – which means that the relevant “asset value” is the price paid for the leasehold estate or the market value (if acquired from an associate).

However, officials agree it is appropriate to clarify/amend the "asset value" concept for land (or an interest in land) where the mixed-use asset itself is only a part of the underlying freehold estate valued by the capital/annual value, and this results in an inappropriately high "asset value" for the purposes of the close company interest apportionment rule in section DG 11, and the loss quarantining rule in section DG 16.

The capital/annual value may give too high an asset value because:

- the mixed-use asset is a leasehold (rather than freehold) estate; or
- a property has a single legal title but different activities are carried on within that single title, only one of which involves mixed use – for example, a farmstay on a large commercial farm or two baches on a single title, only one of which meets the mixed-use asset criteria.

When these situations arise, the legislation should provide an option to use as the "asset value" a reasonable apportionment of the capital/annual value of the freehold property to the mixed-use asset based on:

- in the case of a leased asset, the market value of the leasehold estate (a valuation that is less than three years old, and has been completed by a registered valuer, will be accepted as the market value); and/or
- in the case of two activities/assets on a single title:
  - the percentage of the land area used for the mixed-use activity (for example, the proportionate area the dwelling and curtilage bear to the total land area); or
  - some other reasonable apportionment determined under a valuation by a registered valuer (such valuation must be less than three years old).

Recommendation

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

Issue: Quarantined losses and depreciation recovery income

Submission
(New Zealand Institute of Chartered Accountants)

When a mixed-use asset has quarantined expenditure, the taxpayer should be able to offset any depreciation recovery income against the quarantined losses if the asset is sold.

There seems to be no policy reason why a taxpayer should not be able to offset any depreciation recovery income against quarantined losses but officials seem to consider that depreciation recovery income cannot be offset against quarantined losses.

This gives rise to various issues. The first is that section DG 17(1)(b) states that section DG 17 applies when (inter alia) the person's income for the current year from the use of the asset is more than the amount of their deductions under sections DG 7, DG8 and DG 11.

We understand that some officials considered that depreciation recovery income would not arise "from the use of the asset" (that is, it results from the disposal of the asset rather than the "use" of the asset) which is defined in section DG 3(7) as "use of the asset for its intended purpose".

The second issue is that section EE 49(3) (which provides the calculation when there is depreciation recovery income and there has been mixed-use of an asset) has a numerator based on the "deductions" which are deductions for which the person is allowed a deduction under Part D (see section BD 2). In the case of quarantined deductions, a person is not allowed a deduction; therefore the numerator would be zero. Accordingly the amount of the depreciation recovery income would be nil or a low amount. This is the correct outcome in our view as it would seem egregious that taxpayers are expected to pay depreciation recovery income when they have not been able to claim depreciation deductions.

The third issue is that, in some instances, there will be situations when a mixed-use asset was used before the advent of the mixed-use asset rules. Accordingly, the formula in section EE 49(3) will have an amount in the numerator as there were deductions permitted in the years before the mixed-use asset rules. We consider that the taxpayer should be able to use the quarantined losses as they have been paying tax on income derived over the period when the mixed-use asset rules were in place, but were denied any deductions under subpart DG. The very least those taxpayers should expect is to be able to use the quarantined losses against depreciation recovery income when they have been denied a depreciation deduction while the mixed-use asset rules have been in place.

Comment

A number of points are covered in this submission:

(a) Taxpayers should be able to access quarantined losses to reduce depreciation recovery income derived from the sale of a mixed-use asset and, under one interpretation of the current rules, they are unable to do so. It is not the role of policy officials to give the Commissioner's interpretation of current law. However, from a policy perspective, depreciation recovery income is a mechanism to reverse depreciation deductions claimed over the life of an asset, where that asset has not depreciated to the extent anticipated by the depreciation rate (in some cases, it will have actually appreciated in value). If the depreciation deductions in respect of the mixed-use asset have been quarantined (thus not been accessible to the taxpayer) and then depreciation recovery income arises upon the sale of the asset, officials agree taxpayers should be able to access those quarantined deductions to offset against the depreciation recovery income. The depreciation recovery income otherwise imposes an additional tax liability on the taxpayer who has not had the benefit of the deductions the recovery income intends to reverse. In summary, officials agree in principle with the submission.

(b) If taxpayers have not had the benefit of depreciation deductions because the mixed-use asset rules quarantine the deductions, when applying the depreciation recovery formula in section EE 49, the numerator should be 0 and therefore no depreciation recovery income arises. Again, policy officials do not give the Commissioner's interpretation of the legislation. However, for the same reason identified above, from a policy perspective, officials accept that the outcome identified by the submitter is the correct policy outcome.

(c) If a taxpayer holds a mixed-use asset and they held the asset before the introduction of the mixed-use asset rules, they should be able to use losses quarantined under the mixed-use asset rules to offset depreciation recovery income arising from the sale of the asset after the rules were introduced. Officials consider that, when the benefit of depreciation deductions have previously been obtained by a taxpayer (because the deductions were claimed before the enactment of the mixed-use asset rules), it is appropriate that depreciation recovery income gives rise to a tax liability (in the absence of other deductions/losses available to the taxpayer). This is because the depreciation recovery income reverses a previous tax benefit obtained by the taxpayer. Therefore, officials disagree with this submission, to the extent the taxpayer has had the benefit of depreciation deductions before the mixed-use asset rules were enacted.

In summary, officials accept in principle the submitter's points in (a) and (b) above, but disagree with the submission in (c). Given the rules in this area are complex and affect a number of taxpayers, officials believe it is appropriate to decline the submission in the context of this bill, but to consider the submissions further, engage with the submitter and design a robust solution that can be included in a future tax bill that will be subject to full consultation.

Recommendation

That the submission be declined.

Issue: Taxation of exempt income when distributed to shareholders

Submission
(New Zealand Institute of Chartered Accountants)

When a company distributes retained earnings that have arisen from exempt income under the mixed-use asset rules, these should retain their character as exempt income rather than being taxed as unimputed dividends.

