Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Bill

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

June 2015

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

CONTENTS

Cash-out of research and development tax losses

ELIGIBILITY

Clauses 192 and 213

Issue: Qualifying companies should be eligible

Submission
(Chartered Accountants Australia and New Zealand, EY)

Qualifying companies should not be excluded. Losses from qualifying companies do not flow through to shareholders as they do for look-through companies and limited partnerships. The intent behind their exclusion is not clear.

Comment

The initiative is targeted at simple companies without complicated structures. The decision to exclude qualifying companies was based on the fact that they have their own regime. Eligible qualifying companies in a current tax loss position may have been in a tax loss position for a number of consecutive years as new companies have not been able to elect into the regime since 2011, while many qualifying companies will have transitioned into the look-through company regime so that losses can continue to flow through to shareholders.

Evidence provided by submitters indicates, however, that qualifying companies remain a large group of taxpayers. Based on this feedback, and that qualifying companies no longer have flow-through treatment of losses, officials support including qualifying companies.

Recommendation

That the submission be accepted.

Issue: Excluding companies within a group that includes a foreign company is not appropriate

Submission
(Chartered Accountants Australia and New Zealand, Deloitte, EY)

Companies in a group that includes a foreign company should not be excluded. It will prevent companies from expanding offshore, which is common as the domestic market is small. There are a number of reasons why New Zealand companies may set up offshore subsidiaries:

- Locally incorporated companies are often preferred by overseas investors and venture capitalists.

- Overseas businesses may prefer to enter contracts with companies incorporated in their own jurisdiction.
- Attracting overseas clients through sales and marketing subsidiaries.

It will also cause a difference in treatment between companies owned by non-resident non-corporate bodies including individuals and partnerships, which are eligible, and non-resident corporate bodies, which are not.

Comment

The exclusion was intended to prevent subsidiaries of non-resident parent companies from being able to cash out their losses. These subsidiaries were not within the target group of the reform as they were considered to have sufficient funding for their R&D activities.

R&D expenditure undertaken overseas is excluded when calculating the amount of the tax credit. This exclusion, in conjunction with the requirement for companies in a group to meet the wage intensity criteria on a group basis, should be sufficient to achieve the policy intent of targeting the relief at R&D performed in New Zealand by New Zealand-based start-ups. We can therefore relax the requirement to exclude companies with a foreign company in the group.

The proposed amendment will allow New Zealand-based start-ups with an overseas subsidiary to qualify if they satisfy the eligibility rules. It will continue to prevent New Zealand subsidiaries of non-resident parent companies from accessing the scheme as the group will not be able to satisfy the wage intensity requirement.

It will be necessary to change proposed section MX 6(a)(ii) to ensure that establishing an overseas subsidiary does not trigger R&D repayment tax.

Recommendation

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

Issue: Provide clarity on the exclusion of special corporate entities (and companies majority-owned by a special corporate entity)

Submission
(Chartered Accountants Australia and New Zealand, EY and TaxTeam)

The exclusion of special corporate entities (and companies which are indirectly or directly 50 percent or more owned by a special corporate entity) should be reconsidered and/or revised. This could exclude incubator entities in the health and tertiary sector operating on commercial terms. It could also prejudice the ability of R&D companies owned by an incorporated society that does not issue shares to apply for a tax credit.

It should also be clarified whether the exclusion of companies 50 percent or more owned by a special corporate entity is also intended to cover a situation where multiple special corporate entities own 50 percent or more of the company when aggregated.

Comment

The main target of exclusions within the special corporate entities rules is publicly funded entities like public and local authorities, Crown Research Institutes, and state-owned enterprises, as they have access to other types of R&D funding. The exclusion will be refined to exclude only these entities. Companies that are majority-owned by one or more of this group of entities will also be excluded from the initiative.

Recommendation

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

Issue: Look-through companies have not been excluded

Submission
(New Zealand Law Society)

The commentary on the bill states that look-through companies are excluded from the proposals but they are not excluded in proposed section MX 2.

Comment

Only a "company" is eligible for the tax credit. Look-through companies are not included in the definition of "company" in the Income Tax Act for the purposes of cashing out R&D tax losses. Therefore there is no need to explicitly exclude them in proposed section MX 2.

Recommendation

That the submission be declined.

Issue: Inclusion of limited partnerships within definition of "group of companies" for R&D tax loss credit purposes

Submission
(EY)

It is not clear how including "limited partnerships" in the definition of "group of companies" for cashing out R&D tax losses purposes will apply without modifying defined terms like "voting interest" and "shareholder decision-making right", and related provisions for determining groupings of companies.

Comment

Our concern is that companies could use a structure involving a limited partnership and an R&D subsidiary to avoid the grouping requirement, and access a cashed-out loss they would otherwise not be able to access. The submitter has pointed out that the existing drafting is difficult to apply to partnerships as they use different terms and concepts than companies. We will update the drafting to ensure it achieves the policy intent of grouping associated partners and companies.

Recommendation

That the submission be accepted.

Issue: Requirement that companies must have complied with tax obligations

Submission
(Independent Advisor to the Select Committee)

The proposed eligibility rules require taxpayers (and other companies in the taxpayer's group) to have complied with all of their tax law obligations. This should be amended to disqualify taxpayers only in cases when the non-compliance has been material. Otherwise, there is a risk that taxpayers could be excluded from applying by, for example, a dispute over an unrelated matter or a delay by Inland Revenue in processing a payment.

Comment

Officials agree that taxpayers should only be excluded from cashing out R&D tax losses in cases when the non-compliance has been material. However, defining materiality or compiling an exhaustive list of material offences is unlikely to provide the necessary level of certainty, or even be possible. Instead, existing provisions already allow the Commissioner of Inland Revenue to use certain refundable tax credits to satisfy a tax liability. This tax credit will be included as one of those refundable tax credits. This should be sufficient for the purposes of preventing non-compliant taxpayers from accessing a tax credit with an outstanding tax liability.

Recommendation

That the submission be accepted.

WAGE INTENSITY CRITERIA

Clauses 192 and 213

Issue: 100 percent of contractor R&D consideration should be included as total R&D labour expenditure

Submission
(KPMG)

Including only 66 percent of contractor R&D costs in the total R&D labour expenditure calculation (used for calculating wage intensity and the amount of the tax credit) should be reconsidered. It is acknowledged that this excludes non-labour and profit amounts from the contract cost, but these costs remain a genuine R&D cost to a business and the total amount should be taken into account in determining whether the proposal applies.

Comment

The 66 percent amount is intended to cover the wage component of the contracting cost, and provides a simple way of determining this amount. Contracting costs are likely to include a profit margin and, in certain cases, other costs like materials. These costs should not be included in the calculation to determine the R&D wage intensity.

The 66 percent amount is very similar to the UK equivalent, which allows 65 percent of contract staff costs as qualifying expenditure for their R&D tax incentives. It is also consistent with the multiplier used when calculating the amount of the tax credit.

Recommendation

That the submission be declined.

Issue: Work performed for below-market remuneration

Submission
(Deloitte)

The R&D wage intensity calculation may not be representative of the actual R&D intensity of the company when an employee (likely a shareholder-employee) works for below-market remuneration. This will detrimentally affect the level of the company's R&D wage intensity. This could be remedied by deeming a shareholder-employee's remuneration at market value for the purpose of calculating R&D wage intensity when the shareholder-employee has a significant ownership interest.

Comment

The situation described above would enable "sweat equity" to be included in R&D wage intensity calculations. We have excluded this from the wage intensity calculations because no expenditure has been incurred by the company at this point in time.

Deeming shareholder-employee's remuneration at market value would create an opportunity for abuse. Remuneration may be inflated above market value to ensure the wage intensity criteria are met. Even though section GB 25 of the Income Tax Act protects against excessive remuneration to shareholders, directors or relatives in a close company, it is possible that inflation could occur at the margins.

It would also require an adjustment to total R&D labour expenditure to remove this deemed market value remuneration when calculating the amount that can be cashed out, as it would not be appropriate to cash out an amount of expenditure that has not been incurred. This would further increase the complexity of the calculation.

Recommendation

That the submission be declined.

Issue: Calculating total R&D labour expenditure when an employee's role is only partly dedicated to R&D activities

Submission
(Deloitte)

Some employees will be splitting their time between R&D and non-R&D activities. The process for determining how the amount should be pro-rated has not been outlined by Inland Revenue. Inland Revenue should release guidance on the level of evidence they require to substantiate the time spent on carrying out R&D activities.

This amount can be pro-rated by basing it on the actual time spent on R&D, or estimating this. Calculating actual time spent on R&D can be complicated, with innovative start-ups unlikely to have sophisticated methods for recording time spent on R&D. In light of this, an estimation method is more appropriate.

Comment

Inland Revenue will communicate its expectations of taxpayer record-keeping for the purposes of pro-rating labour expenditure between R&D and non-R&D activities.

Inland Revenue is committed to lowering compliance costs to the extent this does not create opportunities for gaming or re-characterisation of expenditure. In this case, requiring only estimation can create a risk of non-R&D expenditure being characterised as R&D expenditure.

Recommendation

That the submission be noted.

Issue: Clarify meaning of "the part of the income year"

Submission
(New Zealand Law Society)

The phrase "or for the part of the income year for which the person exists if that is not the whole income year" in proposed section MX 3(1) should have the words "(the part of the income year)" following it to clarify the use of "the part of the income year" in the definitions of "total R&D labour expenditure" and "total labour expenditure" in that section.

Comment

Officials agree with this submission, and will make changes to this effect.

Recommendation

That the submission be accepted.

Issue: Clarify that the use of "acquiring" does not exclude contractor R&D consideration from being considered R&D material or R&D expenditure

Submission
(New Zealand Law Society)

The definitions of "contractor R&D consideration" and "R&D expenditure" exclude the provision of goods and services to the extent they relate to an activity described in proposed schedule 22 (Proscribed R&D activities). One of the proscribed activities is acquiring intellectual property or know-how. The definitions of "intellectual property" and "know-how" are sufficiently broad to make the application of the provisions uncertain. It is difficult to envisage what "R&D material" could be provided by a contractor that is not excluded by schedule 22 due to the use of the word "acquiring". It should be made clear that the development of new intellectual property or know-how from carrying out R&D is not included within what is meant by "acquiring" for the purposes of the above definitions.

Comment

"Acquiring" refers to existing intellectual property or know-how already developed. When a company (Company A) provides R&D on behalf of another company (Company B) that Company B will retain the rights over, this should not be considered as acquiring intellectual property or know-how, and is valid R&D expenditure for company B only. On the other hand, if company A carries out R&D and claims the tax credit, and then sells the R&D asset to company B, expenditure incurred by company B on acquiring company A's existing R&D asset should be excluded from cashing out R&D tax losses. Further guidance on this will be provided.

Recommendation

That the submission be noted.

Issue: Clarify references to "external contractor" in definitions of "R&D expenditure" and "R&D material"

Submission
(Matter raised by officials)

The use of "external contractor" in the definitions of "contractor R&D consideration" in proposed section MX 3 and "R&D material" in section YA 1 could be confusing as they refer to different parties of a respective contract.

Comment

It should be clarified which party is the contractor company (Company A above) that is doing R&D on behalf of the contracting company (Company B above).

Recommendation

That the submission be accepted.

Issue: Clarify who the user of R&D material is when providing a service of R&D to a third party

Submission
(New Zealand Law Society)

In the definition of "R&D material", the user of the R&D in the contracting situation should be clarified. The words "by the recipient or, if the recipient is a member of a group of companies, by a member of the group" after "are used" has been suggested.

Comment

An addition similar to that suggested above would provide further clarity that when a company (Company A) performs R&D on behalf of another company (Company B), that provision of R&D by company A (or provision by another group member) is not considered "R&D material" for Company A for the purposes of cashing out R&D tax losses. Company B can consider this "R&D material" though.

Recommendation

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

AMOUNT OF THE CASH-OUT

Clauses 192 and 213

Issue: The refundable amount should be capped at the lesser of the maximum cap and the tax value of a company's tax losses

Submission
(KPMG)

Requiring businesses to calculate the various amounts (total dollar threshold cap, total losses of the business, total qualifying R&D expenditure and R&D labour expenditure times a multiplier) on the amount that can be cashed out will disproportionately increase compliance costs.

The refundable amount should be capped at the lesser of the total dollar threshold and the tax value of the company's total tax losses. No other caps are necessary.

Comment

The initiative is targeted at innovative start-ups, as this is where the existing tax treatment (of carrying forward losses) creates the most serious cashflow constraints and distortions on investment decisions. The two calculations relating to R&D expenditure are necessary to target the initiative and reduce opportunities for gaming. Capping the cash-out at total qualifying R&D expenditure ensures that only losses derived from R&D expenditure can be cashed out. Capping the tax credit at 1.5 times the R&D labour expenditure reduces opportunities for non-R&D expenditure to be characterised as R&D expenditure, a problem identified from the previous R&D tax credit.

Recommendation

That the submission be declined.

Issue: Change "0.28" to "the company tax rate" for the relevant income year

Submission
(Chartered Accountants Australia and New Zealand, EY)

References to "0.28" should instead refer to "the corporate tax rate" that applies to that income year. This would allow the legislation to reflect that the corporate tax rate is subject to change when calculating the amount to be cashed out or calculating repayment tax, for example.

Ideally, R&D repayment tax and loss reinstatement deductions should reflect the company tax rate that applied when the tax credits were cashed out.

Comment

Officials agree with this submission as it will allow changes in the company tax rate to take place without requiring legislative amendment.

If the company tax rate does change, R&D repayment tax and loss reinstatement deductions will reflect the new company tax rate. Applying the same tax rate to ordinary business income and repayments of tax credits will reduce overall compliance costs.

Recommendation

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

Issue: References to "tax year" should read "income year"

Submission
(EY)

References to "tax year" should refer instead to "income year" as these references do not specify a credit level for those companies with a non-standard balance date.

Comment

Officials will review the use of "income year" and "tax year" to ensure the above situation does not arise. This will ensure the proposed legislation is effective for taxpayers with non-standard income years.

Recommendation

That the submission be noted.

R&D EXPENDITURE

Clauses 213, 217 and schedule 1

Issue: Specific and relevant guidance should be provided on defined terms and excluded activities

Submission
(Chartered Accountants Australia and New Zealand, PwC)

Inland Revenue should issue specific and relevant guidance on the definition of "research and development", "excluded activities" and "expenditure" with commercially relevant examples to help minimise compliance costs and provide greater certainty. An example would be clinical trials or software development, for which expenditure goes through a number of stages. Industry-specific guidance would also be useful. Some of the terms in schedule 22 are too broad or open to interpretation.

Comment

Inland Revenue will publish appropriate guidance on its website soon after the legislation is enacted. Special attention will be paid to clinical trials and software development because these are areas where it is more difficult to determine when the activity ceases to be R&D.

Inland Revenue will have access to expertise from Callaghan Innovation to advise on the eligibility of R&D activities. This service should enable R&D performers to discuss their R&D activities with experts.

The exclusions listed in schedule 22 are similar to the exclusions used for Callaghan Innovation's business R&D grants and Statistics New Zealand / OECD guidance on how to measure R&D for statistical purposes (the Frascati Manual). For this reason many R&D performers will already be familiar with these exclusions, which should reduce overall compliance costs.

Recommendation

That the submission be noted.

Issue: Certain expenditure undertaken overseas should not be excluded

Submission
(Chartered Accountants Australia and New Zealand, EY)

It may not be appropriate to exclude all R&D expenditure undertaken overseas. Some testing is integral to the product's development. For example, products that require approval by the US Food and Drug Administration must be tested and approved in the US. Research on product packaging may also be required to be undertaken in the target overseas country itself because of legislative requirements. This could be done by exempting expenditure that is integral to product development.

Comment

The measure is targeted at R&D performed in New Zealand as this R&D is likely to generate higher benefits for the New Zealand economy than R&D conducted offshore. It is simpler to maintain an exclusion for overseas expenditure than create an exemption to the exclusion when the expenditure is integral to product development. Some of this expenditure may also be excluded by another item; item 11, for example, excludes expenditure on activities involved in complying with statutory requirements or standards.

Recommendation

That the submission be declined.

Issue: Finance leases should not be excluded from the definition of "R&D expenditure"

Submission
(Deloitte)

Taxpayers who enter into operating leases will have an advantage over taxpayers who enter into finance leases. This difference should be removed so that all leases are treated equally as R&D expenditure.

Comment

Finance leases more closely resemble debt instruments, such as a loan, than an ordinary lease. The proposed rules do not allow interest deductions to be cashed out as these are funding costs, rather than R&D costs. This includes the interest component of finance leases. The tax treatment is therefore the same regardless of whether a finance or operating lease is used.

Recommendation

That the submission be declined.

Issue: The definition of "R&D expenditure" should include capitalised expenditure

Submission
(KPMG)

Eligible "R&D expenditure", as defined in section YA 1, excludes expenditure for which no deduction is available. This means that any "R&D expenditure" must be directly deductible. Capital expenditure will be excluded despite the company incurring real costs – for example, salary and wage expenditure. The intent behind this exclusion of capital expenditure should be clarified.

Comment

The intention is to cash out R&D tax losses that arise from expenditure on R&D. Capital expenditure does not generate losses, and therefore is excluded from the definition of "R&D expenditure". This ensures that the amount calculated for the cash-out using "R&D expenditure" in proposed section MX 4(1)(h) does not include capital expenditure.

To clarify a further issue, it is possible that "total R&D labour expenditure", used to calculate the tax credit amount in proposed section MX 4(1)(i), could include capital expenditure.[1] If this occurs, we expect that the amount calculated in section MX 4(1)(h) based on "R&D expenditure", which does not include capital expenditure, will be lower than the amount calculated in section MX 4(1)(i). Consequently, it is unlikely capital expenditure will not contribute to the tax credit.

We do not wish to add further complexity to the definition of "total R&D labour expenditure" by requiring taxpayers to remove capital expenditure from the eligibility calculation when calculating the tax credit.

Recommendation

That the submission be declined.

Issue: Interactions with section EJ 23 (Deferred deductions arising from expenditure on R&D)

Submission
(Deloitte)

Section EJ 23 allows taxpayers to defer deductions until the taxpayer derives taxable income from the corresponding R&D. It is possible that the drafting of this section and the "R&D expenditure" definition could enable this deferred expenditure to be cashed out in an income year after the expenditure was incurred.

[1] This will likely take place when the asset recognition criteria in the relevant accounting standard (NZIAS 38) is met for the R&D asset.

Comment

This is not the policy intent. Only R&D expenditure incurred in that income year should be eligible for a tax credit. Officials will make the necessary changes to ensure that this situation cannot arise.

Recommendation

That the submission be accepted.

Issue: References to disestablished business R&D grants

Submission
(EY)

Section CX 47(4) references to "technology development grant" and "technology transfer voucher" should be removed or replaced by more appropriate descriptions of the current grants. These grants have special tax treatment because of a timing issue where the grant is derived in a later income year than that in which the related expenditure is incurred, and a deduction is denied by section DF 1 (this matches the treatment of government grants as excluded income). This situation could arise in any situation, not just for business R&D. Consequently, references to the superseded grants should be removed. If it must be retained, the terminology should be updated to reflect the current grants that the section should apply to.

Comment

The reference to this section will be removed from the definition of "R&D expenditure". The taxpayer's treatment of the government grant as either "excluded income" under section CX 47 or "income" will provide the correct result for the purposes of the R&D tax loss credit.

Officials will look to update section CX 47(4) when possible.

Recommendation

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

REINSTATEMENT OF LOSSES

Clauses 99, 117, 192, 194, 195 and 213

Issue: Cashed-out loss should only be repaid to the extent a profit is made on the deemed sale of R&D assets when a loss of eligibility or liquidation occurs

Submission
(Chartered Accountants Australia and New Zealand)

The calculation of R&D repayment tax proposed to apply in cases of loss of eligibility and liquidation should be amended so that it is the lesser of the tax credits received minus income tax paid and earlier payments of R&D repayment tax, and the profit on the deemed sale at market value of the intellectual property.

Comment

This measure is to protect the integrity of the new rules by ensuring that companies cannot liquidate or migrate to an overseas jurisdiction without paying back the tax credit balance. As either event will likely mean the entity will no longer have tax liabilities in New Zealand, it is appropriate to require the tax credit balance to be repaid.

Recommendation

That the submission be declined.

Issue: R&D repayment tax should not exceed the market value of the shares sold

Submission
(Matter raised by officials)

The calculation of R&D repayment tax proposed to apply upon the sale of more than 90 percent of the company as set out in proposed section MX 6(4) should be amended so that it is the lesser of the tax credits received minus income tax paid and earlier payments of R&D repayment tax, and the market value of the sale of the shares in the company.

Comment

This change ensures that taxpayers who sell the company for less than the tax credit balance are not liable to pay back the entire amount, as they are unlikely to be in a position to do so. If the tax credit balance is not fully paid off, it will remain attached to the company. The new shareholders will remain liable to repay this amount.

Recommendation

That the submission be accepted.

Issue: Imposing repayment tax on liquidation of the company may not be appropriate in all cases

Submission
(Chartered Accountants Australia and New Zealand, EY)

Imposing R&D repayment tax in all cases of liquidation may not be appropriate. A company which fails and liquidates its assets may have no value, meaning that the R&D repayment tax is unlikely to be recoverable. When companies are liquidated because they cannot meet their debts and continue trading, the proposed R&D repayment tax will increase the amount of outstanding debt. It is assumed that the Commissioner of Inland Revenue would rank with other unsecured creditors in respect of R&D repayment tax debt claim, but this should be clarified.

Comment

We have anticipated that a number of R&D companies will be liquidated because they cannot meet their debts. The Commissioner of Inland Revenue will be an unsecured creditor. The unrecoverable nature of much of this debt is included in the estimated fiscal cost of the policy. However, requiring R&D repayment tax on liquidation remains an important integrity measure because companies may liquidate for other reasons.

Recommendation

That the submission be declined.

Issue: Amalgamating companies should not impose repayment

Submission
(Chartered Accountants Australia and New Zealand, Deloitte, EY)

A company that has cashed out losses previously should not be required to repay them because it has amalgamated with another company (especially when the company continues as the amalgamated company). The company may be constrained by the same cashflow constraints and market failures before amalgamation.

One submitter proposed allowing amalgamations between related parties or at least within a wholly owned group of companies. Others proposed allowing amalgamations between all companies.

Comment

An amalgamation would trigger R&D repayment tax as this is an event that would otherwise transfer repayment obligations from the amalgamating company(ies) to the amalgamated company, creating a risk of greater non-compliance. As noted above, amalgamation does not necessarily reduce cashflow constraints and market failures faced by the company.

We are prepared to relax this requirement to allow amalgamations to proceed without requiring the tax credit balance to be repaid. The amalgamated company will take on any liability to pay R&D repayment tax of the amalgamating companies. Any deemed disposals of property owned by the amalgamating companies that occur when an amalgamation takes place should not apply for the purposes of subpart MX, so as not to trigger R&D repayment tax.

Recommendation

That the submission be accepted.

Issue: Clarify when a company is an "amalgamating company"

Submission
(Chartered Accountants Australia and New Zealand, EY)

Amalgamations can take some time to complete, and may cover multiple income years. It should be clarified when the company is an "amalgamating company".

Comment

Officials recommend removing the requirement to pay R&D repayment tax when a company amalgamates. There is no need to clarify this issue further.

Recommendation

That the submission be declined.

Issue: Repayment should not take place when the business continues after the R&D asset is sold (disposed of)

Submission
(KPMG)

When the business continues after the R&D asset is sold, the R&D repayment tax rule should not apply.

Comment

It would be too difficult for Inland Revenue to ensure taxpayers continued to meet a business continuity test. There are also questions surrounding its design. For example, how long would the business have to continue for?

Requiring the tax credit balance to be repaid on disposal of an R&D asset fits with the policy intent as these taxpayers are in a position to repay the amount when a return on the investment has been made. It is also an important integrity measure. We note that taxpayers are not required to pay back the full tax credit balance when an asset is sold; they are only required to pay back the market value of the asset (if this is less than the tax credit balance).

Recommendation

That the submission be declined.

Issue: Loss repayment penalises successful companies

Submission
(PwC)

While appreciating that the aim of the initiative is to be as fiscally neutral as possible, requiring the tax credit balance to be repaid by successful companies will penalise the small group of successful companies. They will still be in a high-growth mode and require cash to grow further.

This requirement does not align with R&D schemes in similar jurisdictions such as Australia and the United Kingdom.

Comment

The initiative intends to provide a timing benefit to the company with regard to the use of its tax losses, where the Government assumes the risk of an amount of those tax losses (arising from R&D expenditure) instead of the company. It is not an R&D subsidy like those in Australia or the UK, hence the requirement to return the cashed-out loss amount when a company is in a position to do so after making a return on its investment.

Recommendation

That the submission be declined.

Issue: It is not clear what the R&D repayment tax obligations are for a company that elects to become a look-through company

Submission
(New Zealand Law Society)

Section MX 6(1), which details when taxpayers will be liable to pay R&D repayment tax, does not address the consequences of a taxpayer becoming a look-through company.