Comment

Officials appreciate the concern raised by the submitter; however this is a policy issue that requires significant consideration. Some tax preferences (such as other tax exemptions) are clawed back when profits are distributed to shareholders. On the other hand, officials can see an argument that the tax exemption should flow through to the shareholder, otherwise the intended symmetry between denial of deductions and exemption of income is arguably not achieved.

Officials therefore note the submission, but recommend that it be declined for inclusion in this bill on the basis that the rules in this area are complex and affect a number of taxpayers, so it is appropriate to engage with the submitter and design a robust solution that can be included in a future tax bill that will be subject to full consultation.

Recommendation

That the submission be declined.

Issue: Clarification of application to shareholders who lease assets to subsidiaries

Submission
(New Zealand Institute of Chartered Accountants)

Clarification is needed as to how the mixed-use asset rules apply when a parent company has, say, leased an asset on a full-time basis to a subsidiary that uses the asset in a way that qualifies it for the application of the mixed-use asset rules.

Comment

Officials note the submission and will engage with the submitter to clarify the issue identified. This may involve including a measure in a future tax bill that will be subject to full consultation.

Recommendation

That the submission be declined.

Issue: Amendment to deal with capital use of a mixed-use asset

Submission
(Deloitte, New Zealand Institute of Chartered Accountants)

An amendment to the apportionment formula is needed when there is capital use of an asset, as well as income-earning use and private use.

The issue is explained by the following example:

A privately owned corporate group owns a plane that has the following use (per year):

- private use (for example, the owner of the group flying overseas on holiday) – 20 days;
- income-earning use (for example, the owner/management flying overseas for business purposes where there is a direct nexus with income) – 20 days; and
- capital use (for example, the owner/management flying overseas to analyse potential capital acquisitions) – 20 days.

The plane is therefore used 1/3 for private use, 1/3 for income-earning use and 1/3 for capital use. The plane is unused for the remainder of the year.

The following expenditure is incurred in relation to the plane:

- $100 solely relating to private use (for example, fuel and pilot costs directly attributable to private use);
- $100 solely relating to income-earning use (for example, fuel and pilot costs directly attributable to income-earning use);

- $100 solely relating to capital use (for example, fuel and pilot costs directly attributable to capital use); and
- $100 "mixed use" expenditure that does not solely relate to any specific use (for example, annual insurance premium for the plane).

Under the general rules (that is, before applying the mixed-use asset rules), the approach would be to apportion the expenditure based on actual use. A deduction would be taken for $100 for the expenditure solely relating to the income-earning use (as per section DA 1). No deduction would be taken for the $200 solely relating to private and capital use (as per the private and capital limitations in section DA 2), and a $33 deduction would be taken for the portion of the mixed-use expenditure that is deemed to relate to the income-earning use (that is, 1/3 x $100 = $33) (as per section DA 1).

In addition, the following tax treatment results from the application of the mixed-use asset rules. In relation to the non-mixed-use expenditure, the $100 solely relating to the income-earning use should be fully deductible (as per section DG 7) and the $200 that solely relates to private and capital use should be non-deductible (as per the private and capital limitations in section DA 2).

$33 of the mixed-use expenditure that is considered to relate to income-earning use should be deductible under the rules. For this to be the case under the mixed-use asset rules, the full $100 of mixed-use expenditure needs to be included in the item "expenditure" in the apportionment formula in section DG 9 as the capital-use days are not income-earning days. This would effectively require there to be no apportionment under the capital limitation and the private limitation before the application of the apportionment formula:

expenditure x income-earning days / (income-earning days + counted days)
i.e. $100 x 20/60 = $33.

However, the item "expenditure" in the apportionment formula only includes expenditure in relation to the asset that is "deductible in the absence of this subpart" and the capital limitation and the private limitation could therefore be considered to apply before the apportionment under section DG 9. Clearly, however, the mixed-use expenditure that relates to private use must be included in "expenditure" in the apportionment formula otherwise the apportionment formula would be redundant.

If section DG 9 is read as requiring expenditure that might otherwise be apportioned as capital expenditure to be excluded from "expenditure" in the apportionment formula, expenditure relating to the capital use of the asset would be subject to two levels of apportionment (that is, denied once by the capital limitation and then again by the mixed-use asset rules). As capital-use days are treated as "counted days" in the apportionment formula, excluding capital expenditure from "expenditure" would limit the deduction for the capital mixed-use expenditure twice:

expenditure x income-earning days / (income-earning days + counted days)
i.e. $67 x 20/60 = $22.

This problem could potentially be corrected by:

(1) extending the words "and that would be deductible in the absence of this subpart" in subsection DG 9(3)(a) and including the words "prior to any apportionment of expenditure due to capital or private use of the asset"; or

(2) excluding "capital use days" from "counted days" in the apportionment formula and addressing the private limitation with something similar to (1).

This would result in the following outcome:

expenditure x income-earning days / (income-earning days + counted days – capital use days)
i.e. $67 x 20/(20+40-20) = $33.

"Capital-use days" could be defined as "the total number of days in the income year on which the asset is in use and the use is of a capital nature". This outcome would then appropriately focus the formula on apportioning otherwise deductible expenditure between private and income-earning use.

The submitter suggests that option 1 would be simpler as it essentially just clarifies that the apportionment formula does all the apportionment for capital and private use. Option 2 would further complicate the apportionment formula.

Comment

Officials agree with the submission and agree in principle that option 1 is a sensible approach to address the issue. Officials recommend however that the appropriate solution is to delete the words: "… and that would be deductible in the absence of this subpart" from section DG 9(3)(a). This is because section DG 8(3)(a) states section DG 8 overrides the capital limitation and the private limitation, and section DG 9 is the formula that determines the amount deductible under section DG 8(1), so the capital and private limitation are already overridden. Accordingly, if the words: "… and that would be deductible in the absence of this subpart" are removed from the definition of expenditure in section DG 9(3)(a), the expenditure that is apportioned under that formula will be all expenditure (including capital and private expenditure).

Recommendation

That the submission be accepted.