Comment

Look-through companies (LTCs) are not considered a "company" for the purposes of the tax credit. This means that the entity will fail to meet the eligibility requirement in section MX 2(a) and will therefore be required to pay R&D repayment tax. This will make transitioning to an LTC unattractive for companies that have accessed a cashed-out loss. However, losses carried forward by a company before becoming a look-through company are extinguished also. As we expect these companies to also have losses carried forward because not all losses can be cashed out, it is unlikely these companies would elect into the LTC rules anyway.

Recommendation

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

Issue: Imposing repayment tax on the sale of an R&D asset developed before the 2015–16 income year is not appropriate

Submission
(New Zealand Law Society)

The commentary on the bill states that the tax credit balance should be repaid when the company makes a return on their investment. This seems to presuppose that the intangible asset sold was created by R&D expenditure for which a cashed-out loss was received.

It is possible that the intangible sold was the product of R&D done before the 2015–16 tax year. In this situation, it is not appropriate that the cashed-out loss amount is repaid.

Comment

It is not practical to allocate the credit to a particular R&D activity. For example, a tax credit may be allocated to a newer project but it will permit the business to spend more of its own money on an older project. When the business makes a return on its investment, it is in a position to repay the tax credit balance, even if that R&D was not directly funded by the tax credit.

Recommendation

That the submission be declined.

Issue: Inconsistency between use of the term "intangibles' market value" for cashing out R&D tax losses and black hole expenditure

Submission
(New Zealand Law Society)

The term "intangibles' market value" is used (and defined) in determining the amount to be repaid when a company sells an R&D asset. There is an inconsistency between this approach and the "consideration" approach in proposed section CG 7C upon the disposal of a depreciable intangible asset that has been written off.

Comment

Valuing the asset through a market value measure ensures that if the asset is disposed of for less than its market value – for example, in a transaction between associated parties, the amount of R&D repayment tax is not reduced.

The consideration approach used in proposed section CG 7C is to provide consistency with similar sections, such as section CG 7B.

Recommendation

That the submission be noted.

Issue: Repayment could be triggered by death or relationship property transfers

Submission
(EY)

It is not clear how existing provisions governing property transfers arising from matrimonial relationship changes or death would apply. These could affect SMEs particularly by requiring payment of the R&D repayment tax through an effective sale of the company when no return has been made.

Relationships between business investors and family groups can also break down, which could also require repayment. These changes are not likely to affect the company's activities or ability to raise funds, and should not require repayment.

These issues could be addressed by excluding associated person ownership changes, possibly limited to closely held company situations, from being counted towards or resulting in loss reinstatement.

Comment

Changes will be made to prevent repayment obligations arising when a relationship property transfer or death would otherwise require payment of the R&D repayment tax. We do not propose excluding the situation when a relationship breakdown takes place between business investors as there are no precedents within the Act for relieving tax obligations in these cases.

Recommendation

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

Issue: Clarify amount of repayment required when intellectual property is disposed of

Submission
(Chartered Accountants Australia and New Zealand)

The policy intent of proposed section MX 6(1)(a)(i) is unclear and the subsection needs to be redrafted to make it clear how much intangible property, core technology, intellectual property or know-how a company needs to dispose of before it must repay its cashed-out losses. Current drafting suggests that if a company were to dispose of any R&D assets the tax credit balance must be repaid, even if this is a very small amount. This seems neither sensible nor equitable.

Comment

When a small amount of any R&D assets is sold, this will not require repayment of the entire amount of the cashed-out loss. Twenty-eight percent (or the company tax rate fraction) of the market value of the asset that has been disposed of will be paid as R&D repayment tax if this amount is less than their tax credit balance.

Recommendation

That the submission be declined.

Issue: Change "before and including" to "up to and including"

Submission
(New Zealand Law Society)

"Before or including" is used in section MX 6(2)(a)(i) and (ii). It is not used elsewhere in the Income Tax Act with a similar effect. It should be changed to "up to and including".

Comment

Officials agree that changes to this effect should be made.

Recommendation

That the submission be accepted.

Issue: Clarify when a company is "put into liquidation"

Submission
(Chartered Accountants Australia and New Zealand, EY)

Liquidation is a process that can take some time to complete. It should be clarified when liquidation takes place.

Comment

Officials agree that more clarity should be provided. Liquidation, for the purposes of part MX, takes place on the appointment of a liquidator.

Recommendation

That the submission be accepted.

Issue: Clarify treatment of the loss reinstatement deduction under proposed section DV 26

Submission
(Deloitte, EY)

The loss reinstatement deduction should be redrafted as a stand-alone provision. The existing drafting which refers to other sections creates uncertainty and circularity.

Comment

The submitters have suggested a much simpler and more practical way to draft the provision. It would be sensible to allocate the deduction to the income year in which the R&D repayment tax is repaid. This would prevent circularity where the loss reinstatement deduction could reduce the liability arising from the R&D repayment tax, and provide a more certain approach for taxpayers to take.

Accordingly, the incorporation of section EJ 23 will be removed. Losses arising under this section will be forfeited if shareholder continuity is breached but it prevents having to substantively redraft section EJ 23 to fit the circumstances of loss reinstatement. It is also possible R&D repayment tax may arise because a 90 percent or greater change in shareholder continuity has occurred; in this case, the deduction will arise after the shareholder continuity breach has taken place so will not be forfeited under the existing shareholder continuity rules.

Recommendation

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

Issue: What amounts should be treated as "income tax paid"

Submission
(EY)

The meaning of the term "income tax paid" requires clarification. Should the focus be on payments of income tax made or the annual income tax impost for each income year in the relevant period? How should tax paid, transferred or purchased through the pooling system be treated?

"Paid" suggests the amount is limited to amounts of tax payments paid or credited. If this is the case, it should be clarified whether this includes payments or deductions on account: for example, by way of provisional tax instalments or source deductions such as resident withholding tax on interest. Amounts paid or transferred through the tax pooling system should also be clarified.

"Income tax" refers to the income tax imposed for income years comprising the relevant period. Some of these amounts may not be due until after the time of calculation of R&D repayment tax.

Should any tax credits be taken into account for section MX 6 purposes? Calculations of income tax take place without deducting any tax credits arising, for example, by way of foreign tax credits or imputation credits attached to dividends received.

Comment

Officials will make the necessary changes to ensure it is the annual income tax impost for the relevant period. This will enable taxpayers to reduce their current balance of R&D tax loss credits by any tax paid, or due to be paid, before calculating the R&D repayment tax amount. Foreign tax credits will be excluded as they do not generate an imputation tax credit but other tax credits that give rise to an imputation credit will be included in the calculation. As this information also has to be collected for imputation purposes, this approach is practical.[2]

Recommendation

That the submission be accepted.

Issue: Imputation debit adjustment

Submission
(Matter raised by officials)

As worded, proposed section OB 47B only creates an imputation debit in years in which a company has a tax credit. It should instead apply to all periods for a company that has had a tax credit in the current year or previous years.

[2] No credit balance will arise in the imputation credit account of a company that has a tax credit balance remaining until that company has repaid the tax credit balance in full. This is to maintain neutrality with taxpayers who are not able to cash out losses.

Comment

This should be corrected so that companies do not have a credit balance in their imputation credit account until they have repaid their tax credit balance.

Recommendation

That the submission be accepted.

ADMINISTRATION

Clauses 180, 181, 187, 230 and 238

Issue: Information sharing with Callaghan Innovation and MBIE

Submission
(Matter raised by officials)

Inland Revenue proposes sharing taxpayer information under a specific exception in section 81(4) of the Tax Administration Act 1994 for the purposes of:

- referring difficult or marginal decisions on the R&D eligibility of applicants to Callaghan Innovation for advice;
- making use of an existing ICT system owned by MBIE to implement and administer the initiative (rather than develop or adapt an Inland Revenue system); and
- enabling Ministry of Business, Innovation and Employment (MBIE) policy officials to have access to taxpayer information for policy research, development and evaluation purposes.

Comment

The information sharing proposed is of a limited nature and involves only the sharing of company information rather than individual data. This work is a joint initiative between Inland Revenue and MBIE; joint initiatives involving Inland Revenue require transparent information-sharing provisions because of the strict taxpayer secrecy rules in section 81 of the Tax Administration Act 1994. The proposed information-sharing makes use of existing skills and IT infrastructure within Callaghan Innovation and MBIE respectively.

Inland Revenue will use Callaghan Innovation expertise to help build capability to assess R&D expenditure and eligibility. Part of this arrangement includes being able to refer particularly difficult or marginal applications to the Callaghan Innovation Grants group to provide support for Inland Revenue's decision-making on R&D eligibility.

MBIE owns the ICT system that administers the business R&D grants programme. Inland Revenue's ICT systems are highly constrained, and making use of MBIE's existing system is efficient from a customer and cross-agency perspective.

This initiative is the joint responsibility of Inland Revenue and MBIE. It is reasonable for policy officials from MBIE to have access to taxpayer information for policy research, development and evaluation purposes.

Recommendation

That the submission be accepted.

Issue: Statements accompanying the income tax return should be filed with the income tax return

Submission
(Matter raised by officials)

Proposed section 70C(2) of the Tax Administration Act 1994 requires taxpayers to file their statement detailing the tax credit amount they are claiming and any R&D repayment tax (R&D statement) they must pay within 14 days after filing their return of income.

Inland Revenue proposes removing this 14-day period. Instead, it will require taxpayers to file the R&D statement at the same time they file their return of income. This change is recommended after consultation with operational areas of Inland Revenue.

Comment

Removing the 14-day period would prevent the creation of a new due date, while the taxpayer should already have all the relevant information necessary at the time they file a return of income. Having two different due dates increases the risk of the taxpayer neglecting to file the required information.

Recommendation

That the submission be accepted.

Issue: Required statements on R&D information should be simple

Submission
(Deloitte)

Under the previous R&D tax credit regime, statements detailing R&D activities could exceed 20 pages, a significant compliance cost to taxpayers. It was possible that the compliance costs of preparing the information could outweigh the benefit of the tax credit. Consequently, the statements required should be as simple as possible. Statements exceeding four pages would impose significant compliance costs that could outweigh the benefits.

Comment

Officials agree that the statements should be kept as simple as possible and taxpayers will be encouraged to be concise. However, the benefits are significant, with tax credits of up to $140,000 in the first year rising to $560,000 in five years, and ultimately the onus rests on taxpayers to demonstrate that their activity is eligible R&D. We would expect the compliance costs to reduce in subsequent years as taxpayers become more familiar with the statements, especially for taxpayers who cash out losses over a number of years.

Recommendation

That the submission be noted.

Issue: Taxpayers should be able to manually file a separate statement with an income tax return

Submission
(Deloitte)

In practice there are a number of other forms or elections that are required to be filed with an income tax return. It would be appropriate to allow taxpayers to manually file a statement for tax credit and R&D repayment tax purposes with their manually filed income tax return as an appropriate alternative to electronic filing.

Comment

Inland Revenue accepts that taxpayers may have important reasons for filing an income tax return manually, and that requiring taxpayers to file electronically may inconvenience some taxpayers. Manually filed returns of income will be permitted.

The requirement to file the accompanying statement for tax credit and R&D repayment purposes by electronic means will remain in order to employ existing ICT infrastructure owned by the Ministry of Business, Innovation and Employment in the administration of the initiative. Taxpayers will be permitted to manually file the accompanying statement in exceptional circumstances at the Commissioner's discretion.

Recommendation

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

Issue: Delays in releasing cash-outs should be mitigated

Submission
(KPMG)

Administration of the regime should reflect the fact that a key objective is to ease cashflow constraints on innovative start-ups. Delays in processing and releasing the tax credit should be mitigated wherever possible. Administration of the proposal should not be based on the previous R&D tax credit regime.

Comment

Inland Revenue will endeavour to release tax credits as quickly as possible while taking the necessary steps to ensure the taxpayer meets the criteria for the tax credit.

Recommendation

That the submission be noted.

Issue: A communications strategy to educate taxpayers is necessary

Submission
(PwC)

It is important that taxpayers are sufficiently educated in order to be able to apply the rules and provide the necessary information required. They will be reliant on guidance provided by Inland Revenue. Inland Revenue should put in communication strategies to ensure taxpayers are adequately equipped to apply the new rules.

Comment

Inland Revenue is preparing a communication strategy as part of the initiative's implementation.

Recommendation

That the submission be noted.

Issue: Uncertainty around the administration process in the first year – extension of time to file

Submission
(Matter raised by officials and the Independent Advisor to the Select Committee)

The retrospective application of this proposed legislation will make it more difficult for taxpayers to comply in the first year of the policy compared with other years. The administration process cannot be established and communicated with certainty until the proposed legislation is enacted.

Comment

In recognition of this, the Commissioner will allow taxpayers without tax agents to extend the time to file their return (and accompanying statement) for the 2015–16 income year until 31 March 2017. This will allow taxpayers further time to prepare their return if required. Taxpayers must still apply to the Commissioner for this extension of time.

After discussing this issue with the Select Committee's independent advisor, an extension of time to file will be granted when taxpayers have reasonable grounds to believe that an application for the tax credit will be made.

Taxpayers will still be able to apply for extensions of time to file after the 2015–16 income year, but intention to apply for the tax credit will no longer be sufficient to obtain the extension of time to file.

Recommendation

That the submission be accepted.

Issue: Better communicating other types of government R&D assistance

Submission
(KPMG)

The 20 percent R&D wage intensity test means the proposal will be of limited value to most medium and large businesses. However they may qualify for other assistance. Much of this is outside the tax system.

There is a role for the Government and its agencies in better communicating and socialising the available R&D assistance with the business community and advisors.

Comment

The Government has a broad suite of measures to support business innovation and R&D. Most of these programmes are delivered by Callaghan Innovation and are outlined on their website, and are promoted through publications such as their Accelerate newsletter, the Business Growth Agenda publications the National Statement of Science Investments and media articles. A summary of some of the main programmes is provided below.

Callaghan Innovation's R&D Grants Programme provides three different types of grants which are designed to increase the amount of private sector R&D activity occurring in New Zealand, and incentivise New Zealand companies to spend more on R&D. The three types of grants are:

R&D Growth Grants (about $122m per year):

- provide a long-term and certain incentive for larger R&D performers to expand their R&D programmes;
- the public co-funding rate is 20 percent of the New Zealand company's qualifying R&D, capped at $5m per year.

R&D Project Grants (about $36m per year):

- targeted at firms with smaller R&D programmes and those that are new to R&D;
- are allocated for specific R&D projects which are beyond the firm's normal R&D programme;
- fund up to 40 percent of the research project.

R&D Student Grants (about $4m per year):

- provide opportunities for students and recent graduates to work within R&D active firms.

R&D Growth Grants are non-discretionary and are automatically allocated to business applicants that meet the published criteria. These include the requirement to spend at least $300,000 annually and 1.5 percent of revenue on R&D in New Zealand for at least two years.

R&D Project Grants and R&D Student Grants are awarded to applicants following an independent assessment from Callaghan Innovation's Grants Committee.

All companies receiving R&D grant funding must conduct their research in New Zealand. Claw-back provisions can require firms to pay back their grants if they cease to meet their research commitments.

Callaghan Innovation also backs innovative start-ups by providing funding for company accelerator and incubator programmes:

- There are five founder-focused incubators spread across the country that work with entrepreneurs to develop their business ideas.
- These were recently joined by three technology-focused incubators. These incubators identify a suitable intellectual property-based idea or technology and then work to build a business team around the IP. Repayable grants of up to $450,000 are available for businesses that are incubated by a technology incubator.
- The accelerator programme run by Lightning Lab works with digital and ICT entrepreneurs to develop their ideas over 12 weeks into an investment pitch.

Other key parts of Callaghan Innovation's work are linking businesses with public and private-sector research experts (through National Technology Networks, Global Expert and Student R&D Grants) and providing specialist research and technical services to firms.

The Ministry for Primary industries provides funding of around $65 million a year for Primary Growth Partnerships to drive substantial economic growth in the primary and food sectors, through joint investment by government and the industry. These partnerships require at least 50 percent industry co-funding and are aimed at market-driven innovations, including R&D, and encourage collaboration and connections between research organisations and business.

Recommendation

That the submission be noted.

Issue: Self-assessment

Submission
(PwC)

Will the application of the rules be based fully on self-assessment?

Comment

To a significant extent, yes. Inland Revenue is likely to pay particular attention to the R&D activity or activities of the taxpayer in order to support compliance.

Recommendation

That the submission be noted.

Issue: Pre-approval process relating to R&D eligibility

Submission
(PwC)

Will there be an initial approval process or "certification" as an R&D company?

Comment

Taxpayers will be required to register for the initiative but no pre-approval of the taxpayer's R&D activity will take place.

Recommendation

That the submission be noted.

Issue: To what degree will Inland Revenue officials have the capability to make informed decisions on R&D eligibility?

Submission
(PwC)

To what degree will Inland Revenue officials have the capability to make informed decisions on R&D eligibility?

Comment

Callaghan Innovation has agreed to provide investment managers to support Inland Revenue officials with making judgements on R&D eligibility in the early years of the tax credit while Inland Revenue develops capability in this area. Callaghan Innovation investment managers have experience in adjudicating on R&D eligibility for the Government's Business R&D grants programme. This will enable consistent decision-making across government in relation to R&D eligibility.

Recommendation

That the submission be noted.

UNINTENDED DRAFTING ERRORS

Submission
(Matter raised by officials)

There are two unintended errors in the drafting. These are:

- proposed section MX 1(e) reads "the person has R&D expenditure relating to research or development", which should read "the person has R&D expenditure"; and
- the proposed definition of "intellectual property" in section YA 1 mentions "Part 11" rather than "Part II".

Comment

These should be corrected.

Recommendation

That the submission be accepted.

Black hole expenditure

RESEARCH AND DEVELOPMENT EXPENDITURE ON DERECOGNISED NON-DEPRECIABLE ASSETS

Clause 85

Issue: Support for the proposals

Submission
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY, KPMG, PwC)

Five submitters expressed their general support for the proposals.

We welcome the extension of the scope of the proposals from the original proposals consulted on in a Government discussion document, such that it is now proposed to allow tax deductibility for both successful and unsuccessful capitalised development expenditure towards intangible assets that are not depreciable for tax purposes (that is, not listed in schedule 14 of the Income Tax Act 2007). This extension of the scope of the proposed reforms should further assist in reducing distortions against investment in R&D caused by the current rules. *(Chartered Accountants Australia and New Zealand)*

We are pleased that officials have acted on submissions made in response to the original proposals consulted on. *(PwC)*

Comment

Officials note the general support for the proposed amendments.

Recommendation

That the submissions be noted.

Issue: Deductibility of impaired capitalised development costs

Submission
(Chartered Accountants Australia and New Zealand, EY)

It needs to be made clear that, when an asset has been impaired for accounting purposes and its carrying value is reduced by that impairment, the amount available to be deducted for income tax purposes upon derecognition of the asset for accounting purposes is the capitalised amount and not the book value of the asset net of impairments. *(Chartered Accountants Australia and New Zealand)*

Deductions should also be allowed for impairment expenses, preferably in the years they occur for financial reporting purposes or, alternatively, a deduction should be allowed for any such amounts in the year of final derecognition or write off (other than on disposal). *(EY)*

Comment

The policy intent is that upon derecognition (other than on disposal) of an intangible asset for accounting purposes, the amount that the taxpayer may deduct is the full amount of capitalised development expenditure they incurred, and not merely the book value of the asset net of impairments.

It is officials' view that, as drafted, the proposed legislation achieves the policy intent. Existing section DB 34(1) of the Income Tax Act 2007 allows a taxpayer a deduction for expenditure they incur on research or development, if various circumstances described in any of subsections (2) to (5) are applicable to the taxpayer, and provided that the expenditure is not excluded by subsection (6). As a "trigger" for a deduction under proposed new section DB 34(3), the proposed legislation refers to derecognition (using the terminology of the new reporting standard) or write off (using the terminology of the old reporting standard) of an intangible asset for financial reporting purposes.

The amount available to be deducted under proposed new section DB 34(3) is further qualified to expenditure incurred on or after 7 November 2013 and before the occurrence of the "trigger" event. Aside from this qualification on when the expenditure must have been incurred, proposed new section DB 34(3) does not impose any restriction on the amount of expenditure able to be deducted under it. Therefore, the full amount of expenditure incurred within this time period will be able to be deducted under proposed new section DB 34(3), provided that section DB 34(1) is satisfied (that is, it is expenditure the taxpayer has incurred on research or development and it is not expenditure that is excluded by section DB 34(6)), and the taxpayer has not already deducted the expenditure (for instance, under section DB 34(2) for research or development expenditure incurred prior to asset recognition for financial reporting purposes).

For the purposes of the income tax legislation, it is irrelevant whether an asset has been impaired for financial reporting purposes and its carrying value reduced by that impairment. Therefore, officials do not consider that legislative clarification is required.

Officials do not consider that deductions should be allowed for impairment losses in the years that they occur for financial reporting purposes. The income tax legislation has its own tax depreciation framework that is separate from the accounting treatment. Because of the impact on tax revenue raised that tax depreciation deductions can have, officials consider that there is good reason for the tax system to have its own depreciation rules, and not merely follow the accounting treatment, which may not necessarily approximate true economic depreciation.

While officials support the use of derecognition for accounting purposes as the trigger for a tax deduction for capitalised expenditure in the specific instance of R&D-generated non-depreciable intangible assets, allowing tax depreciation to mirror the accounting treatment in the case of these assets would be inconsistent with the tax depreciation treatment of other assets under existing policy settings. Officials do not consider such an inconsistency to be justified.

Recommendation

That Chartered Accountants Australia and New Zealand's submission be declined.

That EY's submission as to their first preference be declined, and their submission as to their second preference be noted, together with officials' comments.

Issue: Clarification of whether expenditure incurred when R&D "work in progress" is purchased is able to be deducted

Submission

(Corporate Taxpayers Group, EY)

It appears that the amended section DB 34 will apply to unsuccessful R&D that has been acquired from a third party. For example, this can occur when Business A has incurred expenditure developing an intangible asset but ultimately decides that, due to the direction of its business, it does not require that asset. It therefore sells the "work in progress" to Business B, who intends to continue the R&D and complete the asset. However, after some initial work, Business B abandons the project. Alternatively, Business B could complete the asset but later derecognise it for accounting purposes. We would appreciate that officials confirm, in a subsequent commentary, that it is intended that Business B receives a tax deduction for the value of the unsuccessful R&D under the proposed amendment to section DB 34. *(Corporate Taxpayers Group)*

It does not seem clear whether or not proposed new section DB 34(3) would allow a deduction upon derecognition or write off of purchased non-depreciable intangible assets. The position should be clarified, and if the deduction is intended to be limited to expenditure incurred on a taxpayer's own R&D work, it may be preferable, for instance, to refer to "capitalised development [or R&D] expenditure", rather than to "expenditure… on an intangible asset". *(EY)*

Comment

The policy intent is that only expenditure incurred by a business in carrying out R&D is deductible under proposed new section DB 34(3). It is not intended that expenditure on purchasing non-depreciable intangible assets is deductible to the purchasing business upon derecognition for accounting purposes. In the absence of a capital gains tax applying to the sale of an asset, allowing the purchaser a deduction for the purchase cost upon derecognition of the asset for accounting purposes would be an asymmetrical tax treatment, and would pose a significant risk to the revenue base. It is intended that a purchaser of a non-depreciable intangible asset is able to receive a deduction upon derecognition of the intangible asset for any development expenditure they incurred on further developing the asset after purchasing it.

For example, assume Business A has carried out some R&D and recognised an intangible asset for accounting purposes. Assume Business A has incurred $200,000 in capitalised development expenditure further developing the asset subsequent to recognising the asset for accounting purposes. Assume the intangible asset is not depreciable for tax purposes as it is not listed in schedule 14 of the Income Tax Act 2007. Now assume Business A sells the incomplete intangible asset to Business B (which intends to continue the R&D and complete the asset) for $10 million. Business A has made an untaxed capital gain of $9.8 million. Assume Business B incurs $300,000 in capitalised development expenditure further developing the asset before abandoning the project and derecognising the asset. It is intended that Business B is able to receive a deduction under proposed new section DB 34(3) for the $300,000 they incurred in capitalised development expenditure. It is not intended that Business B is able to receive a deduction for the $10 million cost of purchasing the asset from Business A.

Officials' view is that, as drafted, the proposed legislation is consistent with this policy intent. However, there may be some room to improve drafting clarity, and we will refer it to drafters.

Recommendation

That Corporate Taxpayer Group's submission be declined.

That EY's submission be accepted, and that the drafting be revisited with a view to refining it, in accordance with the policy intent.

Issue: Legislation should cover taxpayers not required to prepare general purpose financial statements

Submission
(EY)

Many taxpayers are no longer required to prepare formal general purpose financial reports, by virtue of the provisions of the Financial Reporting Act 2013. Technically, neither the old nor the new reporting standards referred to in section DB 34 will apply to them.

In principle, these taxpayers should be able to take advantage of the proposed deduction, just as much as those who are preparing formal general purpose financial reports and clearly applying the old or new reporting standards in doing so.

It should be clarified that taxpayers who are not required to, and who choose not to, prepare such statements may also claim deductions for capitalised development expenditure when it is written off in some manner.

Comment

The new reduced minimum financial reporting requirements under the Tax Administration Act 1994 that apply to many businesses are *minimum* requirements. Businesses subject to these minimum requirements can choose to comply with a higher level of accounting standard in relation to R&D, so are able to receive the deductions in this way. We note that compliance with a higher level of accounting standard than the new minimum requirements is generally required to receive tax deductibility for any R&D expenditure under the existing section DB 34 of the Income Tax Act 2007, so this is not exclusive to the proposed allowance of deductibility for capitalised development expenditure under proposed new section DB 34(3).

Because the aim of R&D is to create an asset, it is arguable from an economic perspective that all R&D expenditure should be capitalised. However, the tax rules follow the treatment for accounting purposes in allowing immediate deductibility for R&D expenditure up until the point that an intangible asset is recognised under the relevant accounting standard. This is arguably a concessionary tax treatment, but reflects the fact that the success of investment in R&D in resulting in a valuable asset is particularly uncertain, and the perceived desirability of investment in R&D. It would be inappropriate, from an economic perspective, to allow immediate deductibility for R&D expenditure incurred subsequent to the recognition of an intangible asset under the relevant accounting standard because the rules in the accounting standards are conservative about the recognition of an intangible asset and require a high degree of confidence that a valuable asset has been created.

Since it is not appropriate for all R&D expenditure to be immediately tax deductible, there should be a certain degree of rigour applied to the question of which R&D expenditure can be immediately deducted and which R&D expenditure should be capitalised. Adherence to the accounting standards referred to in section DB 34 provides a sufficient degree of rigour. Therefore, officials' view is that taxpayers that wish to receive deductions for R&D expenditure should have to adhere to one of these accounting standards. While this will mean higher compliance costs than businesses will incur under the new minimum requirements, businesses would only incur these additional costs if they considered the benefit to them of the allowance of deductions for R&D expenditure outweighed these compliance costs.

It might be argued that businesses applying the new minimum financial reporting requirements should at least be able to receive a deduction for their R&D expenditure if the R&D undertaken is no longer of any value. However, since these businesses would never apply a test for intangible asset derecognition like those that adhere to the higher accounting standards, there would be no means of determining that their expenditure is of no on-going value, such that a tax deduction would, in principle, be warranted.

Recommendation

That the submission be declined.

CLAW-BACK FOR DERECOGNISED NON-DEPRECIABLE ASSETS

Clause 73

Submission
(Chartered Accountants Australia and New Zealand, EY)

A deduction taken for capitalised development expenditure on a derecognised non-depreciable intangible asset should not be clawed back, as income, if the intangible asset becomes "available for use". If a company's auditors have determined that an asset must be written off for financial reporting purposes that should be sufficient and the deduction should not be clawed back if the asset is "available for use", which is a very subjective test. *(Chartered Accountants Australia and New Zealand)*

Proposed paragraph (b) of new section CG 7C(1) should be deleted. That is, there should be no claw-back where a derecognised non-depreciable intangible asset is subsequently used or becomes available for use. We acknowledge the policy objective of including such claw-back provisions as an integrity measure and the general similarity of the proposed new section CG 7C to the existing section CG 7B, but consider that proposed paragraph (b) of new section CG 7C(1) is expressed too broadly and could render the proposed extended deductibility of R&D expenditure meaningless in some cases. *(EY)*

Comment

Upon further consideration, officials agree that clawing back deductions if a derecognised intangible asset subsequently becomes "available for use" may not be workable in the case of intangible assets as, so long as the taxpayer retained relevant records and/or personnel, the asset may be regarded as "available for use". We accept that an "available for use" test is too subjective for intangible assets.

Officials acknowledge EY's argument that even a claw-back based on subsequent "use" may be problematic because arguably some intangible assets, such as know-how, can never be disposed of or discarded. As the submitter points out, an absence of expected future economic benefits from an asset's use or disposal (that is, the test for derecognition), may not preclude that know-how from informing subsequent R&D work. The know-how may thus be regarded as continuing to be "used" in any event, arguably meaning that taxpayers could effectively never receive deductions under proposed new section DB 34(3).

The claw-back upon subsequent "use" was not intended to apply in such circumstances. Rather, it was intended to apply when a previously derecognised intangible asset becomes substantively useful again. For example, if an intangible asset had been derecognised because it became apparent that the market it was believed existed for the technology developed did not actually exist but then, several years later, the market conditions changed and there was a market for the technology. In these sorts of situations, officials consider that a claw-back is appropriate and an important integrity measure.

However, in light of the concerns raised about the "use" test, officials consider that it is preferable that a clearer test is used as a proxy for "use". Officials consider that reinstatement for financial reporting purposes of the previously derecognised intangible asset would be a more appropriate trigger for a claw-back of a deduction.

Recommendation

That Chartered Accountants Australia and New Zealand's submission be accepted.

That EY's submission be accepted, subject to officials' comments, and that the drafting be amended accordingly.

NEW DEPRECIABLE INTANGIBLE ASSETS

Clauses 72, 87, 104, 107, 111 to 116, 213(2), (9), (10) and (12), and 216

Issue: Support for the proposals

Submission
(Corporate Taxpayers Group, EY, KPMG)

Three submitters expressed their overall support for the proposals to make the following intangible assets depreciable: design registrations, applications for the registration of a design, and copyright in an artistic work that has been applied industrially.

Comment

Officials note the general support for the proposed amendments.

Recommendation

That the submissions be noted.

Issue: Expenditure that is eligible for depreciation

Submission
(Corporate Taxpayers Group)

The proposed reforms should allow for depreciation deductions for *all expenditure* (to the extent that it is not otherwise deductible) on intangible assets created on or after 7 November 2013, not merely *expenditure incurred* on these assets on or after 7 November 2013.

Comment

The date of 7 November 2013 was chosen as the boundary for eligible expenditure for all of the proposed black hole expenditure amendments in the bill that represent policy changes. It was the date of release of the Government discussion document, *Black hole R&D expenditure*, which contained the Government's initial proposals for providing tax deductibility for capitalised R&D expenditure and was chosen to avoid creating an undesirable incentive for businesses to defer their spending in anticipation of new tax rules. Allowing deductibility for expenditure incurred before this date would be giving windfall gains to businesses that made an economic decision to incur the expenditure under the expectation that it would not be tax deductible. It would also increase the fiscal cost of the proposed changes.

While the discussion document did not specifically propose making three new intangible assets depreciable, the proposed amendments are the result of submitters' feedback. Therefore, for consistency with the proposed black hole R&D expenditure amendments in the bill, officials consider that the eligibility of expenditure for depreciation as part of the costs of these new depreciable intangible assets should be based on the same boundary date. The proposed

addition of these intangible assets to the list of depreciable intangible assets in the Income Tax Act 2007 is not remedial in nature; rather, it represents a change in policy. Officials do not, therefore, consider that allowing additional historical expenditure to be depreciable is justified.

Recommendation

That the submission be declined.

Issue: Reference to Copyright Act 1994 in relation to the copyright in an artistic work that has been applied industrially

Submission
(EY)

We appreciate the policy desire to incorporate the criteria and definitions used in section 75 of the Copyright Act 1994 in relation to the copyright in an artistic work that has been applied industrially, but consider that the straight cross-reference may cause some confusion and uncertainty for users of the income tax legislation. For example, it is not clear when section 75 of the Copyright Act 1994 can be said to apply to a particular copyright. A defined standalone term may be preferable.

We assume that the legal life of the copyright in an artistic work that has been applied industrially is intended to equate to the 25 and 16–year periods running from the times artistic works are applied industrially, as defined in section 75(3) and (4) of the Copyright Act 1994, and should be triggered once any one or more of the paragraph (a) to (c) criteria in section 75(4) are met. In other words, the use of "or" in that provision should not be read as intending the alternatives to be "one only" qualifications for income tax purposes. Some clarification would be desirable.

Comment

Officials agree that the legislative clarity could be improved and, accordingly, recommend some drafting changes, including deleting the words "to which section 75 of the Copyright Act 1994 applies" and inserting a standalone definition into section YA 1 of the Income Tax Act 2007. Officials consider that the preferable drafting approach is for this definition to incorporate a cross-reference to section 75 of the Copyright Act 1994. Section 75 of the Copyright Act 1994 contains a definition of "applied industrially", exclusions of some specific types of artistic work, and time periods, in relation to specific types of artistic work, from industrial application before the special exception from copyright protection applies. The policy intent is that only the copyright in an artistic work that (i) has been "applied industrially" as defined in section 75 of the Copyright Act 1994, and (ii) is not one of the excluded artistic works in section 75 of the Copyright Act 1994, should be depreciable for income tax purposes. Furthermore, it is the policy intent that the legal life over which the copyright is to be depreciated for income tax purposes should reflect the time period, for the specific type of artistic work, running from the time the artistic work is applied industrially until such time as protection against infringement of the copyright in the artistic work is no longer available due to the operation of section 75 of the Copyright Act 1994. Officials consider that including a cross-reference to section 75 of the Copyright Act 1994 is desirable as it ensures that any changes to the relevant parts of that section, which it is the policy intent to mimic for income tax purposes, are incorporated automatically into income tax law.

Officials note that the submitter's assumption that the legal life, for tax depreciation purposes, of the copyright in an artistic work that has been applied industrially is intended to equate to the 25 or 16–year period (depending on the type of artistic work) running from the time that the artistic work is applied industrially, as defined in section 75 of the Copyright Act 1994, and should commence once any one or more of the paragraph (a) to (c) criteria in section 75(4) of the Copyright Act 1994 are met, is the correct interpretation of the policy intent.

Recommendation

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

DEPRECIABLE COSTS OF CERTAIN DEPRECIABLE INTANGIBLE ASSETS

Clauses 105, 106, 109 and 110

Issue: Support for the proposals

Submission
(KPMG)

We support the proposed amendments to include capitalised development expenditure relating to patents, patent applications and plant variety rights as part of the depreciable costs of these assets.

Comment

Officials note the submitter's support for the proposed amendments.

Recommendation

That the submission be noted.

Issue: Guidance on the meaning of specific words used

Submission
(PwC)

Proposed new section EE 18B of the Income Tax Act 2007 will enable taxpayers who have created an intangible asset that is depreciable for tax purposes to include capitalised expenditure that relates to the asset as part of the depreciable costs of the asset.

It would be helpful if officials provided some guidance on the meaning of "gives rise to, supports, or is an item in which the person holds, the amortising item" in proposed new section EE 18B(a). It would also be helpful if the guidance included some examples using some of the types of intangible property listed in schedule 14 of the Income Tax Act 2007.

Comment

These words describe the requisite relationship between an underlying item of (non-depreciable) intangible property and an item of depreciable intangible property for amounts of expenditure incurred by a taxpayer for the underlying item to be included in the depreciable cost base of the item of depreciable intangible property. Officials intend to provide some guidance on what is meant by these words, including examples, in a *Tax Information Bulletin* to be published following enactment.

Recommendation

That the submission be noted.

OTHER SUBMISSIONS

Issue: Further "black hole" expenditure issues

Submissions
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, KPMG)

While welcoming of the proposals in the bill to address certain types of black hole expenditure, there are still other areas of black hole expenditure that need to be addressed.

Consideration should be given to the development of a comprehensive solution to address black hole expenditure, such as a "catch-all" provision that provides tax deductibility for expenditure that is not otherwise deductible. *(Corporate Taxpayers Group, KPMG)*

There should be a broader review looking at all areas of black hole expenditure. *(Chartered Accountants Australia and New Zealand)*

Comment

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. Given policy resource and fiscal constraints, policy consideration of further areas of black hole expenditure must be weighed against other Government priorities when setting the tax policy work programme.

Officials do not support developing a comprehensive solution to black hole expenditure, such as the Australian approach of allowing all business expenditure that would otherwise be black hole expenditure to be deducted over five years. Under that approach, deductions would be given for expenditure towards creating assets that would not decline in value over time if they were successful, which would be an inappropriate outcome from an economic perspective. This would artificially incentivise investment in such assets, which would be inconsistent with the goal of encouraging productivity and growth. Furthermore, it would be fiscally expensive, and any time period chosen would be arbitrary. Moreover, Australia has a comprehensive capital gains tax, so providing tax deductibility for capital expenditure leads to fewer fiscal pressures.

Recommendation

That the submissions be declined.

Issue: Alternative approaches to the current tax depreciation framework should be explored

Submission
(KPMG)

The proposed allowance of a tax deduction for capitalised development expenditure on a non-depreciable intangible asset when the asset is derecognised allows no deductibility during the life of the asset. This is a consequence of the framework of New Zealand's tax depreciation rules, which allow depreciation only when an asset can be demonstrated to have a finite economic (or, in the case of intangibles, legal) life. Other countries have different approaches, which could be considered.

Comment

The policy framework underlying New Zealand's tax depreciation rules is that tax depreciation should approximate true economic depreciation, so that, as far as possible, tax does not distort investment decisions. As a general principle, expenditures that result in an asset of enduring value should not be deducted. The classic example is land.

The tax depreciation rules for intangible assets, however, differ in some notable respects from the rules for tangible assets.

The first is that intangible assets have to be expressly listed in schedule 14 of the Income Tax Act 2007 for them to be depreciable. This is because the potentially uncertain form, value and useful lives of intangible assets make the risks of allowing tax depreciation deductions much greater than in the case of tangible assets.

Secondly, in the case of intangible assets, the estimated useful life on which depreciation is based is generally the asset's legal life – for example, 20 years in the case of a patent. Some might argue that the true economic life of a patent is much shorter than 20 years, so a shorter estimated useful life should be used for tax depreciation purposes. However, the issue that arises is determining what an appropriate economic life for patents as an asset class is, given that all patents are different. For example, it may well be that some mechanical patents become obsolete prior to expiry of legal life, while others like pharmaceutical patents may be held for the full legal life. Different classes of mechanical and pharmaceutical patents may also have varying economic lives. Also, the costs of holding a patent are unlikely to be significant (just renewal fees) which may mean that taxpayers are more readily able to "carry" patents, even though they are not being used in the income-earning process (for example, as a defensive ploy to prevent a competitor from extracting rents from a patented technology, product or process).

A seven or 10-year economic life, for instance, would therefore be no less arbitrary than the current estimated useful life, which is based on the legal life of a patent. Officials recognise that the legal life of an intangible asset, such as a patent, is unlikely to be an accurate reflection of true economic life in all instances, but then depreciation is not meant to be a perfect reflection of how assets actually depreciate. Rather, it is an approximation and, as with any approximation, there will be some assets in the class that depreciate faster and others that depreciate slower than the average.

In the case of an intangible asset, "legal life" is arguably one of the better proxies available as it provides a cap on the life of an asset. Also, when an event occurs that has the effect that the owner of an intangible asset is no longer able, and will never be able, to exercise the rights that constitute or are part of the asset (for example, where a patent lapses because it is not renewed), the tax rules allow the remaining book value to be written off. We therefore do not consider that the general approach of depreciating intangible assets over their legal life should be changed.

In the case of intangible assets that have indefinite useful lives because there is no legal limit on their lives, allowing a tax deduction before it is clear that the expenditure is of no on-going value would be inappropriate from an economic perspective as the asset may not actually be declining in value over time. Even if the asset was declining in value over time, if its useful life is incapable of being estimated with a reasonable degree of certainty, it would not be possible to determine what the economically appropriate life to be used for depreciation purposes should be.

A broad review of New Zealand's tax depreciation policy settings, involving consideration of approaches in other countries, is not currently under consideration.

Recommendation

That the submission be declined.

Issue: Unsuccessful software development

Submission
(Matter raised by officials)

A remedial amendment should be made to section DB 40B of the Income Tax Act 2007, to ensure that taxpayers can obtain a deduction for expenditure they incur in unsuccessful software development.

Comment

The bill contains an amendment in clause 105 that clarifies that capitalised expenditure incurred by a person in the successful development of software for use in their own business is depreciable.

The clause achieves this by inserting new section EE 18B into the Income Tax Act 2007. This enables the capitalised costs incurred in developing the software to be included in the depreciable cost of "the copyright in software", which is already listed as an item of "depreciable intangible property" in schedule 14 of the Income Tax Act 2007, rather than making "software" a separate depreciable intangible asset, by adding it to schedule 14. The primary reason for this drafting approach is that it is preferable to have one general provision that includes expenditure incurred on a non-depreciable intangible asset in the depreciable costs of a related depreciable intangible asset. Otherwise, separate legislative amendments would be necessary whenever a legislative interpretation is reached about what the depreciable costs of an item of depreciable intangible property are that is inconsistent with the policy intent.

Officials have identified that, as a consequence of this drafting approach, a remedial amendment to the wording of existing section DB 40B of the Income Tax Act 2007, which allows a taxpayer a deduction for expenditure they incurred in the unsuccessful development of software for use in their own business, would be desirable. To obtain a deduction, section DB 40B(1)(b) requires that "the software would have been depreciable property … if the development had been completed".

Under the drafting approach adopted in the bill, "software", in its own right, will still not be depreciable property. Therefore, on a literal interpretation, a deduction under section DB 40B could never be obtained because the requirement in section DB 40B(1)(b) could never be met.

Therefore, officials recommend that a remedial amendment be made to section DB 40B of the Income Tax Act 2007, to ensure that taxpayers can obtain a deduction for expenditure they incur in unsuccessful software development.

Recommendation

That the submission be accepted.

Other policy matters

CALCULATION OF FRINGE BENEFITS FROM EMPLOYMENT-RELATED LOANS

Clause 203

Issue: Support for the proposal

Submission
(KPMG, PwC)

Two submitters have expressed support for the proposal.

Comment

The proposed amendment will allow persons in the same group of companies as a person who lends money to the public to use the market interest rate method of calculating the fringe benefit arising from an employment-related, low interest loan.

Currently, the method is restricted to employers who themselves lend money to the public, as the method requires the employer to assess what the market interest rate would be on a comparable loan to an unrelated third-party borrower.

Officials welcome the support for the proposal.

Recommendation

That the submission be noted.

Issue: Transitional rule

Submission
(PwC)

Proposed section RD 45(4C) should refer to a period ending "with the finish of the" year, rather than "with or after the finish of the" year.

Comment

Under existing legislation, when an employer chooses to use the market interest rate method, they must use the method for at least the income year following that in which the election was made and the following income year – in other words, for two income years. They must also give advance notice of a change in method at least one year before the start of the income year to which the method is to apply. These minimum periods are intended to deter "flip-flopping" between calculation methods to get the lowest calculation rate.

The proposed amendment that allows a wider set of organisations to use the market interest rate method includes transitional provisions modifying both the normal minimum notification period and the minimum application period so that an employer can apply the market interest rate method soon after enactment of the amendment. As this may result in a change of method part-way through an income year, the intention was that the method would then be applied for at least the rest of that income year and the following income year.

The submitter argues that, as drafted, proposed new section RD 45(4C) would allow a person to apply the method indefinitely whereas the existing rule entitles a person to use the method for only a two-year period, unless they make a further election.

Officials do not agree that the existing rule can only be applied for two years unless a further election is made. Both the current and transitional minimum application periods are intended to allow an employer to apply the elected valuation method for an indefinite period of time, so long as it is at least as long as the specified minimum time period. However, officials acknowledge that the two provisions express this concept differently, which could be confusing.

Officials therefore agree that the wording of the proposed transitional rule in section RD 45(4C) should be better aligned with that in the existing minimum application period to make it clearer that both provisions are intended to allow an employer to apply the elected valuation method for an indefinite period of time, so long as it is at least as long as the specified minimum time period. Accordingly, the matter has been referred to drafters.

Recommendation

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

Issue: "Income year" versus "tax year"

Submission
(PwC)

Proposed section RD 45(4C) should refer to "income year" rather than "tax year".

Comment

The existing minimum application period is expressed in terms of income years whereas the transitional application period refers to tax years. Given this difference, and the submitter's previous argument that the application period rule only entitles a person to use the method for a two-year period, the submitter is concerned that the interaction of the two application rules could result in the market valuation method not being able to be applied continuously when a taxpayer has a non-standard balance date.

As noted above, the rules are intended to allow an employer to apply the chosen valuation method indefinitely, provided the minimum application period is met. Therefore, there should not be a problem with applying the method continuously.

However, when the employer has a non-standard balance date, so their income year does not align with the tax year, the transitional rule will produce a result that is inconsistent with the previously stated intent that the rule should treat the period of application for part of an income year as if it were for a whole income year.

Officials therefore agree that references in the proposed section RD 45(4C) to "tax year" should be replaced with "income year". This will also necessitate a further minor change to address the situation where the first quarter for which the method is used straddles two income years – for example, when the method is first used for the October to December quarter 2015 and the income year ends on 31 October 2015. The matter has been referred to drafters.

Recommendation

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

GST AND BODIES CORPORATE

Issue: Support for the proposal

Clauses 248 to 254

Submissions
(Chartered Accountants Australia and New Zealand, KPMG, PwC, Retirement Villages Association)

Four submitters expressed their general support for the proposals.

We believe this proposal is a sensible solution and will provide bodies corporate with clarity and certainty. We wish to record our thanks to the Minister of Revenue and officials for listening to feedback on earlier proposals and for developing a well thought-out solution. *(Chartered Accountants Australia and New Zealand)*

We support the proposed changes introduced in relation to bodies corporate. In particular, excluding from the definition of "body corporate" a body corporate that is part of a retirement village registered under the Retirement Villages Act 2003. *(Retirement Villages Association)*

Comment

Officials note the general support for the proposed amendments.

Recommendation

That the submissions be noted.

Issue: Definition of "body corporate"

Clause 249

Submissions
(PWC, KPMG, Chartered Accountants Australia and New Zealand)

The bodies corporate amendments apply from 1 October 1986, which is necessary to preserve past tax positions taken by bodies corporate. Due to the retrospective nature of the rules, they apply to bodies corporate established under both the Unit Titles Act 1972 and Unit Titles Act 2010.

However, as currently drafted, the rules may not apply to bodies corporate that were established under the Unit Titles Act 1972, after the commencement of the Unit Titles Act 2010. This is because the Unit Titles Act 2010 defines "body corporate" as a body corporate of a unit title development created under section 75 of that Act. A body corporate created under the Unit Titles Act 1972 is not a body corporate created under section 75, as instead it is deemed to be a body corporate by section 219 of the Act.

Comment

Officials agree with the submissions, and recommend that the rules be amended to ensure that they apply to bodies corporate established under the Unit Titles Act 1972, and that the new definition of body corporate applies only for the purposes of the new rules.

Recommendation

That the submissions be accepted.

Issue: Definition of "funds"

Clause 250

Submission
(PWC, Chartered Accountants Australia and New Zealand)

If a body corporate decides to register for GST, or is required to do so, proposed section 5(8AB) provides that the total value of a body corporate's funds on the day of registration will be treated as consideration received for the supply of services in the course or furtherance of its taxable activity.

A definition of "total funds" for these purposes should be included in the amendments and the definition should be the same as that in the Unit Titles Act 2010.

Comment

Proposed section 5(8AB) ensures that bodies corporate cannot obtain a tax advantage from the ability to choose to register for GST. In the absence of section 5(8AB), a tax advantage could be achieved by a body corporate accumulating untaxed funds while it is not registered and then registering immediately before it spends the funds to claim input tax deductions.

There are some risks associated with a narrow definition of "total funds" as a body corporate could re-characterise its funds to avoid the application of GST upon registration. The Unit Titles Act 2010 defines "funds" as "the operating account, the long-term maintenance fund, the optional contingency fund, and the optional capital improvement fund". This definition is tailored to the purposes of that Act and may not be sufficiently broad to encompass the total funds of the body corporate, which would include all cash and non-cash investments held by the body corporate.

Officials recommend that the meaning of "funds" for the purposes of proposed section 5(8AB) should be clarified as including money and investments held by the body corporate.

Recommendation

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

Issue: Income tax treatment of bodies corporate

No clause

Submission
(Chartered Accountants of Australia and New Zealand, EY)

The income tax treatment of bodies corporate should be clarified by the Commissioner. For example, there is some uncertainty as to how any distributions should be treated in the hands of the unit holders for income tax purposes.

Comment

The income tax treatment of bodies corporate is an interpretative matter that is outside the scope of the proposals in this bill. Inland Revenue would welcome discussions with bodies corporate about this issue.

Recommendation

That the submission be noted.

Issue: Guidance on the amount of output tax deemed upon registration

Clause 250

Submission
(Chartered Accountants Australia and New Zealand)

Inland Revenue should provide guidance to make it clear that the effect of proposed section 5(8AB) in treating the total value of the body corporate's funds as consideration received for services supplied upon registration is that output tax must be paid on 3/23 of those funds, rather than 15 percent.

Comment

Officials agree that the effect of proposed section 5(8AB) is to treat the total value of a body corporate's funds on the day it becomes "a registered person" as consideration received, deeming output tax to be paid on the fraction of 3/23 of the funds. This is consistent with the meaning of "consideration" under the GST Act which includes the tax fraction of the value of the supply (see section 10(2) of the GST Act for the meaning of "value of supply"). This information will be included in the *Tax Information Bulletin* when the new rules are enacted.

Recommendation

That the submission be noted.

Issue: The effect of receipt of insurance payments by bodies corporate

Clause 253

Submission
(Chartered Accountants Australia and New Zealand)

Section 5(13) of the GST Act 1985 provides that, where a registered person receives a payment under an insurance contract in the course or furtherance of their taxable activity, the payment is deemed to be consideration received for a supply of services performed by that registered person.