Issue: Different definition of "asset income" for quarantining rules

Submission
(Matter raised by officials)

The definition of "asset income" in section DG 17 should be aligned with the definition of the same term in section DG 16.

Comment

If a taxpayer generates assessable income from a mixed-use asset in an income year of less than 2 percent of the asset's value, some of the deductions generated by the asset are quarantined until a future income year. The low relative level of income generated by the use of the asset suggests that the asset is likely to be a predominantly private asset and therefore it is appropriate to suspend tax deductions that could otherwise be used to offset the taxpayer's income from other sources.

If the income does not reach the 2 percent threshold, any deductions above the **assessable income** from the asset (the "asset income") derived in that income year are quarantined, to be accessed in future income years. The effect is that, in a year when a taxpayer derives a low level of assessable income from the asset, the taxpayer is allowed deductions sufficient to offset that assessable income (so no tax is payable in respect of the income from the asset), but is not able to generate a net loss on that asset.

In a future income year, the taxpayer is able to access quarantined deductions if they have income from the use of the asset that exceeds their current year deductions. The amount of quarantined expenditure that can be accessed by the taxpayer is the lesser of the quarantined expenditure and the excess of current year **income** from the asset (the "asset income") above current year allowable deductions.

Officials have identified a problem with the definition of "asset income" in the provision that allows taxpayers to access quarantined expenditure (section DG 17).

In the primary quarantining provision (section DG 16), the "asset income" is the total amount of income, **other than an amount of exempt income**, derived for the income year from the use of the asset. This is the correct approach as taxpayers should not be able to access excess deductions because they have earned exempt income.

In contrast, in section DG 17, which is the section that allows taxpayers to access previously quarantined amounts, the definition of "asset income" is the total amount of income derived for the current year from the use of the asset. There is no exclusion for exempt income. This means that taxpayers can access excess quarantined deductions on the basis of exempt income they derive in relation to the asset (for example, income from associates, which is easily manipulated). Given the income is exempt, accessing quarantined deductions in this way will also give rise to a net loss on the asset for that income year which is contrary to the policy intention of the provision.

Accordingly, officials recommend that the definition of "asset income" in section DG 17 should be aligned with the definition of the same term in section DG 16.

Recommendation

That the submission be accepted.

LOOK-THROUGH COMPANIES

Clauses 147 and 148

Issue: Support for the amendment

Submission
(New Zealand Institute of Chartered Accountants)

The submitter supports the amendment which proposes that the references in the promoter (section 141EB) penalty legislation which refer to loss attributing qualifying companies be updated to refer to look-through companies (LTCs), and that the penalty relief provision for loss attributing qualifying companies be repealed.

Recommendation

That the submission be noted.

Issue: Further reforms to the LTC rules

Submission
(New Zealand Institute of Chartered Accountants)

The amendment corrects a minor technical error rather than deals with any of the fundamental and more significant issues with the look-through company rules that we and others have raised over the last two years. We submit that the Committee should consider asking the Government and officials to treat the reform of the LTC rules as an urgent priority.

Comment

The amendment is concerned with correcting the terminology. Officials note that this submission raises issues that would require further analysis as part of the Government's tax policy work programme. The Government's tax policy work programme, announced on 8 November 2013, includes a review of the tax rules for closely held companies. This work will consider simplification, technical and base maintenance issues that arise under current tax rules applying to closely held companies, including improving the overall coherence of the rules. These include the rules for look-through companies and other close company regimes.

Recommendation

That the submission be noted.

UNACCEPTABLE TAX POSITION SHORTFALL PENALTY

Clause 146

Issue: Support for the amendment

Submission
(Corporate Taxpayers Group)

The submitter is supportive of the proposed amendment to clarify that the unacceptable tax position penalty does not apply in respect of GST and withholding tax shortfalls, and the retrospective application of this amendment.

Recommendation

That the submission be noted.

Issue: Drafting

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

The proposed method of clarifying "income tax" in section 141B is unnecessarily complex, involving the introduction of a new term "core income tax". We submit that "income tax" should be retained as the relevant term in section 141B(2) and new section 141B(10) should define "income tax" for the purpose of the section as "income tax as defined in section YA 1 of the Income Tax Act 2007 ignoring the effect of section RA 2 of that Act".

Comment

The proposal clarifies that the unacceptable tax position penalty does not apply to shortfalls that arise in respect of GST and withholding-type taxes. That is, the penalty will only apply to income tax shortfalls. Officials agree with the submission which would align the proposal with the original intent of the 2007 amendment. It would also prevent the introduction of a new term.

Recommendation

That the submission be accepted.

SETTING NEW DUE DATE FOR PAYMENT OF TAX

Clause 149

Issue: Extension of provision

Submission
(Ernst & Young)

A further amendment should be made to clarify that a new due date should be set when a new assessment is made or issued, regardless of whether it is the Commissioner or the taxpayer who makes the assessment in question.

Comment

Officials consider that the submission raises issues that would result in a significant widening of the existing provision and which would require further analysis as part of the Government's tax policy work programme.

Recommendation

That the submission be declined.

SERIOUS HARDSHIP

Clauses 128(4) and 153 to 157

Issue: Support for the proposal

Submission
(New Zealand Institute of Chartered Accountants)

The submitter accepts that, on occasion, the Commissioner may need to bankrupt a taxpayer who is in serious hardship, and considers that the Commissioner should not have regard to the reasons why a taxpayer is in serious hardship when the taxpayer applies for financial relief.

Comment

The proposals in the bill are being made to allow the Commissioner, in appropriate circumstances, to bankrupt taxpayers who are in serious hardship, and to ensure that the reasons why the debt arose are not a factor in determining whether the taxpayer is in serious hardship.

The submission supports the proposals in the bill.

Recommendation

That the submission be noted.

Issue: Relevant factors in determining "serious hardship"

Submission
(New Zealand Institute of Chartered Accountants)

The inclusion of proposed section 177A(2)(c) should be reconsidered as it could lead to questions about the factors that the Commissioner considered are "relevant" factors.