It should be clarified that receipt of insurance payments by a body corporate would not create a liability to register for GST under section 5(13), either by acknowledging that current law is sufficient to deal with the issue or by an amendment to the current rules as part of this bill.

Comment

Under the proposed rules, bodies corporate will be required to register for GST if their supplies to third parties exceed the $60,000 registration threshold. The intention is that the receipt of insurance payments by an unregistered body corporate should not in itself create a liability to register for GST.

Recommendation

That the submission be noted.

Issue: Remedial amendment to the transitional rules relating to the treatment of dwellings

No clause

Submission
(New Zealand Law Society)

The Taxation (GST and Remedial Matters) Act 2010 amended the definitions of "dwelling" and "commercial dwelling". Section 21HB of the GST Act was subsequently inserted as a transitional rule that enables persons affected by the change in these definitions to elect not to treat a supply of accommodation, in certain circumstances, as a taxable supply.

The Law Society is concerned that the changes to section 21HB do not achieve their desired effect, because it appears that section 21HB(4) requires that the property was previously treated as a "dwelling" and is now treated as a "commercial dwelling". However, not all dwellings (for example, a holiday home) affected by the amendment are now treated as "commercial dwellings".

A remedial amendment should be made so that the transitional rule also applies where a property was previously treated as a dwelling and is now no longer treated as a dwelling because of the changes to the definitions, as GST liability can also arise in this situation.

Comment

Officials agree with the submission. Section 21HB(4) was inserted by the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 to allow a person affected by the change in the definitions of "dwelling" the option of not including a commercial dwelling as part of their broader taxable activity.

It has since been identified that this transitional rule does not capture situations when a property that was previously treated as a dwelling no longer fits into either the definition of "dwelling" or "commercial dwelling" as a result of these changes.

Officials recommend that an amendment should clarify that the transitional rule applies where a person is no longer able to treat a property as a dwelling because of the amendment to the definition by the Taxation (GST and Remedial Matters) Act 2010. This amendment should take effect from 1 April 2011, the same date as section 21HB came into effect.

Recommendation

That the submission be accepted.

Issue: Adjustments for assets acquired prior to registration

Clauses 248 to 254

Submission
(Matter raised by officials)

Section 21B of the GST Act should not apply to allow a body corporate that registers for GST to make an adjustment and claim an input tax deduction in relation to goods and services acquired before the body corporate registered for GST.

Comment

Officials consider that section 21B should not apply to a body corporate that registers for GST, which would otherwise allow them to make an adjustment and claim an input tax deduction in relation to goods and services acquired prior to registration.

The policy intent behind the proposed rules is to ensure that bodies corporate are GST-neutral, which is achieved by imposing an output tax liability on the total funds held by the body corporate at the time of registration. This prevents a body corporate from obtaining a tax advantage by accumulating untaxed funds prior to registration, and then registering so that it can claim input tax deductions when the funds are spent.

However, a body corporate could achieve the same result by using untaxed funds to acquire goods and services prior to registration, and then making adjustments to deduct amounts in relation to these assets once it is registered. Therefore officials consider that a body corporate that registers for GST should not be able to make an adjustment under section 21B for goods and services acquired prior to registration.

Recommendation

That the submission be accepted.

Issue: Definition of body corporate

Clause 249

Submission
(Matter raised by officials)

As "body corporate" is used with a different meaning in the existing definitions of "company" and "equity security" in the Act, the proposed definition of "body corporate" should be clarified as applying only for the purpose of the new rules.

Comment

Officials consider that the new definition of body corporate should apply only for the purpose of the new rules.

Recommendation

That the submission be accepted.

GST RATIO METHOD FOR CALCULATING PROVISIONAL TAX

Clauses 200 and 201

Submission
(Chartered Accountants Australia and New Zealand)

The criteria for using the GST ratio method for calculating provisional tax should be relaxed to allow all taxpayers the option to use this method.

The operational requirements should be simplified.

Comment

The remedial amendment is to clarify the circumstances in which a person must stop using the GST ratio method of calculating provisional tax.

The submitter is requesting a relaxation of the current policy settings that allow a person to use the GST ratio method for calculating provisional tax. Officials note that this submission raises issues that would require further analysis as part of the Government's tax policy work programme.

Recommendation

That the submission be declined.

WORKING FOR FAMILIES

Clause 188

Issue: Main income equalisation account withdrawals

Submissions
(Matter raised by officials)

The remedial amendment to section MB 1(5D) should be clarified to ensure that when a Working for Families (WFF) recipient's associated entities draw on funds deposited into their main income equalisation accounts it does not reduce the recipient's WFF tax credit entitlement, but that withdrawal of interest earned on the accounts should continue to reduce the WFF tax credit entitlement.

Comment

Section MB 9 in the Income Tax Act 2007 ensures that when WFF recipients or their associated entities (listed in sections MB 4 and MB 7) deposit amounts into the main income equalisation accounts the deposits are added back for the purposes of the calculation of family scheme income. This prevents a person or their associated entities from depositing income into main income equalisation accounts in order to artificially deflate the person's family scheme income, and hence increase their WFF tax credit entitlement.

When a person or their entities withdraw the deposits and associated interest earned on those deposits, it is treated as taxable income. Section MB 1(5D) is intended to ensure the WFF recipient's WFF tax credits entitlement is not reduced a second time when they or their associated entities withdraw the deposits. However, when a WFF recipient or their associated entities withdraw the interest that has accrued on deposits in their main income equalisation account, it should be included in family scheme income and reduce the WFF recipient's WFF tax credits entitlement.

An amendment has been made to section MB 1(5D) in the bill that ensures when a person's associated entities withdraw interest that has accrued on deposits in their main income equalisation account it reduces their WFF tax credits entitlement. However, the current drafting of the part of section MB 1(5D) that ensures a WFF recipient's WFF tax credits entitlement is not reduced a second time when their associated entities withdraw the deposits is still unclear and should be amended to be clear that withdrawal of a deposit by associated entities is not counted as family scheme income.

Recommendation

That the submission be accepted.

Issue: Main income equalisation account associated entities attribution rules

Submission
(Matter raised by officials)

A further remedial amendment is proposed to clarify the part of section MB 9 that indicates when a WFF recipient's associated entities make a deposit into or receive a refund from their main income equalisation account, the WFF recipient's family scheme income (and therefore WFF tax credits entitlement) should only change by the proportion of the interest the WFF recipient has in the associated company and trusts.

Comment

It is intended that when a WFF recipient's associated company makes a deposit into their main income equalisation account, the WFF recipient's family scheme income should only increase by the percentage share the WFF recipient has in the associated company using the formula in section MB 4. Similarly, a deposit made by a WFF recipient's associated trust should reflect the number of settlors and the formula in section MB 7. Likewise, when the WFF recipient's associated entities draw on these deposits, the WFF recipient's family scheme income should only decrease by the proportion attributable to the recipient by the associated company and trusts. However, the wording in sections MB 9 and MB 1(5D) that aims to achieve this intent is unclear and it could be read as including the whole amount of the deposit made by the recipient's entities, not just the proportion attributable to the WFF recipient.

Recommendation

That the submission be accepted, and apply from the beginning of the 2011–12 tax year.

CFC and FIF remedials

Issue: Attribution of income for personal services

Clauses 125 and 166

Submissions
(KPMG, PwC)

The submitters support the proposal to clarify that either the personal services attribution rules or the controlled foreign company rules can be used if personal services are provided through a foreign company.

There should be an appropriate communication strategy on the application of the CFC rules to individual taxpayers in this context and also in a wider context as the taxpayers who are likely to fall within these rules may not always have access to the same level of tax advisors that corporate taxpayers do. *(PwC)*

Comment

Officials welcome support for the proposal. The proposal clarifies that a taxpayer who derives income from providing personal services through an associated foreign company, and who attributes that income under the CFC rules, is exempt from attributing that income under the separate attribution rule for income from personal services (under section GB 29).

For example, Dr Paul could provide medical services to his patients, but incorporate a company to be the contractual provider of those services. The company would then employ Dr Paul, who would see the patients and carry out the services. Dr Paul may be required to attribute income derived by the company in relation to his services under the attribution rule in section GB 29. If the company were a CFC and the services were performed in New Zealand, the CFC rules would also attribute the services back to Dr Paul. Under the proposed amendment, Dr Paul would be able to make a one-off election to determine whether he attributes the income earned by the company for his services under the CFC rules or the rule in section GB 29. If Dr Paul would like to attribute under the rule in section GB 29, his one-off election would be in the form of filing an income tax return that includes the amount attributed to him under the rule in section GB 29 after the date of Royal asset of the Taxation (Annual Rates for 2015–16, Research and Development, and Remedial Matters) Act 2015.

The practical effect of the proposal is that a taxpayer who derives only personal services income through an associated foreign company can attribute this income either under section GB 29 or under the CFC rules. The rules are duplicated and have the same tax effect for a taxpayer who derives only personal services income from the foreign company, but the CFC rules are generally more complex to apply, as they require attribution of personal services income and other forms of passive income.

Officials will work to ensure that the communication strategy is appropriate to inform taxpayers who derive personal services income through a foreign company of their obligations.

Recommendation

That the submissions be noted.

Issue: Support for prepaid expenditure proposal

Clause 126

Submission
(Corporate Taxpayers Group)

The submitter supports the proposal to apply the prepaid expenditure rules to CFCs, so that deductions for prepaid expenditure would need to be spread over a number of periods.

Comment

Officials welcome the submitter's support for the proposal.

Recommendation

That the submission be noted.

Issue: Prepaid expenditure – correctness vs compliance

Clause 126

Submission
(KPMG)

It should be considered whether the proposed rule, which increases the "correctness" of the amount attributed, is necessary when compared with the costs of complying.

Comment

Under New Zealand's domestic tax law, New Zealand taxpayers are able to claim deductions for expenses incurred in generating taxable income. If a taxpayer incurs an expense in one year for something that will last more than one year, adjustments are made so that the deduction is spread over the relevant income years (subject to certain exclusions and exemptions). These rules, known as the prepayment rules, are separate to the depreciation rules, but have a similar function.

Officials consider that the application of the prepayment rules to CFCs is necessary to protect the integrity of the CFC rules, and that any additional compliance costs should be relatively minor, particularly as many taxpayers should be familiar with the prepayment rules (as a long-standing part of New Zealand's domestic tax laws).

Recommendation

That the submission be declined.

Issue: Anti-avoidance rule for the test-grouping concession

Clause 165

Submission
(Corporate Taxpayers Group)

The submitter supports the proposal to introduce an anti-avoidance rule relating to the test-grouping concession.

Comment

Officials welcome support for the proposed anti-avoidance rule to prevent taxpayers from using the test-grouping rules, which were introduced as a compliance concession, to gain an unintended tax advantage.

Recommendation

That the submission be noted.

Issue: Anti-avoidance rule for the test-grouping concession – guidance

Clause 165

Submission
(KPMG)

Guidance should be provided on the criteria that the Commissioner of Inland Revenue will apply to the application of the anti-avoidance for the test-grouping concession. The concern is that the "consistency" requirement has been drafted as an anti-avoidance rule to allow the Commissioner to reject a test-grouping election, but there may be legitimate reasons for changing test groups.

Comment

Officials understand the submitter's desire for clarity on the operation of the proposed rule, and will provide appropriate guidance when drafting the *Tax Information Bulletin* item for any changes.

Recommendation

That the submission be noted.

Issue: Support for part-year exemption in Australian FIFs

Clause 134

Submission
(Corporate Taxpayers Group, KPMG)

Under current rules, a person's income interest in certain Australian-resident foreign investment funds is exempt from the FIF rules for an income year if the income interest is 10 percent or more at all times in the year (on average). The submitters support the proposal in the bill to instead limit the 10 percent requirement for exemption to the period in the year over which the interest in the FIF is held.

Comment

Officials welcome support for the proposal.

Recommendation

That the submission be noted.

Issue: Inconsistency in the part-year exemption for Australian FIFs

Clause 134

Submission
(New Zealand Law Society)

The proposal to apply the test for exemption to the period in the year over which the Australian FIF is held gives rise to inconsistencies. The example given is that a taxpayer who holds no income interest in the FIF in the first half of the year, but a 15 percent interest in the second half of the year, would meet the test for exemption, but a taxpayer who holds a 4 percent income interest in the FIF for six months of the year, then increases their holding to 15 percent for the remainder of the year, would not – even though in the second situation, the taxpayer would hold a greater interest in the FIF over the entire period of the year. Further thought should be given to an alternative test – for example, one that focuses on whether the 10 percent threshold was met for a minimum period of time.

Comment

The current rule provides an exemption from the FIF rules for an income year when a taxpayer holds an income interest of 10 percent or more (a non-portfolio interest) in certain Australian FIFs at all times during the year. In determining whether a person's income interest in the FIF satisfies the 10 percent threshold, the taxpayer's interest in the FIF is averaged out across the year irrespective of whether the taxpayer had an interest in the FIF at all times in that year.

The proposed change relates to the situation when a taxpayer acquires an interest in an Australian FIF part-way through the year. Depending on the extent of the taxpayer's income interest in the FIF, they may fail the 10 percent threshold test because they held a zero percent interest for part of the period, even if they satisfy the test in all subsequent years. The proposed change allows the taxpayer to effectively ignore the period in the year when they held no interest in the Australian FIF when undertaking the averaging-out calculation.

The averaging-out calculation means that in the example identified by the submitter, the taxpayer would not have the requisite 10 percent holding at all times of the year, as the taxpayer's holding averages out to 9.5 percent.

The concern raised by the submitter is a common feature of threshold tests. However, officials consider that the issue is sufficiently mitigated in most cases by the use of an averaging-out calculation, which allows for fluctuations in shareholdings. Furthermore, officials note that the same averaging-out calculation is used in the CFC rules and certain other rules for non-portfolio interests in FIFs, and consider that the introduction of a minimum-holding period in the threshold test for this provision could introduce further complexity and create an inconsistency in the application of the rules.

Recommendation

That the submission be declined.

Issue: Support for indirectly held FIF proposal

Clauses 136, 140 and 213

Submission
(Corporate Taxpayers Group, KPMG, PwC)

The submitters support the proposal to align the treatment of directly held and indirectly held FIFs.

Comment

Officials welcome submitters' support for the proposal.

Recommendation

That the submission be noted.

Issue: Definition of "indirect attributing interest"

Clauses 136, 140 and 213

Submission
(Corporate Taxpayers Group)

For the purposes of section EX 58, the proposed definition of "indirect attributing interest" does not appear to be correct. The definition is also used for the purposes of section EX 50, where it does make sense. An additional definition should be drafted for section EX 58.

Comment

Officials have reviewed the proposed definition for "indirect attributing interest" and agree that the current proposed drafting does not work as intended for the purposes of section EX 58.

Recommendation

That the submission be accepted, and the matter referred to drafters.

Issue: Disregarding the CFC

Clauses 136, 140 and 213

Submission
(Corporate Taxpayers Group)

To make the provision clearer, section EX 58 should be rewritten to essentially disregard the CFC interest and apply the FIF rules as if the person held the interest in the FIF directly. The proposed rules still apply the calculation rule "to the CFC and the CFC's interest in the FIF" and only restrict it to the period in which the person held the indirect attributing interest. There may be situations when looking through the CFC gives rise to unintended tax consequences – for example, if an individual owns an interest in a FIF directly, they may be able to use the comparative value method, which is not available if the individual owns the FIF interest via a CFC.

Comment

Officials consider owning an interest in a FIF via an interposed CFC to be fundamentally different from owning an interest in a FIF directly. As a result, the two situations should be treated differently under the income tax rules. For example, in the case of direct ownership in a FIF, if the FIF makes a distribution to the interest holder, it is made directly to the person – they have little control over when the funds will be repatriated to them. However, where the FIF distribution is made to the CFC, the person is likely to have control over when the FIF funds will be repatriated back to them, because of the control that the person has over the CFC's affairs.

To maintain the distinction between directly held FIF interests, and FIF interests held through CFCs, officials consider that the reference "to the CFC and CFC's interest in the FIF" to be a necessary feature of the proposed rule.

Recommendation

That the submission be declined.

Issue: Other anomalies relating to indirectly held FIFs

No clause

Submission
(PwC)

Further work is required to identify and address other legislative anomalies that exist with respect to indirectly held FIFs. The most common example is the interaction of sections EX 58 and EX 59. The attribution of FIF income is the only taxable income applying to attributable FIF investments, and section EX 59(2) provides for this policy intent for directly held FIFs. However, section EX 59(2) does not adequately deal with indirectly held FIFs. As a result, dividends paid by the CFC in respect of underlying FIF investments will be taxed in the hands of New Zealand-resident shareholders (that are not corporate taxpayers). Corporate taxpayers are not adversely exposed to this issue due to the foreign dividend exemption they enjoy. Therefore, individual and trust taxpayers are liable to a different level of taxation due to the existence of a CFC.

The legislation should be amended to ensure that the dividend income of underlying FIFs is included within section EX 59(2). This would align the New Zealand tax treatment of dividends received by directly and indirectly held FIFs. For this to work, a tracking account may be required to record what income has already been returned for New Zealand tax purposes to ensure only the relevant dividends fall within the scope of any section EX 59(2) amendment.

Comment

While the basis of this submission is slightly different from that raised in the previous submission, officials consider the analysis to be relevant in this context.

As noted above, officials consider owning an interest in a FIF via an interposed CFC to be fundamentally different from owning an interest in a FIF directly. As a result, the two situations should be treated differently under the income tax rules. An interest holder in a CFC has more influence over that foreign company's affairs than an interest holder in a FIF would.

This additional level of control presumably extends to decisions relating to whether dividends are paid out or not. For example, in the case of direct ownership in a FIF, if the FIF makes a distribution to the interest holder, it is made directly to the person – they have little control over when the funds will be repatriated to them. However, when the FIF distribution is made to the CFC, the person is likely to have control over when the funds will be repatriated back to them because of the control the person has over the CFC's affairs.

As noted by the submitter, section EX 59(2) does not apply to a dividend ultimately received by the individual from a CFC.

However, officials note that double taxation is relieved in another manner. Individuals are taxed on dividends paid by CFCs, but can claim a tax credit for tax paid under the CFC rules (and the FIF rules if the person is required to return FIF income on an indirectly held FIF interest).

This is because individuals can maintain a "branch equivalent tax account" or BETA. The BETA rules provide a credit for tax paid on attributable CFC income and tax paid in relation to indirectly held FIF interests. A BETA credit for the latter is provided for in section OE 5 of the Income Tax Act 2007. Officials note that the BETA rules operate similarly to the tracking account proposed by the submitter to record what income has already been returned for New Zealand tax purposes.

Officials are satisfied that this relieves any double taxation concerns relating to the payment of dividends by CFCs when the CFC also has an interest in a FIF.

The submitter notes that individual and trust taxpayers are subject to a different level of taxation than companies are on dividends paid by a CFC in relation to underlying FIF investments. Officials note that before the introduction of the foreign dividend exemption, foreign dividends received by New Zealand-resident companies were taxable but companies, like individuals, maintained BETAs to relieve double taxation. However, the foreign dividend exemption does not extend to taxpayers other than companies. This preserves equivalent treatment between individuals who hold their foreign investments directly and those who hold their interest through a New Zealand company. The latter group will be taxable when the New Zealand company subsequently distributes its profits relating to the dividend.

In general, officials consider that while there should be some alignment between the treatment of directly held and indirectly held FIFs, this does not necessarily require identical tax treatment due to underlying differences in the level of control exercised over the investment.

Recommendation

That the submission be declined.

Issue: Foreign tax credits in relation to dividends paid by CFCs when there is an indirectly owned FIF

No clause

Submission
(Corporate Taxpayers Group)

There is an inability to claim foreign tax credits in some circumstances when a New Zealand taxpayer holds a FIF through a CFC in the same jurisdiction. For example, when a New Zealand taxpayer holds an Australian CFC that in turn holds an Australian FIF, the FIF income is directly attributed to the New Zealand taxpayer rather than to the CFC. However, the withholding tax is deducted by the CFC on repatriation (there is no withholding tax paid when the FIF distributes income to the CFC as no funds have crossed a border). The outcome is that no foreign tax credit is available in New Zealand for the amount withheld, because the

underlying income has been derived from the FIF rather than the CFC. This can be contrasted with the situation when the New Zealand taxpayer holds the FIF directly and a distribution is subject to withholding tax for which a foreign tax credit is available under section LJ 2(6). Interposing a CFC should not distort the outcome in this situation.

Comment

As noted above, officials consider owning an interest in a FIF via an interposed CFC to be fundamentally different from owning an interest in a FIF directly and, as a result, the two situations should be differentiated under the income tax rules. An interest holder in a CFC has more influence over that foreign company's affairs than an interest holder in a FIF would.

This additional level of control may extend to decisions relating to whether dividends are paid out, and when. In the case of direct ownership, if the FIF makes a distribution to the interest holder, it is made directly to the person – they have little control over when the funds will be repatriated to them.

The difference between the issue raised by this submitter and the one raised by the submitter in "Issue: Other anomalies relating to indirectly held FIFs" is that the New Zealand interest holder is likely to be a company in this case (as opposed to an individual).

New Zealand-resident individuals are subject to tax on dividends received from foreign companies, but they are able to maintain a BETA which takes into account income tax they have paid under New Zealand's international tax rules and may be able to claim a foreign tax credit for foreign income tax paid on the foreign dividend.

Dividends received by New Zealand companies from foreign companies are generally exempt from New Zealand income tax under section CW 9. Previously, New Zealand tax was payable on such foreign dividends under the foreign dividend payment (FDP) rules. However, the FDP rules generally took account of the foreign tax paid (both withholding tax levied on the dividend and underlying company tax paid) and also provided for credits under the BETA rules. When the CFC rules were substantially reformed at the time the active income exemption was introduced, the FDP rules and the BETA rules as they applied to companies, were repealed.

This means two things for New Zealand companies receiving foreign dividends: a credit is not available for foreign income tax withheld on the dividend, but at the same time, that foreign dividend is exempt from New Zealand tax. The former is a consequence of the latter.

Officials note that a distribution made by a CFC to a New Zealand interest holder will reflect the overall income earned by the CFC, not just the income that the CFC derives from the FIF. Designing a rule that would allow a New Zealand taxpayer to provide a foreign tax credit for the part of the withholding tax levied on the CFC distribution to be credited against income tax paid in relation to the indirectly held FIF interest would be complex and could be difficult to administer. This would especially be so when there is more than one interposed CFC.

Recommendation

That the submission be declined.

Issue: Reference to section EX 21(33) in section EX 58(1)(b)

Clause 140

Submission
(EY)

An additional amendment to section EX 58(1)(b) is required to remove or modify its current reference to FIF income or loss not being taken into account in calculating the net attributable CFC income or loss of the CFC for the period, because section EX 21(33) applies.

Section EX 21 applies for several purposes, including determining whether a CFC is a non-attributing active CFC under the default test in section EX 21D, and calculating net attributable CFC income or loss under section EX 20B.

Section EX 21 does not apply in determining whether a CFC is a non-attributing active CFC under the accounting test in section EX 21E. If a CFC is a non-attributing active CFC under section EX 21E, there is no need to calculate net attributable CFC income or loss under section EX 20B. Accordingly, it is arguable that section EX 58 does not apply in such circumstances, so it would be preferable to remove any remaining possible source of confusion.

Comment

Officials note that the proposed amendment to section EX 58(6) clarifies that the provisions of section EX 58 apply regardless of whether the CFC is a non-active attributing CFC or a non-attributing Australian CFC. However, officials acknowledge that the reference to section EX 21(33) in section EX 58(1)(b) may create confusion in relation to FIF interests held by non-attributing active CFCs when their non-attributing active status is determined under section EX21E.

Officials agree that this potential confusion could be resolved by removing from section EX 58(1)(b) "because section EX 21(33) applies", while still retaining "FIF income and FIF loss is not taken into account in calculating the net attributable CFC income or loss of the CFC for the period for the person". However, if the Committee accepts the submission, officials will consult with drafters to ensure that the removal of the reference to section EX 21(33) in section EX 58(1)(b) would not result in any unintended changes to the section.

Recommendation

That the submission be accepted, and the matter referred to drafters.

Issue: Four-year rule for FDR annual and periodic methods

Clauses 137, 138, 139 and 213

Submission
(KPMG)

The submitter can see the rationale behind the proposed change, as taxpayers are able to undertake the calculation with the benefit of hindsight (and switch between methods to minimise income for a FIF interest under the fair dividend rate (FDR) method).

Comment

The proposal is that the choice between an annual or more frequent basis (the periodic method) for calculating FDR income for a FIF interest will be available only once every four years.

Officials acknowledge the submitter's acceptance of the rationale for the proposed change.

Recommendation

That the submission be noted.

Issue: Opposition to four-year rule for FDR annual and periodic methods

Clauses 137, 138, 139 and 213

Submissions
(Baucher Consulting Limited, Corporate Taxpayers Group, New Zealand Law Society)

The submitters do not support the proposed amendment to limit switching between the fair dividend rate (FDR) annual method and the FDR periodic method for calculating FIF income for a FIF interest to once every four years.