Comment

The bill proposes a new definition of "serious hardship". The current definition uses the word "includes" and lists factors that may give rise to the taxpayer being in significant financial difficulties. The proposed definition does not use the word "includes, but rather states that the Commissioner can make a decision and consider "other factors that the Commissioner thinks relevant would likely arise". The current definition and the proposed definition are not definitive lists of circumstances but allow the Commissioner to consider individual circumstances.

Recommendation

That the submission be declined.

WFF – CHANGES TO DEFINITION OF "FAMILY SCHEME INCOME"

Clauses 114, 115 and 116

Submission

(New Zealand Institute of Chartered Accountants)

The submitter supports the proposed amendments to correct errors and clarify the definition of "family scheme income" but considers they add another layer of complexity to an area where simplicity is fundamental. The process of applying section MB 13 is becoming unwieldy. The "family scheme income" rules in subpart MB should be reviewed and simplified.

Comment

Officials acknowledge that the definition of "family scheme income" for Working for Families (WFF) tax credits has become more complex. Complexity is a feature of social policy income definitions more generally and reflects the desire for accuracy and integrity in targeting financial assistance to those in genuine need.

The broadening of the definition of "family scheme income" from 2011, including the addition of subpart MB 13, 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 2004–07 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 families 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.

Recommendation

That the submission be declined.

Issue: Entry and exit fees

Submission
(PricewaterhouseCoopers)

For an entity to be a portfolio investment entity (PIE) it must meet various requirements, including in relation to the types of income it can derive. A PIE must derive less than 10 percent of its income from sources other than land, financial arrangements, excepted financial arrangements, and rights and options in relation to those things.

This restriction should be modified so a PIE does not face the 10 percent restriction on entry and exit fees. These fees are payable when investors invest in, or exit, a PIE. They are intended to cover the brokerage and administration costs incurred by the PIE.

Comment

PIEs are intended to be passive investment vehicles. A PIE must earn most of its income in forms that might be expected to arise from passive investments such as rents, dividends or interest. The ability for a PIE to derive up to 10 percent of its income from other sources was designed to cover incidental forms of income such as entry and exit fees.

Officials understand that entry and exit fees could inadvertently become a large portion of a PIE's income if there is a period of particularly low investment returns. However, officials consider this issue would need further analysis to ensure removing the 10 percent restriction from entry and exit fees does not have any unintended consequences.

Recommendation

That the submission be declined.

Issue: Disposal of certain shares by a PIE

Submission
(PricewaterhouseCoopers)

Section CB 26 should not apply in relation to dividends from a listed PIE. There is no need for the section to apply as the unimputed portion of such dividends are not taxable under section CX 56C.

This change should apply no later than the commencement of the 2013–14 income year.

Comment

Officials agree there is no need for section CB 26 to apply. Section CX 55 provides that gains arising from the sale of most Australian and New Zealand-listed shares are excluded income for PIEs and similar entities. However, section CB 26 deems a taxable dividend to arise when a share that satisfies the criteria of section CX 55 is sold after a dividend is declared but before the dividend is paid. This is to prevent a PIE turning a taxable dividend receipt into a non-taxable gain on sale.

These concerns do not arise for dividends received from listed PIEs as those dividends are not taxable in any event. There is no tax advantage in selling a share in a listed PIE after a dividend is declared but before it is paid.

Officials do not agree that the application date of this change should be the beginning of the 2013–14 income year. Many PIEs will have already finalised their tax positions for most of that year. As such, only some investors in some PIEs would benefit from the retrospective application. Officials consider an application date of Royal assent more appropriate.

Recommendation

That the submission be accepted subject to officials' comments.

REMOVAL OF 20% UPLIFT FROM LAND IMPROVEMENT PROVISIONS

Submission
(BDO Wellington Ltd)

Clauses 50 and 125 have already been enacted and should be removed from the bill.

Comment

Clauses 50 and 125 aim to remove the remaining 20% uplift rules. These two clauses have already been enacted through the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 (sections 103 and 104 of that Act).

These two clauses should be removed from the current bill.

Recommendation

That the submission be accepted.

REMITTED AMOUNTS ON DISCHARGE FROM BANKRUPTCY

Clause 15(1)

Submission
(Ernst & Young)

Proposed section CG 2B should be amended to apply to an individual whose discharge from bankruptcy occurs in the same income year as enactment of the bill.

Proposed section CG 2B(2)(b)(ii) should be amended to ensure the amount calculated is relevant only if it is a positive amount.

Comment

The bill is likely to be enacted during the 2014–15 income year, and returns of income for this tax year are not required until July 2015. Therefore, adopting this application will provide consistent tax outcomes for all discharged bankrupts for the 2014–15 income year.

Officials do not agree with the second submission. The debt adjustment can completely extinguish the loss balance from the preceding tax year (giving a zero result in the formula). A zero result in the formula will result in the discharged bankrupt having no income under section CG 2B, as intended.

Recommendation

That the submission for the application date be accepted.

That the submission for section CG 2B(b)(ii) be declined.

Submission
(New Zealand Institute of Chartered Accountants)

We support this proposal as it is consistent with the "fresh start" principles of insolvency law. Where the Official Assignee has administered the bankruptcy, s/he has considered the bankrupt's position in depth and it is therefore sensible and preferable for the tax legislation to "defer" to the Insolvency Act 2006.

We agree that any tax losses carried forward by a former bankrupt should be reduced by the lesser of the amounts remitted or the total losses carried forward.

Comment

Officials note the support for the amendments.

Recommendation

That the submission be noted.

LOSS GROUP CONTINGENT ON GROUP LOSS COMPANY SATISFYING ITS LIABILITIES FOR DEDUCTIBLE EXPENDITURE

Clause 15(2)

Submission
(Corporate Taxpayers Group)

We support the amendments as being reasonable in principle, subject to technical and drafting issues being resolved but do not agree the amendments are remedial in nature.

Comment

Officials note the submission supports that the amendments are reasonable in principle but cannot identify any drafting issues raised in the submission.

Technical points raised by the Group in relation to specific submissions are dealt with separately in this report.

The Corporate Taxpayers Group considers the amendments ought to have been more appropriately dealt with as a policy matter rather than an "other remedial matter" in the Commentary to the bill.

We consider that the proposed amendments are appropriately classified as remedial measures, as they correct an unintended consequence arising from earlier amendments.

Before the commencement of the Income Tax Act 2004, the Commissioner could amend past years' assessments of a taxpayer to cancel the benefit from using past tax losses if the taxpayer's liabilities for deductible expenditure were later discharged without full consideration, were remitted or had become unrecoverable or unenforceable through the lapse of time. This power to issue this amended assessment was not limited to the normal four-year time bar. This power also applied to the benefit of loss grouping in past years.

To achieve consistency with self-assessment, the rewrite of these provisions altered both the manner and timing of the adjustment to cancel the benefit of using past tax losses. The adjustment was treated as income in the year a taxpayer's liabilities for deductible expenditure were later discharged without full consideration, were remitted or had become unrecoverable or unenforceable through the lapse of time. However, this policy change did not adequately address how this policy applied to past loss grouping.

The proposed amendments:

- correct this gap in the law arising from the 2004 Act change to the manner and timing of the adjustment; and
- do not involve a change in existing policy.

Recommendation

That the submission that the amendments are reasonable in principle be noted.

That the submission that the amendments are remedial in nature be declined.

Submission
(New Zealand Institute of Chartered Accountants)

We agree in principle with what the amendment is aiming to achieve.

Comment

Officials note the support for the amendments.

Recommendation

That the submission be noted.

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

Income should not be deemed to arise prior to amounts being remitted. *(Corporate Taxpayers Group, Deloitte)*

The proposals targeting companies leaving consolidated groups and voidable preference transactions seem to go too far and do not leave companies with many options when trying to refinance an insolvent company prior to a group profit company trying to exit a group. *(Corporate Taxpayers Group, Deloitte)*

The amendment results in an overreach when a company wishes to leaves a consolidated group. The profit company may be subject to a tax liability as a result of the financial position of other members of the consolidated group in certain situations merely because either the profit company or the loss company exits the group. *(New Zealand Institute of Chartered Accountants)*

Comment

These submissions relate to proposed section CG 2D, which applies in circumstances when the group loss company and group profit company are in the same group.

This approach addresses concerns raised in submissions on a consultation paper that an adjustment to cancel the benefit of past loss grouping should not apply if the group loss company and the group profit company are not in the same group of companies.

The proposed amendment is consistent with the general adjustment rule that cancels the benefit of using past tax losses if unpaid liabilities for past deductible expenditure (related to those past tax losses) became unrecoverable or unenforceable through the lapse of time. The proposed amendment in section CG 2D identifies that at the time loss grouping status is broken:

- if the group loss company is insolvent, there is a high risk that the liability will not be satisfied in full (that is, it is likely to be unrecoverable); and
- that risk will be known to the management of the group of companies.

Officials consider that as the unpaid liabilities have a high risk of being unrecoverable, it is appropriate to cancel the benefit of related past tax losses used under the loss grouping rules. It also ensures proposed section CG 2C cannot be easily avoided. Section CG 2C applies if the loss company is liquidated, struck off or otherwise removed from the register of companies.

Submitters also comment it is possible the group loss company may later satisfy its liabilities. We consider that, in most circumstances, it is unlikely that the insolvent group loss company would later satisfy its obligations for unpaid deductible expenditure.

Recommendation

That the submissions be declined.

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

Subsections CG 2D(4), (5) are unnecessary and should be removed. *(Corporate Taxpayers Group, Deloitte, Ernst & Young)*

References to "transactions or arrangements" in proposed subsection CG 2D(4) introduce uncertainty into the rules. *(New Zealand Institute of Chartered Accountants)*

Comment

The reference to an arrangement was intended to take into account:

- guarantees given by other taxpayers that enable the insolvent group loss company to meet the solvency test;
- a release given by creditors of the group loss company from the obligation to pay the unsatisfied liability; or
- an agreement of composition with the group loss company's creditors.

The policy concern is that funding provided to the group loss company to satisfy the solvency test should not subsequently be used to make an insolvent transaction. An insolvent transaction could subsequently be reclaimed by a liquidator of the group loss company. An example of payments that could be at risk are payments to satisfy outstanding accident compensation levies, or fringe benefit tax, both of which are normally deductible expenses for a company.

However, we agree that the use of "an arrangement" might cause uncertainty in the mergers and acquisitions market. To address the uncertainty, the provisions in section CG 2D(4), (5) should be aligned more closely with the insolvent transaction provisions under company law and omit the reference to "arrangement". There appears to be a low risk that an arrangement would subsequently be used to fund an insolvent transaction. We do not consider that the two provisions otherwise create uncertainty.

Submitters comment that the general anti-avoidance provisions in the Income Tax Act 2007 could address the insolvent transaction concerns. We consider the policy for the proposed provisions address a specific issue relating to insolvent transactions, and this is preferable, for compliance and administration cost reasons, to leaving the matter to be addressed under the general anti-avoidance provisions.

Recommendation

That the submission that the provisions relating to voidable transactions be removed from the bill be declined, subject to officials' comments.

Submission
(Ernst & Young)

The provisions of proposed sections CG 2C and CG 2D should not apply if a loss company is removed from the register of companies through formal amalgamation under the Companies Act 1993 or any equivalent Court order, whereby the liability to pay their relevant unpaid expenditure amounts pass to the on-going amalgamated company

Comment

Officials agree that, if the group loss company has been removed from the register by reason of amalgamation, proposed sections CG 2C should not apply. This is because the unsatisfied liabilities of the group loss company are assumed by the amalgamated company (the company remaining after the formal amalgamation).

However, as the liabilities have been assumed by the amalgamated company, proposed section CG 2D should apply to the amalgamated company. This ensures that the formal amalgamation process cannot be used as a means to avoid the assessment of income to the group profit company under proposed sections CG 2C and 2D (for example by amalgamation and then liquidating the amalgamated company).