Why has the practice sought to be countered only now been identified as being contrary to the original policy intention? The proposals would prevent taxpayers who are unable to use the comparative value method from being able to adjust their position in the event of a dramatic market event, like the Stock Market Crash in October 1987 or the Global Financial Crisis in 2008. *(Baucher Consulting Limited)*

There are a number of instances where a choice of calculation method is available for each year – for example, individual taxpayers are able to choose between the FDR method and the comparative value method. Similarly, taxpayers should be able to choose between applying the FDR annual method and FDR periodic method for each year. *(Corporate Taxpayers Group)*

A lock-in period of four years is likely to be regarded by taxpayers as unacceptably long, with no self-evident reason for such a lengthy restrictive period. As an alternative, a similar policy objective could be achieved by requiring a global change across the full portfolio when an election to change method is made. *(New Zealand Law Society)*

Comment

The FDR periodic method was originally only available for unit-valuing funds such as portfolio investment entities (PIEs), which determine the value of an investor's units in the fund's investments on a periodic basis. However, the Taxation (Business Matters and Remedial Amendments) Act 2007 introduced an amendment which allows any other person to choose to use the method for an attributing interest in a FIF. This amendment was effective from 1 April 2008.

The FDR periodic method is information-intensive as it requires taxpayers to calculate the market value of their interest in the FIF on a daily basis. The policy intent behind the amendment to allow certain taxpayers to choose to use this method is that taxpayers who have access to such detailed information about their investments should be able to use that information to calculate their income. However, it was not envisaged that these taxpayers would only use the information-intensive FDR periodic method for the years in which its use resulted in a lower tax liability for the year, thereby gaining a tax advantage over the FDR annual method. Additionally, unit-valuing funds are required to use the FDR periodic method and are not able to choose between the FDR annual and periodic method.

Officials note that there is a general requirement in the FIF rules that once a person uses a particular calculation method to calculate their FIF income or loss for an attributing interest in a FIF for a year, they must use the same method the following year (section EX 62). However, section EX 62 only limits taxpayers from switching between the FDR method and other methods. It does not deal with switching between methods that fall under that wider FDR method umbrella.

Officials consider the proposed four-year rule would be consistent with the general requirement in section EX 62 that limits switching between FIF calculation methods, while also providing taxpayers with some flexibility to switch between the FDR periodic and annual methods from time to time.

The New Zealand Law Society has suggested an alternative proposal – that a global change across a taxpayer's full portfolio could be required when an election to change method is made. Along similar lines, the effect of section EX 46(8) is that a taxpayer who chooses to switch to the comparative value method to calculate FIF income for one FIF interest must not use the FDR method for their other FIF interests. Note that this is not the same as requiring a global change across the taxpayer's portfolio.

The FIF rules do not generally require a taxpayer to use the same calculation method for all of their foreign investments. This is because the rules recognise that a taxpayer may have a varied investment portfolio with investments in a number of different types of FIFs and a particular income calculation method may not be practical or even possible for all of their investments. Officials consider that requiring a global change across the full portfolio when an election to change method is made could be complex and may be impractical in a number of situations.

Recommendation

That the submissions be declined.

Issue: Four-year rule – prospective application

Clauses 137, 138, 139 and 213

Submission
(Corporate Taxpayers Group)

The introduction of the four-year consistency requirement should be prospective, so that decisions made by taxpayers up to the introduction of the consistency requirement do not limit their ability to change methods going forward. Taxpayers should only be bound by the method decisions they make from the 2017 income year and after. This could be achieved by amending the drafting so that the period for which decisions under the FDR method are taken into account begins from the start of the 2015–16 income year.

Comment

Officials understand the submitter's concern that the introduction of a consistency requirement should be truly prospective, otherwise taxpayers may be locked into a specific method based on decisions they made before introduction of the bill.

Officials consider that the proposed four-year rule should strike a fair balance between maintaining the integrity of the FIF rules and acknowledging the decisions that taxpayers have taken in previous income years under the current rules.

Recommendation

That the submission be accepted, and the matter referred to drafters.

Issue: Four-year rule – drafting

Submission
(Corporate Taxpayers Group)

We recommend that officials revisit the wording of the proposed new section and consider whether it can be simplified. In addition, the positioning of the proposed new section could create some confusion among taxpayers.

Comment

Officials understand the concerns raised by the submitter in relation to the drafting of new section EX 51B, with respect to the clarity of the drafting and the placement of the provision.

Section EX 62 of the Income Tax Act 2007 deals with limitations on changes of method and officials are considering whether it would be appropriate to insert the provision there instead.

Recommendation

That the submission be noted, and the matter referred to drafters.

Issue: Exclusion for certain types of passive income

No clause

Submission
(Corporate Taxpayers Group)

There are a number of same jurisdiction, non-attributing active CFC exemptions (royalties, rent, financial arrangements) that can be applied in determining "removed passive" under section EX 21E(9) and the attributable CFC amount under section EX 20B. However, an exemption is not provided for a deductible foreign equity distribution or a distribution from a fixed-rate foreign equity received from an associated non-attributing active CFC. There should be an exclusion for these types of passive income from same jurisdiction active CFCs.

Comment

Officials contacted the submitter for clarity on the submission and understand that this concern was remedied in the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014.

Recommendation

That the submission be noted.

Issue: General support

Submissions
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, EY)

The submitter supports the proposals in the bill relating to CFCs and FIFs and is pleased that the remedial issues they and others have identified are being addressed. *(Chartered Accountants Australia and New Zealand)*

The submitter is generally supportive of the policy behind most amendments in the bill, subject to comments within the submission. *(EY)*

The submitter is supportive of the minor technical remedials in the bill relating to international tax. *(Corporate Taxpayers Group)*

Comment

Officials welcome submitters' support.

Recommendation

That the submissions be noted.

Issue: Test grouping for part-year acquisitions and disposals

Clauses 128 and 129

Submission
(KPMG)

The submitter is supportive of the proposal to allow groups of foreign companies acquired (or disposed of) during a year to be included in CFC test groups.

Comment

Officials welcome the submitter's support for the proposal, but note that the proposal the submitter is referring to is to allow taxpayers who acquire or dispose of a group of foreign companies at the same time to have access to the test group concession in that year for those companies.

Recommendation

That the submission be noted.

Issue: Test grouping proposal too limited

Clauses 128 and 129

Submission
(Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group)

The 50 percent grouping requirement should be amended to make it clear that same-jurisdiction CFCs that are only held for part of an accounting period are able to form a test group with each other as long as the interest holder has a more than 50 percent interest in the CFCs for that part of the income year that the interest is held by the person. There is no reason why a group of target companies all acquired during the period should not be able to be grouped under the active business tests. The same argument applies to groups disposed of during the period that could otherwise have been grouped in prior years. *(Chartered Accountants Australia and New Zealand)*

The submitter supports the intent of the proposed amendment and the retrospective application date. However, the drafting of the amendment is too restrictive and there are a number of legitimate instances where the proposed amendment will not apply in practice. In particular, the test grouping concession should be able to be accessed where sister CFCs are acquired or disposed of during the year. The requirement that the New Zealand interest holder acquires or disposes of the relevant CFCs "at the same time" is also too restrictive as acquisition or disposal transactions can take a variety of forms in practice. This rule should also be extended to apply to income interests held by companies that are members of a wholly owned group of companies that include the interest holder (in line with section EX 21E(2)(c)(ii)) and not be restricted to CFCs held by one interest holder alone. *(Corporate Taxpayers Group)*

Any concerns regarding a CFC being a member of more than one test group for an accounting period (which is unlikely) could be removed by requiring the part-year test calculation option detailed below to be utilised for the purposes of the test group calculations if this part-year grouping approach is utilised. *(Corporate Taxpayers Group)*

Comment

The intent of the proposed amendment is to account for situations when a pre-existing structure of companies is acquired or disposed of, and to maintain the treatment that this structure of companies would otherwise be subject to.

Officials understand that acquisitions and disposals can take a variety of forms and that these transactions may not occur at the same time. While the original intent of the proposed amendment focuses on a very particular type of disposal or acquisition, officials consider that it is appropriate to extend the proposed part-year test grouping proposal to include sister companies acquired or disposed of in the same accounting period, as well as income interests acquired or disposed of by members of a wholly owned group of companies that includes the interest holder.

However, to maintain the integrity of the test-grouping rules, officials would consider it necessary to distinguish between CFCs acquired during the same accounting period and CFCs disposed of during the same accounting period.

Regarding the submission on a part-year test calculation option, please refer to "Issue: Other matters relating to part-year acquisition and disposal – calculation of ownership interest" and "Issue: Other matters relating to part-year acquisition and disposal – calculation of income" for further discussion. Officials consider that further work needs to be undertaken in relation to the part-year test calculation option proffered by the submitter to ensure that any change in this area does not create unintended consequences in the operation of New Zealand's international tax rules.

Recommendation

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

Issue: Other matters relating to part-year acquisition and disposal – calculation of ownership interest

No clause

Submission
(Corporate Taxpayers Group)

A number of sections in the international tax rules refer to the need for a 10 percent or more income interest in the CFC/FIF for the relevant accounting period for the section to apply.

In particular, section EX 46 provides that at all times in the accounting period the person must hold an income interest of 10 percent or more in the FIF to apply the attributable FIF income method. This means that if a FIF is acquired or disposed of during the year, the taxpayer would not meet the 10 percent threshold at all times in the accounting period, and would be unable to apply the attributable FIF income method.

Sections CQ 2 and EX 14 provide that a person has an attributed CFC income or loss only if the person has an income interest in the CFC of 10 percent or more for the relevant accounting period. If a CFC is acquired or disposed of during the year, then they may not meet the requirements to attribute under the CFC rules and may be considered a FIF in the relevant period.

The issues are the same as that being addressed by the proposal concerning the part-year exemption for Australian FIFs. The rules should be amended by providing that the 10 percent or more income interest required under section EX 46 and 14, and section CQ 2 applies to the total period in the year in which the person has rights in the CFC/FIF, as proposed for section EX 35. The amendment should be retrospective back to the start of the new regime.

Comment

Officials consider that the proposed amendment to section EX 35 (the FIF exemption for Australian FIFs) is different from the issues raised by the submitter in relation to part-year acquisitions and disposals of CFCs and non-portfolio FIFs.

The issues that the submitter raises relate to rules that determine whether income should be attributed to the interest holder. This is more complex than determining whether an exemption from the FIF rules applies.

Officials note that one potential issue relating to part-year acquisitions or disposals of attributing interests in CFCs and non-portfolio FIFs is whether the interest holder has the ability to get the required information to correctly apply the attribution rules.

Officials consider that this submission should be analysed in conjunction with "Issue: Other matters relating to part-year acquisition and disposal – calculation of income" as both matters relate to the complexities of dealing with part-year acquisitions and disposals.

Further work needs to be undertaken to ensure that if any change is made to how income interests are calculated in years of acquisition or disposal, there would be no unintended consequences in the operation of New Zealand's international tax rules.

This could raise wider policy considerations, 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 submission be noted.

Issue: Other matters relating to part-year acquisition and disposal – calculation of income

No clause

Submission
(Corporate Taxpayers Group)

The active business test is performed based on the full accounting period for CFCs (or FIFs applying the attributable FIF income method). This is the case even for CFCs/FIFs that are not held for the full accounting period (that is, they are acquired or disposed of during the year).

In order to use the accounting method active business test in section EX 21E, audited IFRS accounts (or US GAAP for FIFs under section EX 50) are required for the full accounting period. There is often a problem in the year of acquisition and disposal as the New Zealand interest holder's IFRS accounts will only cover the period for which the CFC/FIF is held. In addition, when a CFC is sold, it is often very difficult for taxpayers to obtain financial information from the purchaser for the period in which they do not own the CFC/FIF. For commercial and accounting purposes there is no reason to have this information and therefore it is not usually able to be obtained.

This means that taxpayers are forced to use the default (tax) method which is significantly more complex and compliance-intensive, or alternatively adopt a pragmatic approach of simply applying the accounting test based on 100 percent of the IFRS results for the period for which the CFC/FIF is held.

An option should also be included for taxpayers to apply the active business test and undertake attribution calculations for the period for which the CFC/FIF is held. This will allow taxpayers to use the reduced compliance accounting test, as they will in other years when the CFC is held for the entire accounting period, as IFRS accounts for this period will be available. For calculation purposes, the income interest would be treated as 100 percent such that the calculations would reflect 100 percent of the result for the ownership period and would more accurately reflect the position of the New Zealand interest holder. The application date for this change should be retrospective back to the start of the new regime.

Comment

Officials consider that this submission should be analysed in conjunction with "Issue: Other matters relating to part-year acquisition and disposal – calculation of ownership interest". There are complexities in undertaking the active business test calculation when a CFC is only held for part of an accounting period.

Officials consider that further work needs to be undertaken to ensure that if any change is made to how the active business test is calculated in years of acquisition or disposal, there would be no unintended consequences in the operation of New Zealand's international tax rules.

This could raise wider policy considerations, 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 future policy work on CFCs and FIFs.

Recommendation

That the submission be noted.

Issue: Review of the FIF rules

No clause

Submission
(Baucher Consulting Limited)

There should be a full review of the FIF regime's impact and effectiveness. As part of this review, the underlying growth assumption for some FIF calculation methods (such as the fair dividend rate and costs methods) should be revised as the current 5% rate ignores the effect of events such as the global financial crisis. A lower rate, say 3%, should apply. In addition when the FIF interest is not paying dividends, the investor should be allowed to roll up his or her FIF liability until such time as the shares are sold or a dividend is paid.

Comment

There is no full review of the FIF regime planned, and officials do not consider that a review is necessary at this time.

Officials regard the 5% annual growth rate used in some of the FIF calculation methods as an accurate representation of medium- to long-term investment growth rates. Events like the global financial crisis are temporary and the growth rates of many financial asset classes have recovered quickly.

Officials note that if the investor is an individual or a trustee of a family trust and the return is less than 5%, tax can be paid on this lower amount using the comparative value method, with no tax payable when the total return is negative. Availability of the comparative value method means that the 5% growth rate acts as an upper limit for many investors.

As noted by the submitter, the current FIF regime was introduced as part of the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006. As noted in the *Tax Information Bulletin* item related to that legislation, the rationale for taxing offshore portfolio investments in shares on accrual is that dividend-taxation is not feasible for taxing investments in companies resident in jurisdictions whose tax systems do not encourage the payment of dividends:

> "Dividend-only taxation was, in many instances, an inappropriate tax base because many foreign companies have a policy of paying low or no dividends. The investor could still, however, derive an economic gain from the investment via an increase in the share price. It was therefore quite easy to achieve a low tax or no tax result for direct portfolio investment in shares outside New Zealand. This could give higher income or more sophisticated taxpayers significant scope to minimise their tax burden by investing offshore."[3]

Recommendation

That the submission be declined.

[3] https://www.ird.govt.nz/technical-tax/legislation/2006/2006-81/2006-81-offshore/

Other remedial matters

REPEAL OF THE SIMPLIFIED FILING REQUIREMENTS FOR INDIVIDUALS LEGISLATION

Clauses 225(4) and (8), 240, 243, and section 33AA of Tax Administration Act 1994

Submissions
(Chartered Accountants Australia and New Zealand, KPMG)

CAANZ understands the rationale for the repeal of the simplified filing requirements for individuals legislation and therefore supports it. However, we are surprised that it was not foreseen in 2012 that the SFRI legislation would be "overtaken by events" and that the cost of developing and enacting the SFRI legislation could have been avoided. *(Chartered Accountants Australia and New Zealand)*

KPMG supports the repeal of the recent changes to the tax return filing requirements for individuals which were intended to apply from the 2016–17 income year, in anticipation of Inland Revenue's Business transformation changes. (*KPMG)*

Comment

Officials welcome this support. We also note at the time the SFRI legislation was enacted in 2012, Inland Revenue's Business transformation programme was in its very early stages and it was not clear how it would address the problem that the SFRI legislation sought to address.

The SFRI legislation addressed concerns of fairness by removing the ability for people to "cherry pick", and removing the requirement for others to file tax returns. These initiatives were seen as a "back-end" solution (that is, stopping the practice of filing tax returns in those years in which an individual is due a refund and not filing when they have tax to pay) to a "front-end" problem of inaccurate PAYE deductions during the year, leading to the need to square-up and file a tax return at the end of the year.

Current Business transformation thinking is for more streamlined processes, with salary and wage earners' information being provided by third parties such as employers and banks to Inland Revenue, and Inland Revenue undertaking the necessary calculations. This should lead to a more accurate PAYE structure, which means fewer people in a refund or tax-debt position at the end of the year. The problem of filing a tax return only in those years in which an individual is due a refund would be reduced.

Recommendation

That the submissions be noted.

EXTENSION OF THE GRACE PERIOD FOR DEREGISTERED CHARITIES

Issue: Eligibility for the grace-period for deregistered charities is too narrow

Clause 264

Submission
(Community Housing Aotearoa)

The proposed extension of the grace-period for deregistered charities will apply too narrowly. One of the requirements under clause 264 of the bill is that the "person's activities are predominantly the provision of housing". Some of Community Housing Aotearoa members may face deregistration due to the extent of their housing programmes. However, because these charities also provide other charitable activities they will not meet the "predominantly" test under clause 264, and therefore will not be afforded protection against the imposition of tax on net assets upon deregistration.

Clause 264 should be amended to require only that the "person's activities include the provision of housing, as part of achieving the person's stated objectives or purposes, before de-registration by Charities Services".

Comment

We agree with the submission. We consider that all providers involved in the provision of housing and who are deregistered by the Charities Services following its compliance review of community housing providers should be eligible for relief under the extended grace-period for reasons of equity. The "predominantly" test is an unfair and unnecessary constraint on the relief offered by the grace-period for providers who, through no fault of their own, have found themselves facing potentially significant tax liabilities.

Recommendation

That the submission be accepted.

Issue: The grace-period for deregistered charities does not fix the underlying problem

Clause 264

Submission
(Queenstown Lakes Community Housing Trust)

We support the amendment in clause 264 but are concerned that it simply provides a two-year extension and does not resolve the underlying lack of certainty of tax-exempt status for community housing providers after this two-year period.

Other concerns include:

- Any permanent fix to the problem should be centred on the objects and purposes of the community housing provider and not on the specific characteristics of the recipients of the housing assistance.
- A properly constituted community housing provider sees housing stress in all sorts of ways within their communities and it is not easy for central government to try and set the guidelines for determining what constitutes housing stress and how each community housing provider should be addressing it.

Comment

The Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 provided for a specific income tax exemption for a specific class of community housing providers (referred to as community housing entities) with the details to be set by Regulation. It was expected that the Regulation would be in place by 1 April 2015. However, owing to delays in setting the detail of the Regulation – in particular, the income threshold for determining who can be a recipient of a community housing entity – the tax exemption has not yet been finalised. Ministers are expecting to finalise these details over the coming weeks.

Recommendation

That the submission be noted.

Issue: Application date is contrary to policy intent

Clause 264

Submission
(Matter raised by officials)

Clause 264 as currently worded allows the extension of the grace-period for deregistered charities to apply to community housing providers who voluntarily deregister as well as to those who are deregistered by Charities Services. This result was unintended.

Comment

The grace period was only intended to apply to community housing providers deregistered by Charities Services, but due to an oversight in the current drafting, also included those that voluntarily deregistered. As a specific tax exemption for community housing entities is currently being finalised, it was considered appropriate to provide relief for community housing providers who, through no fault of their own, would have found themselves facing potentially significant tax liabilities. Community housing providers who voluntarily deregister should not be afforded the same relief provided by the grace-period as they have made a conscious decision not to have the grace-period apply to them.

Recommendation

That the submission be accepted.

TERTIARY EDUCATION INSTITUTIONS

Issue: Section CW 42 applies too narrowly

Clause 76

Submissions
(EY, KPMG)

Clause 76 of the bill amends section CW 55BA to allow wholly owned subsidiaries of tertiary education institutions to be treated as exempt from income tax on their business income and incorporates certain provisions of section CW 42 in that regard.

Section CW 42 gives rise to an unintended policy outcome by excluding businesses carried on by a company for charitable purposes, and owned by a charitable trust, from the income tax exemption for charities and for community housing entities. This unintended policy outcome was specifically addressed in clause 76 in relation to the wholly owned subsidiaries of tertiary education institutions and should be extended to the wholly owned subsidiaries of charities and community housing entities.

Comment

Under current interpretation, section CW 42 of the Income Tax Act 2007 excludes businesses carried on by a company for charitable purposes and owned by a charitable trust, from the income tax exemption for charities. This is because the charitable trust is deemed to have control over the business and is able to direct or divert amounts from the business for its own benefit or advantage. Practically, the application of section CW 42 as currently drafted means that a charity is not able to derive tax-exempt charitable business income in a subsidiary company (which may be desired for legal limitation of liability purposes, for example), but that same income would be tax-exempt if derived directly by the shareholder charitable trust. This is an unintended consequence.

In defining "tertiary education subsidiary", the proposed amendment to section CW 55BA fixes this unintended consequence for tertiary education institutions, as it allows tertiary education subsidiaries to remain tax-exempt by adding the words "other than the tertiary education institution" in the context of the control requirements. The effect of this is that when a tertiary education institution has control over its subsidiary, the subsidiary will remain tax-exempt.

KPMG has suggested that this problem could be resolved by amending section CW 42(1)(c) of the Income Tax Act 2007 and adding the words in italics:

> (c) no person, *other than a charitable entity referred to in section CW 41(1),* with some control over the business is able to direct or divert, to their own benefit or advantage, an amount derived from the business.

We agree with the general tenor of KPMG's suggested amendment in relation to wholly owned companies of charitable entities.

We also agree that a similarly worded amendment should be made to section CW 42B (the tax exemption for community housing entities) which also has control requirements similar to section CW 42. This amendment would ensure that when a community housing entity is itself a wholly owned subsidiary of a charitable trust or another community housing entity, the wholly owned subsidiary is eligible for the community housing entity tax exemption.

EY has suggested that this matter be resolved by granting the Commissioner the discretion to approve entities for income tax exemption under sections CW 42 and CW 42B. As mentioned earlier, we accept the need to resolve this matter but consider that it is best dealt with by clarifying the intended scope of the exemptions, rather than leaving it to the discretion of the Commissioner.

Recommendation

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

Issue: Support for section CW 55BA reform

Clause 76

Submission
(PwC)

PwC supports the intent of clause 76.

Comment

Officials welcome this support.

Recommendation

That the submission be noted.

Issue: Section CW 55BA is too narrow

Clause 76

Submission
(Te Whare Wānanga o Awanuiarangi)

The proposed section should be widened to include tertiary education companies which are wholly owned by one or more tertiary education institutions. The Wānanga sees no policy reason why the exemption should not apply if each shareholder is individually a tertiary education institution. Furthermore, extending the exemption would assist with planning structures for jointly owned tertiary education companies in the future.

Comment

Officials agree with the submission that the exemption should apply in circumstances when a tertiary education subsidiary is wholly owned by more than one tertiary education institution.

Recommendation

That the submission be accepted.

ACCOMMODATION

No clause

Issue: Employer-provided overseas accommodation

Submission
(Matter raised by officials)

The rule in section CE 1C of the Income Tax Act 2007 for valuing overseas accommodation provided by employers to their staff should be amended to also cover accommodation payments and accommodation allowances.

Comment

We are recommending a remedial fix to clarify that the section CE 1C rule for valuing overseas accommodation provided to employees was intended to cover both actual accommodation and accommodation payments, including allowances. The special report published on the Tax Policy website soon after the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 was enacted indicated this intention. Currently, the rule is inadvertently limited to actual accommodation provided, which means that there is a different tax outcome depending on how the overseas accommodation benefit is provided.

In the case of accommodation payments, the specific valuation rule in section CE 1C would only be able to be applied when the allowance or other payment provided either reflects the actual cost to the employee for the accommodation or is a reasonable estimate of the expenditure likely to be incurred.

Recommendation

That the submission be accepted.

Issue: Project of limited duration

Submission
(Matter raised by officials)

The definition of "project of limited duration" in section CW 16B of the Income Tax Act 2007 should be amended to clarify that it is intended to apply to employees when their employer is the contractor or a subcontractor who undertakes the work rather than the person who has hired the contractor.

Comment

When an employee is required, because of their job, to work away from their normal place of residence, the employee can be eligible for an income tax exemption of up to two years on any accommodation or accommodation payment that their employer provides. However, when an employee is involved in "a project of limited duration", such as the building of a dam, the employee can be eligible for an income tax exemption on accommodation of up to three years. This longer exemption reflects the likelihood that the employee's stay at the distant workplace will be longer because of the nature of such projects.

Given that it is a relatively generous exemption, the definition of "project of limited duration" is intended to be tightly defined, focusing on work projects whose principal purpose is to create, build, develop, restore, replace or demolish a capital asset. The projects would be carried out under a contract of service between an employer and one or more persons who are not associated with the employer. It is this latter aspect that needs to be clarified to emphasise that the intention is that the employer being referred to is the contractor or a subcontractor and not the ultimate client – for example, the construction company that builds the dam or the specialists who install the turbines, not the client that has contracted the construction company to undertake the work.

Recommendation

That the submission be accepted.