Recommendation

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

Submission
(Ernst & Young)

Proposed sections CG 2C and 2D should be clarified as to whether or how the proposed rules might apply if loss companies have been part of a consolidated group for income tax purposes.

Comment

Officials agree that it would be helpful to clarify how the consolidated group rules are to interact with proposed sections CG 2C and 2D as that would assist in minimising compliance and administration costs.

Recommendation

That the submission be accepted.

Submission
(Ernst & Young)

The Commissioner of Inland Revenue should provide appropriate guidance for the application of proposed sections CG 2C and 2D in situations when loss companies have losses representing a combination of paid and unpaid expenditure and when they have apportioned losses to more than one group of company.

Comment

The recovery rules in proposed sections CG 2C and 2D modify the general recovery rule applying to taxpayers with unpaid liabilities (relating to an amount of deductible expenditure) that have been remitted or cancelled. This includes liabilities that have become unrecoverable or unenforceable through the lapse in time.

Under this general rule, there is no requirement to match or trace the unpaid liability for deductible expenditure and match those amounts to specific use of tax losses. Instead, the taxpayer is assessed for an amount of income equal to the relevant amount remitted or cancelled. Proposed sections CG 2C and 2D adopt the same approach for consistency and to maintain the integrity of the tax system.

We agree with the submission relating to apportionment. We consider that allocation of the recovery income arising under sections CG 2C and 2D should be explicit in the legislation. This will assist in minimising compliance and administration costs.

Recommendation

That the submission on paid and unpaid expenditure be declined.

That the submission on tax losses apportioned to more than one group company be accepted.

Submission
(Ernst & Young)

Exclusions for financial arrangements within proposed sections CG 2C and 2D should be clarified.

Comment

As drafted, proposed sections CG 2C and 2D make it clear that they do not apply to financial arrangements. For example, proposed sections CG 2C and 2D apply to unpaid liabilities for normal trade debts.

Recommendation

That the submission be declined.

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

The interaction of proposed sections CG 2C and 2D with sections IC 11 and IC 12 should be clarified. *(Ernst & Young)*

The effect of section IC 11 should be considered. *(New Zealand Institute of Chartered Accountants)*

Comment

Section IC 11 applies if the Commissioner amends an assessment to determine that the tax loss of a group loss company (for a tax year) is less than the total amounts made available and subtracted from net income of group profit companies. This section applies, for example, when the group loss company has taken a tax position on an expenditure that has not been accepted by the Commissioner.

Officials consider section IC 11 is not suitable for cancelling the benefit of past grouping of tax losses on remission or cancellation of unpaid liabilities for deductible expenditure of a group loss company because:

- section IC 11 results in retrospective amended assessments of the group companies. That approach was strongly opposed in submissions on a consultation paper;
- section IC 11 is subject to the time bar, preventing the Commissioner from cancelling the benefit of past tax losses if more than four years have passed since the last assessment.

However, we agree that it would be desirable to adopt an apportionment rule similar to the apportionment in section IC 11 to minimise compliance and administration costs.

We agree with the submission that proposed sections CG 2C and 2D should not apply to tax losses for which other provisions apply (such as section IC 12). We recommend that this be clarified.

Recommendation

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

Submission
(Russell McVeagh)

Sections CG 2 and 2D should be treated as coming into force and applying to all income years ending on or after the date upon which the bill is introduced.

Comment

Officials can see no policy reason why the proposed provisions should not apply from the date of introduction of the bill (22 November 2013). The proposed provisions apply if a group loss company with unpaid liabilities or past deductions has subsequently:

- been removed from the register or companies; or
- lost group status with a group profit company that received the benefit of past tax losses.

The long-standing policy is that the use of tax losses is contingent on the payment of liabilities for deductible expenditure. The proposed amendments are consistent with the general rule for all taxpayers that cancels the benefit of past tax losses if liabilities for past deductible expenditure are remitted or cancelled.

We also consider the amendments in sections CG 2C and 2D are significantly more constrained than the previous law, which permitted the Commissioner to amend assessments to cancel the benefit of past tax losses, without any time constraints, whether or not the group loss company or group profit company were in the same group of companies.

Recommendation

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

Issue: Income derived in trust by public and local authorities

Clauses 25 and 26

Submission
(Ernst & Young)

The amendments to sections CW 38 and 39 are too restrictive and may prevent exemptions applying to income derived in trust for charitable or other exempt public purposes.

Comment

The exemption for income derived by a public authority or a local authority (sections CW 38 and 39) is not available for income derived by a trust for which a public authority or a local authority is the trustee. The policy of this exemption has never been related to the terms of the trust, as suggested by the submitter.

However, the amendment addresses an issue raised with the Commissioner relating to the trustee's tax obligations for the beneficiary. As the income derived by the trustee is not exempt under section CW 38 or CW 39, we consider that the amendment clarifies, for the avoidance of doubt that:

- the exemption for income derived by a public authority or a public authority does not extend to income derived in the capacity as trustee that has not been distributed; and
- the trustee may take into account any exemption from income of the beneficiary for determining the trustee's income tax obligations on that beneficiary income.

However income derived by a public authority or local authority as trustee may be exempt under other provisions of the Income Tax Act which may take into account the terms of the trust. We consider this amendment does not disturb these principles and that the submitter is raising issues that would require further analysis as part of the Government's tax policy work programme.

Recommendation

That the submission be declined.

Submissions
(New Zealand Law Society, Tax Team, The Whyte Group)

The proposed amendments are unnecessary, as the current position in relation to trust income distributed as beneficiary income is clear. *(New Zealand Law Society)*

The amendments are ad hoc amendments that potentially exacerbate existing uncertainty in relation to the interpretation and application of the exclusions from the public and local authority exemptions for income derived "as a trustee". *(New Zealand Law Society, Tax Team)*

If any amendments are made to the exclusions, they should only be made following a more comprehensive review of the underlying policy and intended scope of the exclusions. *(New Zealand Law Society)*

The amendment to section CW 39(3) should be removed from the bill. *(The Whyte Group)*

Comment

We consider the submission is seeking a review of the scope of the policy for the public and local authority exemptions which raises issues that would require further analysis as part of the Government's tax policy work programme.

The long-standing policy is that the public and local authority exemptions do not extend to income that a public or local authority derives as a trustee. This is because income is derived in trust beneficially for the beneficiaries of the trust and not for the public or local authority.

The amendment clarifies, for the avoidance of doubt that if a public or local authority derives income as a trustee:

- whether the income derived and retained by the trustee is exempt income and is determined by whether other exempt income provisions in the Income Tax Act apply to the trustees and the trust, and not by the public or local authority exemptions; and
- income distributed as beneficiary income to a public or local authority is exempt income.

Recommendation

That the submissions be declined.

Issue: Spreading of income derived from land

Clauses 58 and 59

Submission
(New Zealand Institute of Chartered Accountants)

We support the amendment as a clarification to the current position.

Comment

Officials note the support for the amendment.

Recommendation

That the submission be noted.

Submission
(BDO Wellington Ltd, PricewaterhouseCoopers)

A taxpayer should be able to choose a shorter timeframe for the spreading of income rather than being locked into a statutory timeframe (set out in the amendment). *(BDO Wellington Ltd)*

A review should be undertaken regarding the timing of income and its allocation between income years. *(PricewaterhouseCoopers)*

Comment

The amendment clarifies that income is to be spread evenly over the time periods referred to in sections EI 7 and 8. This was the practice before the following drafting changes were made:

- in 2002 to give effect to formal self-assessment; and
- in rewriting those provisions into the Income Tax Act 2004.

The submission raises a policy question relating to a number of spreading provisions (both deduction and income) in the Income Tax Act 2007. These provisions are mainly concerned with:

- the primary sector; and
- certain intangibles (such as copyright, patents or leases).

Officials consider that, consistent with the objective of maintaining the integrity of the tax system, any review of the timeframes should consider all similar spreading rules which would require further analysis as part of the Government's tax policy work programme.

Recommendation

That the submissions be declined.

Issue: Rewrite amendments relating to use of foreign balance dates

Clauses 57 and 176

Submission
(Ernst & Young)

The proposed amendments should be revised or deleted as they do not appear to make any substantive difference to section EG 1 as currently enacted and they do not appear to relate to either of the related submissions to the Rewrite Advisory Panel.

Comment

The election under section EG 1 allows a taxpayer to adopt a simpler method for returning foreign-sourced income for compliance cost reasons.

The amendment to section EG 1(6) ensures that this election is not available for a person whose net foreign-sourced income is more than $100,000 in any income year. The current law restricts the application of the election to income years falling after the year in which the election is made. The amendment reflects the Rewrite Advisory Panel's recommendation on that submission.

We note that the second submission to the Rewrite Advisory Panel on this provision was declined by the Panel, and that no amendment is therefore required.

Recommendation

That the submission be declined.

Issue: Tax Administration Act 1994: Cross-references to sections 108 and 109

Clauses 135 to 145

Submission
(Corporate Taxpayers Group, Deloitte)

The amendments contained in the bill do not actually result in the relevant provisions within the Tax Administration Act linking into section 108. We recommend that each of clauses 135 to 145 of the bill be amended and a cross-reference to section 108 added.

Comment

The submission is requesting that the time-bar referred to in section 108 be extended to apply to tax types, for which the time-bar does not currently apply. The time-bar prevents the Commissioner from making an amended assessment to increase the income tax payable more than four years after the previous assessment.

The amendment is a simple correction of cross-referencing from each of the provisions in clauses 135 to 145 of the bill, into section 108 or 109, as appropriate.

Recommendation

That the submission be declined.

Submission
(New Zealand Institute of Chartered Accountants)

We support the intention of the proposal.

That the drafting of each of clauses 135 to 145 of the bill should be reviewed to ensure the intended effect is achieved.

Comment

Officials note the support for the amendments, and agree that the drafting should be reviewed.

Recommendation

That the support for the amendments be noted.

That the submission to review the drafting be accepted.

NON-CASH DIVIDENDS

Clause 120

Issue: Drafting correction

Submission
(Ernst & Young)

The proposed remedial amendment is technically correct, but it needs to be repeated in section RE 16(3).

Comment

Officials agree with the submitter on this drafting correction.

Recommendation

That the submission be accepted.

Issue: Reconciling tax treatment of bonus issues

Submission
(Ernst & Young)

That the resident withholding tax treatment of the two types of bonus issue should be reconciled.

Comment

Officials agree that there is some scope for refinement in this area. The matter has been previously raised with officials by another firm of accountants and is being considered as part of the review of the tax rules for closely held companies that is currently on the Government's tax policy work programme.

Recommendation

That the submission be noted subject to officials' comments.

MINOR DRAFTING POINTS

Clauses 22, 60, 123(9), 123(32) and 155

Submission
(Ernst & Young)

- Clause 60 – The new paragraph to be inserted in section EW 15D(2) should be labelled (ae), rather than (ad) as proposed, as the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act (122-2) already inserted paras (ac) and (ad).
- Clause 123(32) – We suggest the proposed new definition of "ownership interest" also needs to recognise amendments inserted by the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Measures) Act 2013 and earlier in relation to corporate reorganisations and reverse takeovers. In particular we note section YC 18B modifies the general tested by ignoring "excluded preference shares".
- Clause 155 – Under the proposed replacement of section 177A of the Tax Administration Act, illness of a taxpayer or dependant would seem to be relevant only if it occurs after the application is made for relief. Is that intended or appropriate? We suggest the wording be revised.

Comment

Officials acknowledge the minor drafting points raised by the submitter and have referred these points to the bill drafters for their consideration.

Recommendation

That the submission be noted.

Matters raised by officials

Issue: Deferred application dates

Clauses 182 to 191

Submission
(Matter raised by officials)

Officials recommend that the child support remedial items in clauses 182 to 191 come into force on 1 April 2015.