TAX POOLING RULES

Clauses 207 to 212

Issue: Support for aspects of the reform

Submissions
(Tax Management New Zealand, Chartered Accountants Australia and New Zealand, Corporate Taxpayers Group, KPMG)

Submitters supported the amendments to the tax pooling rules to enable purchased tax pooling funds to be used to meet outstanding interest obligations on increased amounts of tax resulting from an amended assessment or the resolution of a tax dispute.

The group strongly supports the proposed amendments, which restore the original intent of the tax pooling rules. The group is pleased that this issue is resolved in the bill having been the subject of discussions with officials since late 2012. *(Corporate Taxpayers Group)*

Comment

Officials welcome this support and recognise the assistance provided by the industry in working through this issue.

Recommendation

That the submissions be noted.

Issue: Extend tax pooling to disputes where proceedings are stayed

Submission
(Tax Management New Zealand)

The tax pooling rules are framed as if every taxpayer will settle a dispute in a timely manner or proceed through to challenge proceedings before a court. This is often not the case. Where a taxpayer's dispute is the same or similar to that of another taxpayer whose dispute is before the courts, the Commissioner and the taxpayer can agree to stay proceedings and be bound by the outcome of the dispute before the courts. This is a sensible course of action for all parties, as it saves both sides the cost of preparing lengthy statements of position, and reduces the pressure on the court system by not requiring cases to be needlessly filed with the courts.

Currently, when a dispute is stayed and does not proceed to court, a taxpayer may not be able to access tax pooling funds when the dispute is finally settled. However, if the dispute had proceeded to court the taxpayer would be able to access tax pooling funds. This is an unintended policy outcome.

The amendments within the bill should be extended to ensure that these taxpayers are not disadvantaged by staying dispute proceedings pending the outcome of a similar case before the courts.

Comment

Officials agree with the submission and support the amendment proposed by the submitter.

Recommendation

That the submission be accepted.

Issue: Application of use-of-money interest and penalties rules

Submission
(KPMG)

Although the amendment to the tax pooling rules is a positive step, the need for tax pooling reflects underlying concerns about the application of use-of-money interest and the penalties rules generally. These need to be addressed more fundamentally. If use-of-money interest and the penalties rules are not reviewed, KPMG supports a wider application of tax pooling funds to meet tax liabilities, which could potentially reduce the historic tax debt.

Comment

The Government recently released a green paper setting out its initial thinking about how to modernise New Zealand's tax administration. This paper outlined the Government's intention to review the provisional tax rules and how the use-of-money interest rules apply to businesses.

The green paper also signalled that, at the same time, a review of the tax pooling rules should be undertaken to identify if they can be improved and made available to more taxpayers.

Officials therefore consider that the Government's work on modernising New Zealand's tax administration will include consideration of the issues raised by the submitter.

Recommendation

That the submission be noted.

Issue: Inland Revenue's interpretation of the current legislation

Submissions
(Corporate Taxpayers Group, Tax Management New Zealand, Chartered Accountants Australia and New Zealand)

The tax pooling rules were drafted in a very prescriptive manner and are producing unintended and unnecessarily restrictive consequences, particularly in the settlement of tax disputes. *(Chartered Accountants Australia and New Zealand, Tax Management New Zealand)*

The amendment in the bill is the latest in a series of legislative changes to the tax pooling rules that have been required because Inland Revenue has not interpreted the existing legislation in the spirit in which it has been intended. This has caused significant uncertainty for taxpayers and tax pooling intermediaries, and the group is hopeful that Inland Revenue will adopt more of a pragmatic operational approach in the future to any remedial tax pooling issues. *(Corporate Taxpayers Group)*

Comment

Officials acknowledge that the tax pooling rules are prescriptive. To enable the smooth running of the tax pooling scheme Inland Revenue interprets the rules in line with their underlying policy intent. When the legislation is clear but does not achieve the intended policy outcome, remedial legislation is required.

As noted earlier, the Government has signalled its intention to review the tax pooling rules to see if they can be improved or made available to more taxpayers. Officials consider that the issue raised by submitters will be addressed as part of this review.

Recommendation

That the submissions be noted.

Issue: Inconsistency between the commentary and the bill

Submission
(Chartered Accountants Australia and New Zealand, Tax Management New Zealand)

There is an inconsistency between the officials' commentary on the bill and the bill itself, in relation to the timeframe for adjustments to be made to the interest transfers. The commentary states that interest transfers must be made within 60 days of the date of enactment of the legislation whereas the bill refers to the timeframe of 60 days from the date on which the Commissioner notifies the amount of interest payable for the transfers to be made.

The application date should be clarified. The timeframe proposed in the legislation is more realistic for both taxpayers and Inland Revenue.

Comment

Officials confirm that the timeframe contained in the bill is correct. The timeframe in the commentary is an error and officials propose to clarify this error in Inland Revenue's *Tax Information Bulletin,* which details the tax changes to the public once the legislation is enacted.

Recommendation

That the submission be accepted.

INCOME STATEMENTS AND INCOME TAX FILING EXEMPTIONS

Clauses 231, 225 and 226

Submission
(Chartered Accountants Australia and New Zealand)

This amendment is a sensible way of reducing the number of people required to file tax returns and therefore is a sensible way of reducing both Inland Revenue administrative costs and taxpayer compliance costs. There are many other "small" changes that could be made to the current rules that would simplify tax and reduce compliance and administrative costs. A real effort should be made to identify and implement them as part of Inland Revenue's Business Transformation or, where possible, in advance of Business Transformation.

Comment

This submission has been referred to Inland Revenue's Business Transformation project for consideration in future tax bills.

Recommendation

That the submission be noted.

FINANCIAL MARKETS (REPEALS AND AMENDMENTS) ACT 2013 – RELATED CHANGES

Clauses 213(55) and 266

Issue: Effective date of change of reference

Submission
(KPMG)

We strongly support this remedial amendment to the definition of "public unit trust" to reverse an unintended change made on the introduction of the Financial Markets Conduct Act 2013, the relevant section of which took effect from 1 December 2014. The amendment is currently proposed to take effect from enactment of the tax bill. As the unintended change was effective from 1 December 2014, the proposed amendment should take effect from that same date.

Comment

Paragraph 30(5)(f) of Schedule 1 of the Financial Markets Conduct Regulations 2014 applies for two years from 1 December 2014. This section treats, for the purpose of the public unit trust definition in the Income Tax Act 2007, a regulated offer made under the Financial Markets Conduct Act 2013 as including a reference to an offer that would have been an offer of securities to the public under the Securities Act 1978 if the Securities Act 1978 had not been repealed.

This transitional provision is intended to ensure that a public unit trust that qualified under the Income Tax Act 2007 definition before 1 December 2014 would continue to do so until a permanent solution could be enacted in this tax bill. Officials will refer to these regulations in the *Tax Information Bulletin* to assist taxpayers to be aware of them.

A principle of law drafting is that retrospective application dates should only be used when necessary. Officials do not consider them to be necessary in this instance.

Further, due to the reduction in the threshold in paragraph (b)(vi) and (vii) from 25 percent to 5 percent, there may be a small number of unit trusts that previously were public unit trusts but that will no longer meet the new criteria. Officials consider it would be inappropriate to retrospectively remove the public unit trust status of these entities.

Recommendation

That the submission be declined.

Issue: Change to the level of allowed investment

Submission
(KPMG)

We do not support the amendment to reduce the 25 percent shareholding percentage in paragraph (b)(vi) and (vii) of the "public unit trust" definition, to 5 percent. This is not a remedial amendment resulting from changes to financial markets regulation.

This change could have significant impacts for unit trusts that currently rely on paragraph (b) of the "public unit trust" definition, who will be caught unawares and potentially lose their status as a result. The change has not been consulted upon and it is not clear that the amendment is required or justified to address any perceived or real concerns. This change should be omitted from the tax bill and subject to wider consultation, rather than being enacted as a remedial amendment, which it is not.

Comment

Before 1 December 2014 a unit trust that qualified as a "public unit trust" under paragraph (b) of the definition could have unit holders who met one or more of a number of categories. These categories included:

- a person with a 25 percent shareholding interest or less in the unit trust, treating all associated persons as one person, if the unit trust offered securities to the public under the Securities Act 1978;
- a person with a shareholding interest of 25 percent or more in the unit trust, treating all associated persons as one person, if their interest is 25 percent or more because of unusual or temporary circumstances, such as the recent establishment or forthcoming termination of the unit trust, and if the unit trust would meet the requirements of any of paragraphs (a), (c), (d) and (e), and if the unit trust offers securities to the public under the Securities Act 1978.

The Securities Act 1978 was replaced by the Financial Markets Conduct Act 2013 on 1 December 2014. The current legislation, as amended by the Financial Markets (Repeals and Amendments) Act 2013 to include regulated offers in respect of the unit trust made under the Financial Markets Conduct Act 2013, covers certain offers that are not covered under the previous wording but also omits other offers that could result in certain unit trusts who currently meet the definition of "a public unit trust" no longer qualifying.

The Financial Markets Conduct Act 2013 does not include a concept equivalent to "securities offered to the public" so it is not possible for the income tax definition of a "public unit trust" to remain identical to its original outcome.

The bill proposes to remove the criteria regulated offers are made in paragraphs (a), (b)(vi) and (vii), and will instead rely on the existing criteria, which relate to the number of unit holders, the widely held status of those unit holders and other similar criteria. In the absence of other changes this would make it much easier for unit trusts who do not make regulated offers or who would not have offered securities the public to meet the public unit trust definition.

For paragraph (a) the existing 25 percent threshold is considered appropriate as it will still be necessary to have at least 100 unit holders, which would usually only occur when the units are offered to the public.

For paragraph (b)(vi) and (vii), if there were no threshold changes, this would allow a public unit trust to not make regulated offers and have as few as four unit holders, each with a 25 percent interest. Officials do not consider this would be consistent with the general concept of a public unit trust. By reducing the threshold to 5 percent a public unit trust that satisfies paragraph (b)(vi) will have to have at least 20 unit holders. It would not be tenable to remove the regulated offer requirement and leave the current threshold in place.

Officials note that a public unit trust only has to meet one of paragraphs (a) to (e) therefore a unit trust that no longer met the requirements of paragraph (b), due to these changes, could still qualify under one of the other paragraphs, such as having more than 100 unit holders (paragraph (a)) or having less than 100 unit holders but being reasonably regarded as a widely held investment vehicle for direct investment by members of the public despite its number of unit holders or investors (paragraph (c)).

Officials consider it is appropriate that any unit trust that, because of the changes in this bill, no longer satisfied paragraph (b) of the definition, and did not meet any of paragraphs (a), (c), (d) or (e), would be excluded from being a public unit trust. As this provision applies from enactment of the bill, this change could only affect a public unit trust on a prospective basis.

Recommendation

That the submission be declined.

THIN CAPITALISATION

No clause

Issue: Introductory provision to the rules

Submission
(Corporate Taxpayers Group)

Section FE 1(1)(a)(iii) refers to an entity that is "controlled by a group of entities, including non-residents and entities controlled by non-residents, that act together". The phrase "act together" appears have been picked up from earlier versions of the thin capitalisation reforms that were proposed in 2013, however that phrase was ultimately not adopted and does not appear elsewhere in the thin capitalisation rules.

Section FE 1(1)(a)(iii) should be removed from the Act, as it creates confusion as to the scope of the thin capitalisation rules.

Comment

The submitter is correct that the concept of non-residents who act collectively for the purposes of the thin capitalisation rules is expressed in the definition of "non-resident owning body" as set out in section FE 4.

There is one exception to this. For trustees of a trust, this concept is expressed as "a group of persons who act in concert". Thus trustees of a trust are subject to the rules if 50 percent or more of the settlements on the trust are made by a group of persons who act in concert and those persons are themselves subject to the rules.

Officials therefore recommend that section FE 1(1)(a)(iii) be amended to clarify that the rules apply when a taxpayer is a trustee and when the majority of settlements have come from people subject to the rules who are acting in concert.

Recommendation

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

Issue: Double counting rule

Submission

(Matter raised by officials)

Section FE 2(1)(cb)(i) provides that thin capitalisation rules apply when the members of a non-resident owning body have, on aggregate, a 50 percent or larger ownership interest in a New Zealand company. However, as a person's ownership interest in a company includes any direct ownership interests that an associated person has in that company, this can potentially result in a person's ownership interest being counted more than once.

To prevent this double counting, the section provides that the aggregate ownership interest of a non-resident owning body should be determined as if the members are associated. The intention of treating the members as associates is to utilise the rule in section FE 41 that prevents double counting. From a technical perspective, however, this does not work as section FE 41 applies only in relation to section FE 40.

Comment

Officials recommend the rules be amended to clarify that the ownership interests of a non-resident owning body should not be counted more than once. This amendment should apply from the beginning of the 2015–16 income year to align with the application date of section FE 2(1)(cb)(i).

Recommendation

That the submission be accepted.

DESIRABILITY OF CONSULTATION ON DRAFT LEGISLATIVE AMENDMENTS – MATTER NOT IN THE BILL

No clause

Submission
(Russell McVeagh)

Inland Revenue should more frequently release, for consultation, exposure drafts of amending legislation, so that interested parties can comment on the drafting prior to the relevant bill being introduced to the House. Related to the need for greater focus on the clarity and correctness of legislative drafting, Inland Revenue should maintain resources dedicated to improving tax legislation, through greater consultation on draft amendments, and by identifying drafting errors and other aspects of legislative uncertainty, and proposing remedial amendments where required.

Comment

Officials will continue to release draft legislation for consultation when this is appropriate and feasible to do so – for example, the *GST treatment of bodies corporate* discussion document released in June 2014. It will not always be appropriate, or possible, to provide draft legislation with consultation documents. Due to the many changes that frequently occur through consultation under the generic tax policy process it would often be inefficient for officials to prepare, and for submitters to consider, draft legislation that may be subject to significant revision before it is introduced in a tax bill.

Officials have an internal process for identifying and proposing remedial amendments to tax legislation. We will continue to refine this process.

Recommendation

That the submission be noted.

TAXATION OF FOREIGN SUPERANNUATION

Issue: Support for changes

Clauses 71 and 213

Submission
(KPMG, PwC)

The submitters support the proposed change that the new foreign superannuation rules, rather than the FIF rules, apply to an interest in a foreign superannuation scheme while the person is a New Zealand tax resident for domestic law purposes, but is considered to be non-resident for the purposes of a double tax agreement.

KPMG expressed general support for the proposed amendments that:

- reinstate the FIF exemption for Australian regulated superannuation schemes;
- allow individuals below the minimum FIF threshold of $50,000 to use the foreign superannuation rules for determining their tax liability; and
- confirm that where pensions have been returned as taxable income prior to 1 April 2014, individuals will not be penalised for non-compliance under the FIF rules.

Submission

Officials welcome support for the proposed changes in the bill.

Recommendation

That the submission be noted.

Issue: Residence test under double tax agreements – drafting

Clauses 71 and 213

Submission
(PwC)

The wording in the proposed amendment to section CF 3 that the foreign superannuation rules should apply where a person is a New Zealand resident under domestic tax law, but treated as non-resident under a double tax agreement when they acquire the rights in their foreign superannuation scheme should be revised to be more technically correct.

The proposed amendment includes the phrase "when the person is a non-resident or is treated under a double tax agreement as not being resident in New Zealand".

From a technical perspective, a person is not treated as being a non-resident of New Zealand under a double tax agreement, but rather, they are treated solely as being a resident of the other jurisdiction for the purposes of the double tax agreement. We propose that the wording should be amended to read "or is treated under a double tax agreement as a resident solely of the Contracting State other than New Zealand".

Comment

The Income Tax Act 2007 contains a number of references to New Zealand's double tax agreements, and in particular, to situations when dual-residence has been dealt with by a double tax agreement.

Officials have undertaken a survey of these references and it does not appear that the use of the phrase "is treated under a double tax agreement as a resident solely of the Contracting State other than New Zealand" or something similar has been used before.

Officials note that the phrase "treated under a double tax agreement as not being resident in New Zealand" is used elsewhere in the Income Tax Act 2007, and therefore do not consider that any further amendment is required. However, a slight variation has also been used, which refers to treatment under, *and for the purposes of*, a double tax agreement. The use of this variation may provide additional clarity and officials have raised this with drafters.

Recommendation

That the submission be noted, and the matter referred to drafters.

Issue: Low-value FIF superannuation interest – transfers into KiwiSaver should be exempt

Clause 71

Submission
(Baucher Consulting Limited)

A transfer of a low-value FIF superannuation interest to a KiwiSaver scheme should be treated as an exempt transfer.

Comment

A similar submission was made when the foreign superannuation rules were considered by the Committee as part of the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill. The Committee declined the submission that transfers into locked-in New Zealand superannuation schemes (for example, KiwiSaver) should be exempt from New Zealand tax. Officials noted at page 24 of the Officials' Report that "exempting transfers into locked-in schemes would create a significant inequity between New Zealand residents with foreign superannuation schemes and those with other financial assets such as New Zealand superannuation schemes, shares, or bank deposits".

This argument applies to all transfers into locked-in schemes, including transfers of low-value FIF superannuation interests into KiwiSaver schemes.

Officials note that a low-value FIF superannuation interest is not a FIF superannuation interest that is valued at less than $50,000, but rather a FIF superannuation interest where the total value of all of the person's interests in FIFs is less than $50,000. Exempting the transfer of a low-value FIF superannuation interest would raise significant equity concerns, not only between foreign superannuation schemes and other financial assets, but also between low-value FIF superannuation interests that would be exempt from tax under the submitter's proposal and foreign superannuation schemes that are taxed on receipt under the foreign superannuation rules or on an annual basis under the FIF rules.

Officials also consider that the submitter's proposal would encourage New Zealand residents to accumulate funds offshore in a foreign superannuation scheme and only transfer their funds to a KiwiSaver scheme immediately before they are able (and wish) to use their funds, without paying any New Zealand tax.

Recommendation

That the submission be declined.

Issue: Low-value FIF superannuation interest – formula method should be available

Clauses 71 and 213

Submission
(Baucher Consulting Limited, KPMG)

A person should be able to use the formula method to calculate the tax payable in relation to their low-value FIF superannuation interest.

Comment

The FIF rules apply to a foreign superannuation interest that has been acquired while a person is a New Zealand resident. This ensures that the FIF rules that apply to foreign portfolio investments held by New Zealand residents are not undermined.

A minimum threshold is available in the FIF rules, whereby an individual is not required to pay tax on an accrual basis under the FIF rules if the total cost of their interests in FIFs is less than $50,000. Instead, tax is paid on receipt of any distributions from their FIFs under other tax rules that may apply to their interest (such as the rules for distributions from trusts or companies). The aim of this minimum threshold is to reduce compliance costs for those with relatively small foreign investments, as these people are likely to be unsophisticated investors.

The bill proposes to introduce the concept of a "low-value FIF superannuation interest" to mitigate some of the complexities of the FIF minimum threshold. As the minimum threshold is intended to reduce compliance costs for taxpayers, allowing a person to apply the schedule method in relation to their low-value FIF superannuation interest would be a balanced approach in reducing some of the complexities of the FIF minimum threshold as it applies to foreign superannuation interests, while also maintaining the integrity of the FIF rules.

Officials consider that allowing taxpayers with low-value FIF superannuation interests to use the formula method would not be in line with the aim of the FIF minimum threshold to reduce compliance costs for taxpayers, because the formula method requires a person to have substantial information about their scheme.

In addition, the FIF minimum threshold is not compulsory and it is possible for people to opt out of the threshold into the accrual rules, if they are able and would like to return accurate economic income arising from their investment. This brings them into the same position as someone who is above the minimum threshold and cannot defer their tax liability. Officials consider this to be a reasonable trade-off; while the schedule method approximates the gains on which an individual should be paying tax, the individual is able to defer the actual payment of tax for several years.

Recommendation

That the submission be declined.

Issue: Low-value FIF superannuation interest – exemption period should be available

Clause 213

Submission
(KPMG)

A person should be eligible for a four–year exemption period when calculating the amount of tax payable arising from their low-value FIF superannuation interest.

Comment

The foreign superannuation tax rules contain a four–year exemption period that is designed to mirror the transitional residence exemption for new migrants.

Under New Zealand's domestic law, new migrants are provided with a four–year exemption on certain foreign-sourced income when they first become New Zealand–resident. The underlying intent is to provide new migrants with time to familiarise themselves with New Zealand's tax rules and get their foreign investments in order. The transitional residence exemption is also available to returning New Zealanders if they have been non-resident for 10 years or more.

Under the foreign superannuation rules, all individuals receive an exemption period in relation to their foreign superannuation interests as long as they satisfy the requirement that they acquired the interest while they were non-resident. This is because in the context of foreign superannuation interests, an individual who is non-resident for nine years should not be treated materially different from someone who has been a non-resident for 10 years (or more).

However, officials do not consider it appropriate to extend the four–year exemption period to low-value FIF superannuation interests. As the bill also contains a proposal to allow individuals who were resident under domestic law but non-resident for the purposes of a double tax agreement to pay tax under the foreign superannuation rules, rather than the FIF rules, officials consider that the majority of individuals with low-value FIF superannuation interests will either have sufficient ties to New Zealand to remain New Zealand-tax resident while living overseas or will be living in New Zealand permanently when they invest into the foreign scheme. Providing these individuals with an exemption period would provide them with a tax exemption for four years' worth of gains derived by their scheme. This would create significant equity concerns between the tax treatment of low-value FIF superannuation interests and other financial assets that a New Zealand resident may invest in (particularly at the same time), held both domestically and offshore.

Recommendation

That the submission be declined.

TAXATION OF FOREIGN SUPERANNUATION: MATTERS NOT IN THE BILL

Issue: Change to the United Kingdom's pension transfer rules – transfers out of KiwiSaver

No clause

Submission
(Charter Square Services)

As a result of a change to the Qualified Recognised Overseas Pension Scheme (QROPS) rules under the domestic law of the United Kingdom (UK), no KiwiSaver schemes qualify as QROPS and therefore a person who has transferred their UK pension scheme into a KiwiSaver scheme cannot even transfer to any other KiwiSaver scheme. The only feasible way to address this issue is with an urgent change to New Zealand legislation that allows those that have previously transferred their UK pension funds into a KiwiSaver to transfer out either back to a UK pension scheme or to another QROPS. This will require urgent action on behalf of the New Zealand Government.

Comment

This submission does not relate to any of the remedial amendments contained in the bill and is not a New Zealand tax issue.

The UK's QROPS rules set out the conditions under which a person with a UK pension scheme may transfer their funds to an overseas pension scheme. One of the reasons that the UK allows transfers of pension savings to be made free of UK tax is so that individuals leaving the UK permanently can simplify their affairs by taking their pension savings with them. However, there are safeguards in place to protect the integrity of the UK tax system and pension regime.

In order to transfer out of a UK scheme, the receiving overseas scheme must be a QROPS. To qualify as a QROPS, a number of requirements must be met, including that the scheme is locked in until retirement.

If a transfer is made from a UK scheme to a non-QROPS scheme, the individual is subject to a penalty of up to 55 percent of the transfer. This could be to discourage individuals from transferring to schemes where individuals have easy access to their funds or where HMRC does not have access to information about an individual's funds. After this, there may be little that the UK is able to do to control what happens to the funds.

Officials understand that the QROPS eligibility rules have recently changed, in particular with respect to the "pension age test" that schemes must satisfy. Officials understand that under the pension age test, funds must remain locked in until at least the age of 55, with early withdrawal only in cases of serious illness.

This change came into effect on 6 April 2015 as part of the UK's new policy on "pension flexibility", which allows individuals to withdraw their entire UK pension as a lump sum, rather than requiring them to use a certain portion to fund a "pension for life". As part of this policy change to make it easier for people to access their funds at and after the age of 55, they have tightened access to the QROPS regime.

Previously, for a New Zealand scheme to qualify as a QROPS they either had to be a KiwiSaver scheme or they had to satisfy the pension age test. From 6 April 2015, officials understand that all schemes must satisfy the pension age test and carve-outs are no longer provided. While KiwiSaver schemes are locked in until the age of 65, there are a number of permitted early withdrawals which mean that KiwiSaver schemes breach the pension age test. These include for example, withdrawals for the purchase of a first home and in the case of financial hardship, as well as the tax withdrawal facility.

New Zealand officials are engaging with HMRC officials in order to fully understand the nature and implications of the recent changes to the QROPS regime. Officials understand that KiwiSaver schemes will not be able to qualify as QROPS on a go-forward basis, because of inherent differences between the UK and New Zealand retirement savings systems, but are working towards finding a practical solution in relation to "legacy transfers". These legacy transfers are where a UK scheme and New Zealand QROPS scheme have signed off on a transfer, but the funds were not received by the New Zealand scheme until after 6 April 2015 (or have not yet been received).

Recommendation

That the submission be declined.

Issue: The United Kingdom's pension transfer rules – New Zealand receiving scheme should pay the tax liability out of a client's transferred funds directly to Inland Revenue

No clause

Submissions
(Baucher Consulting Limited, Charter Square Services)

The foreign superannuation tax liability should arise upon the transfer of a foreign superannuation interest into the New Zealand scheme and the tax liability should be paid directly by the New Zealand receiving scheme to Inland Revenue out of the individual's transferred funds. This would ensure a more prompt payment of tax.