Comment

The application dates for the child support reforms in the Child Support Amendment Act 2013 were deferred by one year as part of the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014. Part one of the Child Support Amendment Act will now apply from 1 April 2015. The child support remedial items in this bill relate to changes in Part one of the Child Support Amendment Act and should likewise be deferred.

Recommendation

That the submission be accepted.

Issue: Payment waiver when non-parent receiving carer is in receipt of a social security benefit

Clause 191

Submission
(Matter raised by officials)

Clause 191 of the bill amends section 179A of the Child Support Act 1991 (as inserted by clause 29 of the Child Support Amendment Act 2013) to recognise that some non-parent carers can qualify to receive a sole parent support benefit payment instead of the unsupported child benefit.

The amendment will mean that a non-parent receiving carer will not be able to waive their right to receive child support if they receive the unsupported child benefit (UCB) or a sole parent support payment. Likewise, if they start to receive either of these two payments any existing waiver is revoked.

Officials recommend that a non-parent receiving carer should be excluded from being able to waive their right to receive child support payments if they are getting the UCB for a child or if they are receiving any other social security benefit (other than the UCB). In such circumstances, non-parent receiving carers should not be able to waive their right to receive child support as the money collected is being retained by the Crown to offset the costs of the benefit payments.

Comment

It has been identified that a non-parent receiving carer could be getting a social security benefit – for example, sole parent support or jobseeker support – in relation to a dependent child and they have another qualifying child in their care who is not included in their benefit. They apply for child support for the qualifying child and any payment is retained by the Crown to offset the benefit costs in accordance with section 142 (Payment of formula assessment child support to custodians who are social security beneficiaries) of the Child Support Act 1991. Under current wording they may be able to waive their right to receive child support under section 179A, which is inconsistent with the Crown payment recovery rules. Section 142 requires the Crown to withhold payment when a receiving carer is in receipt of a social security benefit – it does not specify that the benefit is in relation to the qualifying child.

In terms of the proposed amendment to section 179A(5), if a "payee" (non-parent receiving carer) begins to receive the UCB for the child to whom the waiver relates, or any other social security benefit, then a waiver under section 179A which is in place is deemed to be revoked.

Such an approach is consistent with the Crown payment recovery principles under section 142 of the Child Support Act 1991.

Recommendation

That the submission be accepted.

Submissions
(Matters raised by officials)

The Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014 amended the rules that applied to miners of certain minerals (such as gold, silver and iron-sands).

The Advisor to the Committee has noted a number of minor drafting concerns with the mineral mining rules in that Act. Because the new rules are to apply to affected mineral miners from the 2014–15 income year, officials consider it is important to clarify the relevant drafting to avoid any unnecessary confusion.

We recommend that any amendments should take effect from the current income year (2014–15) to ensure that different rules do not apply within the same income year. Although, strictly speaking, this makes the amendments retrospective, the changes are not anticipated to have a material effect on the positions adopted as enactment is anticipated well before the first end-of-year assessments using the new rules are due.

Comment

The following matters are technical drafting issues and only serve to reinforce the stated policy intent of the provisions in question:

Prospecting and exploration expenditure

The intent of the original changes was that a miner should always get a deduction for expenditure that is either "prospecting" or "exploration expenditure" (subject to a claw-back rule that applies to exploration expenditure in some cases). This deduction was always meant to be available. However, the relevant provision, in section DU 1 of the Income Tax Act 2007, does not explicitly override the capital limitation. It may therefore be possible for a miner to be denied a deduction for prospecting expenditure.

Officials recommend that section DU 1 be amended to clarify that the deduction should be available even if this expenditure is ordinarily regarded as capital. It is not anticipated that this drafting suggestion will impinge on the operation of the claw-back rule in appropriate instances.

Spreading of development expenditure

It is intended that development expenditure and clawed-back exploration expenditure should be capitalised and amortised (deducted) over the life of the mine. This amortisation should take place on either a time or a "unit of production" basis. However, there is a technical question about whether clawed-back exploration expenditure is adequately catered for in section EJ 20E(4) of the Income Tax Act 2007, which operates when a miner operates on a unit of production basis. Failure to capture this expenditure properly could result in the miner being unable to amortise the amount – possibly resulting in "black hole" expenditure.

To remedy this, officials recommend that clawed-back expenditure should be specifically included in amounts that are subject to amortisation on a unit of production basis.

"Operational expenditure"

"Operational expenditure" is defined in section DU 12 (4) of the Income Tax Act 2007 as an exclusion to "development expenditure". Development expenditure is capitalised and amortised over the assumed life of the mine, whereas operational expenditure is treated according to general tax principles. An issue has been raised that may result in a miner claiming immediate deductions for expenditure that is properly categorised as "development expenditure".

This could arise when a miner has elected to allocate expenditure on a mine-by-mine basis, rather than over the entire permit area. It may be that the miner can treat development expenditure on a second mine as "operational" on the basis that it creates an asset that has an estimated useful life of less than one year.

To remedy this, officials recommend that expenditure that "contributes to the creation of an asset that has an estimated useful life of more than one year" should also be treated as development expenditure. On a single mine operation, this is not intended to expand the definition of "development expenditure".

Cap on amortising development expenditure

As described above, it is intended that development expenditure be amortised over the assumed life of the mine. An exception is when the assumed life is expected to be 25 years or longer. In this case, it is intended that the amortisation period be capped at 25 years.

However, the current drafting of section EJ 20D(3) of the Income Tax Act 2007 arguably does not achieve this result. Officials therefore recommend that the wording be clarified to ensure that the 25 years operates as a cap.

Reassessing the life of the mine

It was anticipated that a miner would be required to reassess the assumed life of their mine each year to take into account any new deposits discovered or possibly to reduce the estimated life because probable deposits did not in fact materialise. This was designed to provide the most accurate estimate possible over time.

The drafting of section EJ 20D(4) of the Income Tax Act 2007 technically does not require this reassessment to take place every year. Officials therefore recommend that this be clarified to ensure that this regular recalculation is undertaken.

Recommendation

That the submissions be accepted.