There is uncertainty about whether withdrawals from KiwiSaver are allowed under the UK's QROPS rules and whether they could be classed as an unauthorised payment. Payment of the tax directly to Inland Revenue would not be an unauthorised payment under the UK's rules and therefore would not be subject to an unauthorised payments charge. *(Baucher Consulting Limited)*

The foreign superannuation tax withdrawal mechanism is preventing KiwiSaver schemes from qualifying as QROPS. If the tax liability were paid by the scheme, then no payment has been made to the member and therefore no issue exists. *(Charter Square Services)*

Comment

Officials note that under the foreign superannuation rules, a tax liability is triggered at the time the foreign superannuation interest is transferred into a superannuation scheme in New Zealand. However, as with other forms of taxable income where there is no withholding, the income needs to be included in a person's income tax return at the end of the income year.

As part of the introduction of the new foreign superannuation rules, a new category of permitted withdrawal was introduced into the KiwiSaver Act 2006 to allow individuals who have transferred their foreign superannuation interest into a KiwiSaver scheme to withdraw the amount of tax payable on the transfer (schedule 1, clause 14C). This recognises that people may wish to transfer their foreign superannuation into a locked-in New Zealand scheme such as KiwiSaver, but may not have the funds available to pay their tax liability. Officials note that this facility is available to transfers from all foreign superannuation schemes, not just those originating in the UK.

Officials also note that the legislation already mandates direct payment of the tax liability to Inland Revenue in certain circumstances when the tax withdrawal facility is used. Clause 14C(5)(b) provides that "if payment to a person other than the member is possible, [the trustees or the manager of the KiwiSaver scheme must] pay to the Commissioner the amount of the withdrawal."

Impact on ability to qualify as QROPS

Charter Square Services' submission is on the basis that the foreign superannuation tax withdrawal mechanism is what is preventing KiwiSaver schemes from qualifying as QROPS. They submit that if the tax liability were paid by the scheme, then no payment has been made to the member and therefore no issue exists.

As noted above, the KiwiSaver rules already require the direct payment of the tax liability to the Commissioner in certain circumstances.

At the time that the foreign superannuation withdrawal tax facility was designed, officials confirmed with HMRC that the introduction of the withdrawal facility would *not* in itself impact the ability of KiwiSaver schemes to qualify as QROPS. This was stated on page 27 of the Officials' Report on the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill.

Officials understand that the QROPS eligibility rules have recently changed, in particular with respect to the "pension age test" that schemes must satisfy. Officials understand that under the pension age test, funds must remain locked in until at least the age of 55, with early withdrawal only in cases of serious illness.

This change came into effect on 6 April 2015 as part of the UK's new policy on "pension flexibility", which allows individuals to withdraw their entire UK pension as a lump sum, rather than requiring them to use a certain portion to fund a "pension for life". As part of this policy change to make it easier for people to access their funds at and after the age of 55, they have tightened access to the QROPS regime.

Previously, for a New Zealand scheme to qualify as a QROPS they either had to be a KiwiSaver scheme or they had to satisfy the pension age test. From 6 April 2015, officials understand that all schemes must satisfy the pension age test and carve-outs are no longer provided. While KiwiSaver schemes are locked in until the age of 65, there are a number of permitted early withdrawals which mean that KiwiSaver schemes breach the pension age test. These include for example, withdrawals for the purchase of a first home and in the case of financial hardship, as well as the tax withdrawal facility.

New Zealand officials are engaging with HMRC officials in order to fully understand the nature and implications of the recent changes to the QROPS regime. Officials understand that KiwiSaver schemes will not be able to qualify as QROPS on a go-forward basis, because of inherent differences between the UK and New Zealand retirement savings systems, but are working towards finding a practical solution in relation to "legacy transfers". These legacy transfers are where a UK scheme and New Zealand QROPS scheme have signed off on a transfer, but the funds were not received by the New Zealand scheme until after 6 April 2015 (or have not yet been received).

Unauthorised payments

Officials understand that under the QROPS rules, once a person has transferred their pension scheme to a QROPS (with no UK tax or penalty), if they make a withdrawal and have been a UK tax resident in any of the five preceding tax years, the withdrawal could be deemed to be an "unauthorised payment" and could be subject to an unauthorised payments charge and surcharge of up to 55 percent.

Baucher Consulting Limited submits that there is uncertainty about whether withdrawals from KiwiSaver are allowed under the UK's QROPS rules. These withdrawals could be classed as unauthorised payments and could be subject to a penalty charge and surcharge in the UK. They also submit that payment of the tax directly to Inland Revenue would not be an unauthorised payment under the UK's rules and therefore would not be subject to an unauthorised payments charge.

Note that unauthorised payments are not exhaustively defined in the UK's legislation, but are simply payments that do not meet the legislative definition of an "authorised payment".

Officials understand from HMRC guidance that whether the payment is made to or on behalf of the member is not relevant in determining whether a withdrawal from the person's transferred funds is an unauthorised payment.

Immediacy of tax payment

The submitters state that having the tax liability created at the time of transfer and paid directly by the receiving scheme to Inland Revenue would mean that Inland Revenue "would not have to wait for a year-end income tax return to determine the tax liability and payment would be made immediately" (Charter Square Services) and that "it should also ensure prompter payment of the relevant tax liabilities on transfer" (Baucher Consulting Limited).

Officials understand that the basis of these submissions is that the tax should be withheld when a transfer is made from a foreign superannuation scheme into KiwiSaver.

A clip-the-ticket approach was considered when the foreign superannuation rules were designed, but was not chosen partly due to the costs and complexities associated with implementation, both for Inland Revenue and providers.

An important feature of the foreign superannuation tax withdrawal facility is that the use of the facility is optional. It provides taxpayers with flexibility in the event that they wish to use other funds to pay their tax liability, or if the laws of their previous country of residence place strict restrictions on what can be done with their funds post-transfer, as with the UK's QROPS rules, for example.

Including the relevant amount in their income tax return ensures that the individual pays the correct amount of tax depending on their circumstances, as the amount of tax payable depends on a number of factors, including the gains derived by the foreign superannuation while the person has been a New Zealand resident, the person's total taxable income for the year, and whether they are eligible to take any deductions.

Recommendation

That the submissions be declined.

Issue: Taxation of UK pension schemes

No clause

Submission
(Baucher Consulting Limited)

There should be a less regressive tax treatment of UK pension schemes to encourage funds into New Zealand.

Comment

The decision to transfer a financial asset, such as a pension scheme, to New Zealand is a significant one and tax should not be the only consideration.

The intent of the foreign superannuation rules is to provide a tax-neutral setting in which an individual can make a fully informed decision about whether or not to transfer their foreign superannuation interest to New Zealand.

The rules were designed to create a level-playing field between foreign superannuation assets and other financial assets, while recognising special features of retirement savings – particularly the fact that superannuation schemes are often locked in until retirement. The amount of tax payable as calculated under the foreign superannuation rules is dependent on the gains that have accrued in the person's foreign superannuation scheme while they have been a New Zealand resident. The amount of tax payable reflects the amount that should have been paid on accrual, but rolls up the tax liability until a lump sum is received with an interest factor to account for the deferral benefit.

Recommendation

That the submission be declined.

Issue: Tax rate on foreign superannuation transfers should be lower

No clause

Submissions
(Baucher Consulting Limited, Charter Square Services)

Transfers to schemes should be taxed based on an individual's prescribed investor rate. *(Baucher Consulting Limited)*

There should be a flat tax rate on the transfers, rather than a variable income tax–related rate. The rate could be set with reference to income tax and if it is we would suggest a rate between 15% and 17.5%. *(Charter Square Services)*

Comment

Officials note that similar submissions were made following the release in 2012 of the issues paper on the taxation of foreign superannuation and again when the foreign superannuation rules were considered by the Finance and Expenditure Committee as part of the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill. While not identical to these submissions, they similarly provided that lump sums should not be taxed at a person's marginal tax rate and instead should be subject to a lower rate of tax.

Officials noted on page 47 of the Officials' Report on submissions on the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill that the general issue also exists in relation to other lump-sum payments (for example, compensatory payments). No relief is provided in relation to other lump sums, so a change here would set a precedent for other lump-sum payments.

Recommendation

That the submissions be declined.

Issue: Drafting clarification – further contributions to a foreign superannuation scheme while New Zealand tax-resident are taxed under the foreign superannuation rules

No clause

Submission
(Independent Advisor to the Select Committee)

The rules should be amended to clarify that when an individual first acquires rights in a foreign superannuation scheme while non-resident (and is therefore subject to the foreign superannuation tax rules in section CF 3 of the Income Tax Act 2007), any subsequent contributions made to the scheme while they are New Zealand-resident are considered to be part of the interest in the superannuation scheme acquired while non-resident, and are taxed under the foreign superannuation rules, rather than under the FIF rules.

Comment

An interest in a foreign superannuation scheme is taxed under the foreign superannuation tax rules in section CF 3 of the Income Tax Act 2007, if the rights in the scheme are acquired while the person is non-resident for tax purposes. If they are a New Zealand tax resident at the time of acquisition, they must account for tax under the FIF rules.

When an individual first acquires an interest in a foreign superannuation scheme while non-resident, and continues to contribute to the scheme while New Zealand-resident, the policy intent is that the person is taxed under the foreign superannuation tax rules in relation to the whole interest.

On pages 6 and 7 of the Officials' Report to the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill, officials considered that in such a case, the individual should not be required to apportion their interest in the scheme between the foreign superannuation rules and the FIF rules as this would be highly complex and compliance-heavy.

Officials consider that the current drafting achieves this policy intent, but could be clarified to provide greater certainty, particularly when the foreign superannuation scheme is constituted as a trust because each contribution to the scheme could constitute a new settlement on the trust and could therefore be considered a separate interest in the foreign superannuation scheme. When a person first acquires interests in a foreign superannuation scheme while non-resident and makes additional contributions to the scheme while New Zealand-resident, these together should be considered a single interest in the scheme for the purposes of the foreign superannuation rules.

Officials consider that the amendment should be retrospective to the beginning of the new foreign superannuation rules, 1 April 2014, as it clarifies the existing position.

Recommendation

That the submission be accepted.

MIXED-USE ASSETS – INTEREST EXPENDITURE

Clauses 91 to 93

Submission
(EY)

As presently drafted, the proposed amendments to section DG 11 would seem to result in some overlap of the apportionment and limitation rules, so far as interest expenditure is concerned. The proposed amendments to section DG 11 appear to provide a self-contained set of apportionment and limitation provisions for interest expenditure when mixed-use assets are owned by certain close companies. Yet the general section DG 9(2) apportionment formula would still apply and would still include interest as part of the "expenditure" item. We assume no such element of double limitation is intended.

Comment

The submitter has correctly identified the intended interaction between the proposed new formula for interest expenditure apportionment in section DG 11(3B), and the current formula in section DG 9(2), in that there should be no double limitation.

Officials agree that this aspect of the drafting should be clarified.

Recommendation

That the submission be accepted.

DISPUTES PROCEDURES

Clauses 236 and 241

Issue: Commissioner's ability to truncate the disputes process by agreement under a taxpayer-initiated dispute

Submissions
(Chartered Accountants Australia and New Zealand, EY)

The proposed amendments should be deleted. (*EY*)

Alternatively, the proposed amendments should be revised so that neither the taxpayer nor the Commissioner is bound by the exclusion rule. (*Chartered Accountants Australia and New Zealand, EY*)

Comment

Under current law, the Commissioner must issue a Statement of Position in response to a taxpayer's Statement of Position. When the Commissioner and taxpayer agree that a dispute should proceed to the challenge phase, this has the potential to delay a dispute unnecessarily and impose unnecessary administration costs. The proposed amendments ensure that truncation is allowed in a taxpayer-initiated dispute after the taxpayer has issued a Statement of Position without requiring the Commissioner to first issue a Statement of Position.

The Commissioner and taxpayer must agree in writing to truncate a dispute. Submitters were concerned that applying the exclusion rule only to a taxpayer in a truncated dispute could place the Commissioner in a different and stronger position than the taxpayer. Officials consider that a taxpayer could avoid the application of the exclusion rule in this way by not seeking to truncate the dispute after issuing their Statement of Position.

Recommendation

That the submissions be declined.

Issue: Commissioner's ability to truncate the disputes process under a taxpayer-initiated dispute

Submission
(Matter raised by officials)

The scope of the remedial change should be expanded so that in a taxpayer-initiated dispute when a taxpayer has issued a Statement of Position, the Commissioner should not be required to issue a Statement of Position if any of the exceptions in section 89N(1)(c) of the Tax Administration Act 1994 apply. The exclusion rule should not apply in a taxpayer-initiated dispute after a taxpayer has issued their Statement of Position if any of the exceptions other than the exceptions for truncation by agreement apply.

Comment

Under current law, the Commissioner must issue a Statement of Position in response to a taxpayer's Statement of Position even if one of the exceptions to completing the disputes process applies. Agreement between the Commissioner and a taxpayer to truncate the disputes process is only one of the circumstances set out in section 89N(1) when the requirement to complete the full disputes process does not apply. The other circumstances are if:

- in the Commissioner's opinion the taxpayer has in the course of the dispute committed an offence that has effectively delayed the process;
- a taxpayer involved in a dispute, or an associated person of the taxpayer, has taken steps to relocate their assets to avoid or delay the collection of tax;
- the taxpayer has begun judicial review proceedings in relation to the dispute or an associated person of the taxpayer involved in another dispute involving similar issues has begun review proceedings;
- during the dispute, the taxpayer fails to comply with a request under a statute for information relating to the dispute and fails to comply within the period that is specific in the request; and
- the taxpayer and the Commissioner agree in writing to suspend the dispute pending a decision in a separate test case that is being challenged.

Officials consider all of these situations could potentially apply in the period between the taxpayer issuing their Statement of Position and the Commissioner issuing hers. It would be contrary to the policy intent of the exceptions in section 89N(1) if the Commissioner was required to issue a Statement of Position when one of the exceptions applied. In these other circumstances it would not be appropriate for the taxpayer to be bound by the exclusion rule.

Recommendation

That the submission be accepted.

PROPERTY TRANSFER RULES

Clauses 149 to 152

Issue: Definition of "settlement of relationship property"

Submission
(New Zealand Law Society)

The definition of "settlement of relationship property" in proposed section FB 1B defines the transactions that are eligible for the concessionary rollover relief under subpart FB. The proposed amendment to the definition broadens the range of transactions that are eligible for the rollover relief.

The Commentary on the bill explains that the reference to "between parties" is to be deleted so that transfers of property between one of the parties to the agreement and a third party (such as a family trust) are included. However, the proposed definition of "settlement of relationship property" goes further than that, in that neither the transferor nor the transferee need to be parties to the relationship property agreement. The consequence of this approach appears to be that transactions between two trusts (such as a resettlement) under a relationship property agreement will be subject to the concessionary treatment in subpart FB.

The concessionary treatment should extend to such situations (as was the case prior to the Income Tax Act 2007), but we are concerned that Inland Revenue may "read down" the new definition, given that the Commentary on the bill implies that the transferor must be a party to the relationship property agreement.

Officials should clarify that the change in the meaning of "settlement of relationship property" means that neither the transferor nor the transferee need to be a party to the relationship property agreement and, as such, subpart FB will apply to the resettlement of trust property under a relationship property agreement.

Comment

Officials agree that the proposed amendment to the definition of "settlement of relationship property" is intended to broaden the category of transactions that are eligible for rollover relief, including a resettlement of trust property. However, officials have concerns about the breadth of the submitter's proposal to extend the definition. Specifically, officials consider that it may not be appropriate to provide rollover relief for transactions between a party to the relationship property agreement and a third party. Officials consider that the proposed amendment should be limited to transactions between the parties to the relationship property agreement or associated persons.

Recommendation

That the submission be accepted in part, by clarifying the proposed amendment to the definition of "settlement of relationship property" should limit the rollover relief to transactions between the parties to the relationship property agreement and associated persons.

Issue: Application date of definition of "settlement of relationship property"

Submission
(New Zealand Law Society)

The proposed change to the definition of "settlement of relationship property" will affect whether the transferor or the transferee bears the income tax liability arising from the transfer of property (such as depreciable property) under a relationship property agreement. These tax implications would (or at least should) have been taken into account by the parties in determining a fair split of relationship property. If the change to the definition of "settlement of relationship property" is enacted with retroactive effect, this could have a significant impact on the financial position of parties who have settled relationship property in good faith, before the date of enactment.

Comment

Officials agree with the submission that a retroactive change could affect the financial positions of people who have previously settled relationship property. Officials propose, therefore, that the application date for the changes to the definition of "settlement of relationship property" should be the date of enactment of this bill.

Recommendation

That the submission be accepted.

Issue: Tax treatment of transfers of relationship property

Submission
(Matter raised by officials)

Section FB 1C is intended to be a rollover relief provision to deal with settlements of relationship property not otherwise dealt with by a specific provision in subpart FB. Section FB 1C ensures:

- the transferor has no tax consequences on disposal; and
- the transferee acquires not only the property, but all the characteristics of the transferor with respect to that property – for example, date of acquisition, cost at acquisition, and intention of acquisition.

There is arguably a mismatch between proposed section FB 1C(1) (which suggests that a transferor is liable for any tax arising on transfer of the property to the transferee) and proposed section FB 1C(2) (which states that a transferor is not liable for a tax obligation that would otherwise arise as a result of disposing of the property).

Comment

Officials consider section FB 1C should be clarified so, for tax purposes, the disposal and acquisition under the relationship property agreement is disregarded. The amendment should also clarify that the transferor is liable for any tax obligations that arise before the transfer under the relationship property agreement.

Recommendation

That the submission be accepted.

Issue: Distribution by a trustee under an arrangement

Submission
(Matter raised by officials)

Under sections FC 1(1)(c) and FC 2(1), a distribution of property from a trustee to a beneficiary of the trust is deemed to be a disposal and acquisition at market value. In some circumstances this is an inappropriate outcome. The proposed amendment to section FC 1(1)(c) provides that a distribution will not be deemed to be at market value when it is part of an arrangement under which a beneficiary pays an amount for the property. The exception should only apply where the beneficiary pays an arm's length amount of money.

Comment

Limiting the exception to situations when an arm's length amount has been paid will better align with the general approach that deems the disposal to be at market value. When a beneficiary pays an amount that is not at arm's length then it seems appropriate to deem the disposal and acquisition to be at market value.

Recommendation

That the submission be accepted.

APPLICATION OF FINANCIAL ARRANGEMENT RULES TO NON-RESIDENTS

Clause 120

Submission
(EY)

The proposed replacement for section EW 9(4)(b) does not achieve the stated aim.

It is inappropriate for the section to refer to the trustee, together with the trust, as a trust, is neither a separate legal entity nor recognised as a person for income tax purposes.

Section EW 9(4)(b) should be rewritten more simply and directly along the lines that the amount is assessable income of the trustee under section HC 25.

Comment

Because the drafting is expressed by way of negative statements, the submitter believes this will give rise to confusion rather improving clarity.

Officials agree that the drafting of the proposed amendment should be reviewed.

Recommendation

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

PETROLEUM MINING RULES

Clauses 97, 98, 100, 101, 213(49), (50), (72) and (73)

Submission
(Chapman Tripp)

We support the amendments to the petroleum mining rules, with the exception of clause 213(73). The savings provision for the definition of "petroleum permit" in clause 213(73) is not appropriate.

Comment

Section DT 2 of the Income Tax Act 2007 applies to arrangements under which a taxpayer incurs petroleum exploration expenditure and subsequently receives economic reimbursement of that expenditure. The section applies to reduce the deductions for petroleum exploration expenditure to the extent of the economic reimbursement.

Section DT 2 is not intended to apply to an arrangement under which petroleum exploration expenditure has been allowed and related property transferred and the consideration derived is fully liable for income tax.

However, section DT 2 should continue to apply to such arrangements entered into before the introduction of the bill to the extent non-taxable economic reimbursement may occur in the future.

We agree the savings provision should be amended to address the concern of the submitter about consideration derived that is fully taxable in New Zealand.

Recommendation

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

TRANSITIONAL RESIDENTS – DEFINITION

Clause 176

Submission
(PwC)

PwC supports the clarification to the definition of transitional resident.

Further work is required, however, to identify and address other legislative anomalies with the current transitional residence rules. In particular, greater clarity is still required over when taxpayers are eligible to access their transitional residence exemption period.

Comment

The policy intent for the transitional resident rules is to reduce tax barriers to international recruitment and to encourage New Zealanders who have lived overseas to return to New Zealand to live and work. The tax relief granted is an exemption from income tax on certain foreign-sourced income during the period of relief.

The submission raises separate policy issues relating to the transitional resident rules. The amendment in the bill is of a remedial and clarifying nature only and is not intended to change the effect of the transitional resident rules.

Recommendation

That the submission be declined.

BAD DEBT DEDUCTION AND APPLICATION OF THE CAPITAL LIMITATION

Clauses 84(4), (7) and 257

Issue: Clarifying that the general capital limitation will not prevent a deduction for a bad debt of a financial arrangement

Submissions
(Corporate Taxpayers Group, KPMG, Russell McVeagh)

The Group strongly supports the proposed amendments to clarify that the general capital limitation will not prevent a deduction for a bad debt of the principal amount of a financial arrangement (subject to the Group's comments on aspects of the proposed amendment). *(Corporate Taxpayers Group)*

KPMG supports the remedial amendments to the bad debt deductibility rules to clarify that the capital limitation does not apply to prevent a bad debt deduction for a loan if the lender has entered into the debt in the normal course of business. *(KPMG)*

Russell McVeagh agrees with the need to clarify, with retrospective effect, the application of the capital/revenue distinction to the deductibility of bad debts (subject to their comments on aspects of the proposed amendment). *(Russell McVeagh)*

Comment

In general terms, the principal amount of a financial arrangement (for example, a loan) is on capital account. This was explicitly stated in the Income Tax Act 1976. Again in general terms, a bad debt deduction is not allowed for a loss of capital. To achieve that policy outcome, the current bad debt deduction rule is subject to the capital limitation (which denies a deduction for an expenditure or loss of capital).

An exception to the capital limitation for bad debts applies to taxpayers (business holders or dealers) who carry on a business of holding or dealing in financial arrangements. This is because, under common law, the principal amount of loans entered into in the ordinary course of a moneylending (banks, for example) or dealing businesses are on revenue account and not on capital account.

The Commissioner applies the law consistent with the policy objectives, so that:

- financial arrangements entered into in the ordinary course of carrying on a holding or dealing business are not considered to be subject to the capital limitation; and
- financial arrangements held by a business holder or dealer outside the holding or dealing business are subject to the capital limitation.

While the current law achieves the intended policy outcome, the Rewrite Advisory Panel recommended the amendment in the bill as an improvement to the legislation to clarify the policy intention of the relationship between the bad debt deduction rule and the capital limitation. This followed a submission to the Panel that the current bad debt deduction rule contained a potential unintended legislative change arising from the rewrite of income tax legislation.

The amendment is made at the recommendation of the Rewrite Advisory Panel to limit the application of the capital limitation rather than leave that to a matter of interpretation. This is intended to reduce compliance and administration costs.

Recommendation

That the submissions be noted.

Issue: Consistency of bad debt deduction rule with pre-2004 position

Submissions
(Chapman Tripp, Corporate Taxpayers Group, Russell McVeagh)

The proposed new test is not consistent with the position prior to 2004 and not appropriate for financial arrangement debt. *(Chapman Tripp)*

The Income Tax Act 2004 removed the 1994 automatic exclusion from the capital limitation for deductions determined under part E, which included financial arrangement bad debts. *(Chapman Tripp)*

The amendments to section DB 31(6)(b)(iii) of the Income Tax Act 2007 and section DB 23(6)(b)(iii) of the Income Tax Act 2004 should be omitted. *(Chapman Tripp)*

Section DB 31(6)(b)(iii) of the Income Tax Act 2007 and section DB 23(6)(b)(iii) of the Income Tax Act 2004 be replaced with "the general limitations apply, except that subsections (2) and (3) override the capital limitation." *(Chapman Tripp)*

The test of "entered into in the ordinary course of business" is not consistent with the position prior to 2004. *(Chapman Tripp)*

The words "for a financial arrangement entered into in the ordinary course of business" should be removed from proposed new section DB 31(6)(b)(iii) (and the equivalent amendment to the 2004 Act) on the basis that these words introduce a new requirement not present in the pre-rewrite section, and which appear to defeat the purpose of the proposed amendment and substantially limit its effectiveness. *(Corporate Taxpayers Group)*

Amendments addressing the bad debt deduction and the capital limitation do not achieve their stated purpose. *(Russell McVeagh)*

The words "for a financial arrangement entered into in the ordinary course of business" should be omitted from clauses 84(4) and 257. *(Russell McVeagh)*

Comment

The drafting of the bad debt deduction rule in the Income Tax Act 2004 (and re-enacted in the Income Tax Act 2007) was intended to clarify the policy intention for financial arrangements of a business holder or dealer not entered into in the course of carrying on their business. Such clarifications were considered to be within the scope of the rewrite of income tax legislation.

The Commentary on the bill noted that the policy for the bad debt deduction rule for a business holder and dealer was recommended by the Consultative Committee on Accrual Tax Treatment of Income and Expenditure (the Brash Committee).[4] The policy is that the bad debt deduction rule for financial arrangements should maintain the common law position in relation to bad debt deductions, except for bad debts entered into between associated persons.

Under the common law, a bad debt suffered by a business holder or dealer which related to a financial arrangement entered into in the ordinary course of business was considered to be on revenue account. In this circumstance, common law held that a bad debt deduction was allowed for a loss of principal and accrued interest, provided some procedural requirements were satisfied.

Common law also considered that a debt entered into outside the normal or ordinary course of business would be usually treated as a non-deductible capital loss as a result of applying the capital/revenue tests.

Chapman Tripp suggests the comments in the Commentary on the bill referring to Brash Committee recommendations are simply referring to the fact that deductions for losses were not to be universally available. Officials note that the comments in the Commentary are directly concerned with the policy for bad debt deductions. A statement relating to the deductibility of expenditure and losses (that is, economic interest costs) under the financial arrangement rules was set out later in the Brash Committee's report.[5]

Officials agree that the bad debt deduction rule in the Income Tax Act 2004 and Income Tax Act 2007 has the potential to produce a different outcome for financial arrangements held outside a holding or dealing business from that given by the Income Tax Act 1994. Officials consider that non-deductibility of a bad debt for a business holder or dealer would be a rare occurrence.

Officials also agreed with the Panel, that there is some uncertainty over whether a special purpose vehicle that is a holder of financial arrangements would be allowed a bad debt deduction under the existing law. The amendment is intended to clarify the law to address this uncertainty.

[4] Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure, April 1987, paras 32-41, comment on drafting para 2.632-41, comment on drafting para 2.6.
[5] Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure, April 1987, paragraphs 64-67.

The following examples illustrate the type of situation when it could be considered appropriate that no deduction be allowed for a loss of capital.

Example 1

A financial institution enters into a joint venture with other financial institutions through a joint venture company to develop an activity that relates to the business structure of each of the financial institutions (such as a data clearing house operation that serves all partners).

The joint venture company is not an associated person of any of the financial institutions (25% interest for each of the financial institutions).

Each institution individually carries on a business of either holding or dealing in financial arrangement (for example, banking).

The joint venture partners contribute their capital by debt.

If the joint venture operation is not successful, its value is dissipated and the joint venture company becomes unable to pay its debts. The debt becomes uncollectible, and is bad. From a policy perspective, a debt of this nature relates to the capital structure of the financial institution's business. If the debt becomes bad it is a loss of capital and no deduction should be allowed.

Example 2

Company X's business includes the supply of certain goods and the making of loans to customers. Company X entered into an arrangement with a major customer, Company Y, which indicated it could buy goods from another supplier.

Under the arrangement Company X made a loan to Company Y and Company Y agreed to buy certain goods exclusively from Company X. The loans are the same as or similar to loans made to other customers (having similar interest rates and other terms).

However, the bad debt under the loan to Company Y is a capital loss because the main purpose of the loans was to obtain a capital advantage (an exclusive supply agreement). This type of loan is generally not made in the ordinary course of business because a moneylending business is usually concerned with interest returns rather than securing a long-term capital advantage.

Example 3

A company in financial difficulty is lent money by a minority shareholder to protect the shareholder's investment in that company. That type of loan is generally not made in the ordinary course of business because a moneylending business does not usually provide funds to an entity having significant credit risk unless the interest rate is high enough to compensate for the credit risk.

Recommendation

That the submissions be declined.

Issue: Financial arrangements are on revenue account

Submission
(Chapman Tripp)

Financial arrangements are necessarily on revenue account.

Comment

The principal amount of a financial arrangement is generally considered to be an item of capital. This was very clearly stated in the Income Tax Act 1976 and the policy remains unchanged from that time. The only exceptions to this general principle are:

- the principal amount of financial arrangements entered into in the ordinary course of a holding or dealing business, which are treated as being on revenue account;
- discounts or losses on disposal that are part of the economic interest return or cost of the arrangement.

The policy of the financial arrangement rules is primarily to determine the timing and quantification of income and expenditure relating to the economic interest arising under a financial arrangement. The economic interest under a financial arrangement is the return or cost to the lender and borrower respectively over the term of the arrangement. These returns or costs include a discount to face value.

For income tax purposes, the economic interest incurred or derived from a financial arrangement is treated as being interest and placed on revenue account, and spread over the life of the arrangement. The deductibility of economic interest incurred under a financial arrangement must satisfy the general permission (the business test or nexus with income test). Economic interest derived is always income of the recipient.

Recommendation

That the submission be declined.

Issue: Clarifying the application of the capital limitation to bad debts

Submissions
(Chapman Tripp)

It is not clear how the test of "entered into the ordinary course of business" is to be applied.

It is not clear when the "carrying on a business of dealing/holding" test would be met.

The proposed "ordinary course of business" test would apply to deny a deduction.

Comment

Officials consider it is a matter of fact of whether and when a financial arrangement was entered into in the ordinary course of business. Officials think this test is implied in the current law when considering the bad debt deduction rule. Officials consider the wording is intended to reflect that implied test but accept that the new wording can be interpreted as a separate test.

Officials agree that the proposed "ordinary course of business" test would deny a deduction for a bad debt on capital account. This is an intended policy outcome.

Recommendation

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

Issue: Application of the capital limitation to bad debts

Submission
(Chapman Tripp)

The capital limitation is not intended to apply to bad debts and this is reinforced when a person sells a debt for a loss because of a decline in creditworthiness:

- the same test as that set out in section DB 31(3)(b) and (c) applies; and
- there is no capital limitation.

Comment

When a loan is disposed of at a discount because of a decline in creditworthiness of the borrower, the policy intent is that a decline in value on disposal due to creditworthiness factors is not normally deductible. However, an exception to this general rule applies for a business holder or dealer if the loan was held within a holding or dealing business.

Officials consider the law allows a bad debt deduction to a business holder or dealer for a decline in creditworthiness for a financial arrangement held within that business (but not otherwise) and this outcome is entirely consistent with the policy intention.

The bad debt deduction rule is an important provision for business because it allows a business holder or dealer to effectively advance the timing of the deduction for the discounted value of the loan to when the loan is considered unrecoverable. In the absence of the bad debt deduction rule, the business holder or dealer would have to wait until disposal or maturity of the loan to have the deduction for the decline in creditworthiness.

Recommendation

That the submission be declined.

Issue: Special purpose vehicles holding financial arrangements

Submissions
(Chapman Tripp, Russell McVeagh)

It is unclear how the capital limitation would apply to bad debts in the context of:

- covered bond arrangements where the provision will only become applicable at the point the covered bond guarantor ceases to maintain Financial Institution Special Purpose Vehicle (SPV) status and is deemed to acquire a financial arrangement; and
- securitisations where the financial arrangements are acquired at the outset of the arrangement and where no further financial arrangements are acquired following that time. *(Chapman Tripp)*

A special purpose vehicle may acquire a portfolio of assets and hold those assets until maturity. As the acquisition of the portfolio would be a one-off transaction, could it be said that each financial arrangement was "entered into in the ordinary course of business"? *(Russell McVeagh)*

Comment

These submissions relate to an SPV holding financial arrangements under a securitisation or covered bond arrangement. The key questions relate to whether:

- the SPV is a business holder or dealer; or
- a financial arrangement for which a bad debt deduction is sought meets the requirement that the arrangement was entered into in the ordinary course of business.

For income tax purposes, an SPV may hold financial arrangements as either:

- a stand-alone taxpayer that acquires and holds a portfolio of loans in consideration for issuing a securitised asset; or
- a transparent entity, where the SPV acquires a portfolio of loans from a bank in consideration for issuing the bank with a securitised asset. For income tax purposes, if the SPV meets certain requirements, the SPV's portfolio is treated as continuing to be held as part of the bank's business. If those requirements cease to be satisfied, the SPV is deemed, for income tax purposes, to acquire the financial arrangements from the bank.

Chapman Tripp and Russell McVeagh consider that the proposed amendment raises uncertainty about whether a stand-alone SPV is allowed a bad debt deduction for a principal amount of a financial arrangement if the acquisition of the portfolio of loans is a one-off transaction and no other lending activity occurs. Russell McVeagh comments that this uncertainty would not arise if the law is restored to the position under the Income Tax Act 1994.

As a stand-alone taxpayer, a bad debt deduction for the principal amount of a loan is allowed if the SPV satisfies the requirements of the bad debt deduction rule for business holders or dealers. This is because financial arrangements entered into, held, or dealt with in the course of a holding or dealing business are normally on revenue account, and the capital limitation would not apply.

The submissions raise the following issues:

- Is an SPV carrying on a business of holding, dealing or carrying on a passive investment activity if it makes a one-off transaction to acquire a portfolio of financial arrangements and does nothing more than hold those assets to maturity carrying on a business of holding or dealing?
- If it is assumed that an SPV carries on a business of holding or dealing, are there circumstances in which a one-off transaction made by the SPV to acquire a portfolio of financial arrangements to be held to maturity is not made in the ordinary course of carrying on that business?

It is a question of fact whether a SPV is a business holder or dealer if it acquires its portfolio of financial arrangements in a one-off transaction. If such a SPV is not a business holder or dealer, officials consider it would not have been allowed a bad debt deduction for the principal amount of a financial arrangement under any of the bad debt deduction provisions of the Income Tax Acts –1976, 1994, 2004 or 2007. The SPV should however be allowed a bad debt deduction for accrued interest income that has been written off as a bad debt.

If the SPV is assumed to be a business holder or dealer, it is a question of fact whether the first one-off transaction is made in the ordinary course of that business (on revenue account) or is made to establish that business (a capital transaction). If the facts show that such a one-off transaction is on capital account, officials consider an SPV that is a business holder or dealer:

- might have been allowed a bad debt deduction for the principal amount of a loan acquired in that one-off transaction under the Income Tax Act 1994; and
- might not have been allowed a bad debt deduction under the Income Tax Act 2004 or Income Tax Act 2007 for the principal amount of a loan acquired. We are not aware of any circumstance in which this has occurred.

Officials note that:

- The wording of the proposed amendment should be reviewed to ensure that the capital limitation does not deny a bad debt deduction for a financial arrangement held or dealt with within a holding or dealing business.
- This submission raises issues relating to the business test for special purpose vehicles holding securitised loans or covered bonds that would require further analysis as part of the Government's tax policy work programme.

Chapman Tripp has raised a concern that the proposed amendment gives rise to uncertainty about the tax treatment of the SPV in relation to bad debts after the SPV loses its "transparent status".

We note that the "transparency" provisions in the Income Tax Act 2007 were enacted after the Reserve Bank introduced its Residential Mortgage-Backed Securities scheme in 2008 in the wake of the Global Financial Crisis.

From this time, securitisation and covered bond arrangements entered into by banks were after enactment of the Income Tax Act 2004 and Income Tax Act 2007. The bad debt deduction provision in both of these Acts is clear that the capital limitation applied to the bad debt deduction rule.

Officials note that:

- this submission raises the same issues for the application of the bad debt deduction provision to an SPV that is a stand-alone taxpayer;
- the wording of the proposed amendment should be reviewed to ensure that the capital limitation does not deny a bad debt deduction for a financial arrangement held or dealt with within a holding or dealing business;
- this submission raises issues that would require further analysis as part of the Government's tax policy work programme; and
- the Panel recommended that a review of the application of the financial arrangements rules in relation to securitisation vehicles be a matter that is placed on the tax policy work programme.

Recommendation

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

Issue: Application to "mum and dad" investors

Submission
(Mark Scott)

The clauses as proposed represent a back-dated narrowing of existing law that will unfairly penalise taxpayers such as Mum and Dad investors who have already returned taxable income arising under financial arrangements before the creditor company became unable to repay its debts and was placed into liquidation (for example, failed finance companies).

Comment

Officials consider the amendments to the capital limitation in the bad debt deduction rule have no effect on investors who are not carrying on the business of holding or dealing in financial arrangements.

An example of this type of investor would be those who have derived interest income that has been accrued by the borrowing company (such as a finance company) and would be paid out on maturity of the investment. If the borrower is liquidated, the accrued income would never be paid out. The investor is normally allowed a bad debt deduction for unpaid interest on liquidation of the borrowing company. We note that recent amendments relating to this deduction mean that the "write-off" procedural requirements do not apply to such investors.

If the investors are carrying on the business of holding or dealing in financial arrangements, as discussed above, the investor is normally allowed a deduction for the principal amount of a "bad" financial arrangement that was entered into in the course of carrying on that holding or dealing business, provided that certain procedural requirements are satisfied.

Recommendation

That the submission be declined.

Issue: No regulatory impact statement

Submission
(Chapman Tripp)

There should be a regulatory impact statement on the amendment given the departure from the position before 2004.

Comment

The current bad debt deduction rule has been in place since the beginning of the 2005–06 income year, a period of almost 10 years.

The amendment to the bad debt deduction rule proposes to amend the law to better reflect the long-standing policy intention. The amendment is therefore remedial in nature.

Recommendation

That the submission be declined.

Issue: Retrospectivity and savings

Submissions
(Chapman Tripp, Russell McVeagh)

If the new "ordinary course of business" test is to be enacted, then:

- The capital limitation for bad debts should be repealed with retrospective effect to 2004.
- The capital limitation should be applied prospectively from the income year beginning 1 April 2016. *(Chapman Tripp)*

The retrospective application would call into question the treatment of bad debts under previous tax positions. *(Russell McVeagh)*

Comment

The Panel did not recommend a "savings" provision for taxpayers who have relied on the application of the bad debt deduction rule in the Income Tax Act 1994. This is likely because it is anticipated that very few taxpayers would be affected by the Income Tax Act 2004 drafting of the bad debt deduction rule.

Under the bad debt deduction rule for business holders or dealers in the Income Tax Act 1994, it is necessary to consider whether the bad debt relates to a financial arrangement connected to the ordinary course of holding or dealing business. The purpose of the proposed amendment is to clarify that the capital limitation applies to a bad debt arising in the rare circumstance that a business holder or dealer holds a financial arrangement outside the ambit of its business.

These submissions seem to be concerned that a risk exists for taxpayers who have previously taken a tax position that a bad debt deduction is allowed for the principal of a financial arrangement not connected with the carrying on a holding or dealing business. To take such a position, the taxpayer must have assumed that the application of the bad debt deduction rule remained constant through the 1994, 2004 and 2007 Income Tax Acts.

The Finance and Expenditure Committee commented on such assumptions in its report on the Income Tax Bill 2002 (which became the Income Tax Act 2004) as follows:

> The provisions contained in the Income Tax Act 1994 are unclear and frequently subject to understandable misinterpretation.
>
> We recognise the risk that some practitioners, having previously misinterpreted some provisions in the old Act, may fail to realise that the rewrite Act clarifies the correct interpretation that applies to those provisions, and continue to apply their erroneous interpretation to the new Act. Such a situation should be minimised as far as possible, and we therefore encourage the Inland Revenue Department to undertake an education programme to inform practitioners that they cannot necessarily rely on their current understanding of the law, and should actively check the provisions contained in the new Act.

This point raised by the Committee was referred to and commented on within the *Tax Information Bulletin* items for both the Income Tax Act 2004 (Vol 16, No. 6, June 2004) and Income Tax Act 2007 (Vol 20, No. 2, March 2008).

The Finance and Expenditure Committee considering the Income Tax Bill 2002 also noted that Chartered Accountants Australia and New Zealand (then known as the Institute of Chartered Accountants of New Zealand) and the New Zealand Law Society had advised officials on their preferred approach for transitioning from the old legislation to new legislation, as follows:[6]

> The transitional provisions should allow the new Act to have effect while preserving, to the extent possible, the usefulness of existing case law and commentary and providing some protection for taxpayers against unintended change.
>
> This means the transitional provisions should be a sign-post and interpretative guide, and provide protection to taxpayers against unintended changes.
>
> We acknowledge that this leaves unintended changes to have effect where the new law is clear and unambiguous. This means that reliance must be placed on:
>
> 1. the commitments to retrospectively amend unintended changes;
> 2. the Rewrite Review Committee process;
> 3. Inland Revenue stating that it will continue to apply its published views and that it will only do otherwise on a prospective basis;
> 4. protection being provided to taxpayers who rely on either the old or the new law from a penalties and interest perspective.

As noted on the Panel's website, it has always been anticipated that the Government would decide to either:

- promote an amendment to the rewritten legislation to reinstate the outcome given under earlier corresponding provisions; or
- retain the unintended change in the legislation.

[6] Letter from Institute of Chartered Accountants and the New Zealand Law Society to chief drafter, dated 30 June 2003.

The Panel considered whether a "savings" provision should be implemented but decided against this.

Officials agree with the Panel that a savings provision is inappropriate as we are not aware of any instances in which a person carrying on a holding or dealing business has been denied a deduction for a bad debt that is not connected to that business.

However, officials are aware of some instances where a bad debt deduction was sought under the business holder or dealer rule, but the facts showed in each case that the taxpayer was not carrying on that type of business. It would be appropriate in these cases that no bad debt deduction is allowed for the principal amount of the loans.

Recommendation

That the submissions be declined.

Issue: The new requirement will cause confusion in practice because it overlaps with the existing criteria for claiming a bad debt deduction

Submission
(Russell McVeagh)

The proposed amendments will introduce a new requirement for claiming a bad debt deduction (being that the relevant loan was "entered into in the ordinary course of business"). That new requirement will cause confusion in practice because it overlaps with (and arguably contradicts) the existing criteria for claiming a bad debt deduction.

Comment

The proposed amendment is consistent with the Commissioner's interpretation of the "same as or similar to" test in the existing bad debt deduction rule. The language was recommended by the Panel to explicitly state in the legislation the effect of the test implied in the "same as or similar to" wording in the bad debt deduction rule.

Officials note that KPMG supports the clarification offered by the proposed amendment.

We agree that there is a risk that the proposed amendment may overlap with the existing criteria that allow a bad debt deduction for a business holder or dealer. We agree the proposed amendment be reviewed to ensure that the potential overlap is addressed.

Recommendation

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

Issue: Application of capital limitation to section DB 31(2) and (4)

Submissions
(Chapman Tripp, Russell McVeagh)

Section DB 31(2) should be amended to clarify that the capital limitation does not apply. *(Chapman Tripp)*

The amendment should extend to bad debts losses under section DB 31(2) and (4). *(Russell McVeagh)*

Comment

The bad debt deduction rules in section DB 31(2) and (4) ensure that taxpayers are not taxed on amounts which may have been derived and included as assessable income – for example, trade debtors. If those amounts are never actually received, and deductions for bad debts were not allowed, taxpayers would pay too much income tax because they would be assessed on income which substantively was not received.

Recommendation

That the submissions be declined.

Issue: Definition of income in the child support formula

Clause 14

Submission
(William Somerville)

Clause 14, which repeals section 35(1) to (5) of the Child Support Act 1991, should be deleted. This would have the effect of preserving the reforms made in 2013, which included indirect sources of income in the child support formula.

Comment

The submitter has asked that the wider definition of "adjusted taxable income" be kept in the Child Support Act 1991 and used in the child support formula assessment.

"Adjusted taxable income" is used in the child support formula assessment to determine a parent's child support income[7] and is defined in new section 35(1) as "taxable income with adjustments". "Taxable income" is a defined term in the Income Tax Act 2007 and the adjustments include those set out in subpart MB when calculating family scheme income and Working for Families entitlements. The adjustments include attributing income in trusts and close companies to the parent in proportion to their interest in those entities.

While the law change came into effect on 1 April 2015, section 35(2) of the Child Support Act 1991 states that for the first child support year only (1 April 2015 to 31 March 2016), "adjusted taxable income" is to be treated as if it were taxable income only. The adjustments are to apply from 1 April 2016 onwards.

The bill seeks to amend the Child Support Act 1991 so that "adjusted taxable income" no longer includes those adjustments under subpart MB of the Income Tax Act 2007 that are used to calculate family scheme income. The result would be that "adjusted taxable income" would now refer to taxable income for the relevant tax year that is adjusted by either inflation, based on a calendar-year of employment income if the parent only has income from which withholding tax applies, or as estimated by the parent.

A broader definition of "income" that includes adjustments in subpart MB could result in a fairer income measure and would reduce the need for parents to avail themselves of the departure[8] process. However, the drawbacks would be:

- potentially higher administration and compliance costs;
- a high implementation cost to receive, store and use the income information; and
- parents may not understand the wider definition.

[7] Section 12 of the Child Support Amendment Act 2013 inserting new section 34 in the Child Support Act 1991.
[8] In certain circumstances, the Commissioner of Inland Revenue or the court may make an order allowing a departure from the formula assessment for calculating child support to reflect matters outside of the standard formula.

Recent analysis of the size of the potential benefit of the change found a very limited number of child support parents are expected to be affected (less than 0.5 percent of possible parents). However, all parents would be required to complete the disclosure forms.

Ultimately, the costs of implementing the change now outweigh any benefits derived from the broader definition of "income" for child support purposes. However, the implementation costs are expected to be reduced following the Business transformation programme.

In the meantime, there are other avenues that might be available to parents should they wish for a broader definition of income to be taken into consideration in relation to their child support relationship.

Where the parents agree, and the receiving carer is not a social security beneficiary, the parents can agree to a private arrangement or to a voluntary agreement that reflects a broader definition of income.

Alternatively, a mechanism for parents to seek a change in their entitlement or payment outside of the formula is through the departure process. The departure process provides an appropriate way of dealing with special situations when the formula set out in the Child Support Act produces an unfair result due to the income, earning capacity, property or financial resources of either of the parents or the qualifying child. The approach enables each child support relationship to be scrutinised on an individual basis by an Administrative Review Officer or the Family Court, according to its merits, and then an order made that is just and equitable as for the child, the receiving carer and the liable parent. The process can be initiated by a parent or by the Commissioner.

For the period 1 July 2012 to 30 June 2013, there were around 2,900 administrative reviews initiated by parents on grounds relating to income, earning capacity, property or financial resources.

Recommendation

That the submission be declined, but that a broader definition of income for use in the calculation of the child support formula will be reviewed again as part of the work Inland Revenue is undertaking on its Business transformation programme.

Issue: Off-setting child support debt

Clause 41

Submission
(Matter raised by officials)

Section 106B(3)(c) of the Child Support Act should be changed so that it clarifies that offsetting child support debt through the departure process cannot apply when the liability has already been offset by virtue of repealed sections 34 and 35 of the Act (when parents have a current liability to each other because they both care for a different child of the relationship).

Officials further propose that section 106B(3)(c) be amended to clarify that when offsetting has previously taken place – for example, for a particular month – further offsetting in that month cannot apply, even if there are still amounts outstanding over and above what has been previously offset.

Comment

In order to still provide some ability to recognise situations when a person with a current liability is owed child support payments in the past from the other parent, the bill proposes that a new departure ground to the formula assessment be established in section 105(2) of the Child Support Act 1991.

Proposed section 106B(3)(c) in this bill clearly indicates that a departure for offsetting cannot apply if a child support liability has already been offset under section 152B (when parents have a current liability to each other because they both care for a different child of the relationship).

As offsetting under the new departure ground can affect assessments raised before the 2013 reforms, officials propose that section 106B(3)(c) be clarified to state that offsetting cannot apply when offsetting has taken place by virtue of repealed sections 34 and 35 of the Child Support Act. These sections had been repealed and replaced by section 152B.

Officials further propose that section 106B(3)(c) be amended to clarify that when offsetting has previously taken place – for example, in relation to a particular month – further offsetting in that month cannot apply, even if there is a remaining liability in that month. Applying an automatic section 152B offsetting and a section 105(2) offsetting in the same month is administratively complex.

Recommendation

That the submission be accepted.

Issue: Objections to child support assessments

Clause 29

Submission
(Matter raised by officials)

To meet fairness requirements, receiving carers should be given the right to object to child support assessments from 1 April 2015 rather than the date of enactment of this bill.

Comment

The bill proposes to amend the Child Support Act to give receiving carers and other payees the same objection rights to an assessment as liable parents.[9]

[9] "Payees" is a term that covers domestic maintenance as well as formula assessments but there is a need to specifically refer to receiving carers because some receiving carers are not "payees" as their entitlement is nil.

Although the proposed amendment is to apply from the date of enactment, and therefore the right to object only becomes available to receiving carers after this date, liable parents can avail themselves of the objection right already as it is in existing law.

A person should be able to object to their assessment if their liability or entitlement has increased, decreased or has not changed (but a component within the formula has – for example, a new income amount has been used that does not affect the liability or entitlement amount but is otherwise objected to). The legislation states that an objection has to be given within 28 days after the date on which notice of the decision or assessment objected to was given by the Commissioner.

The child support year beginning 1 April 2015 is the first year under the new formula assessment and a number of receiving carers have made objections. To meet fairness requirements, and in recognition of the time restrictions for making objections, receiving carers should be given the right to object to child support assessments from 1 April 2015 rather than the date of enactment.

Recommendation

That the submission be accepted.

Issue: Commencement date for sole-parent students claiming benefit during university breaks

Clause 2

Submission
(Matter raised by officials)

To avoid a retrospective administrative change, there should be an alternative commencement date in relation to the proposed amendment to the definition of "social security beneficiary" in the bill.

Comment

The proposal is for an amendment to the definition of "social security beneficiary" in section 2 of the Child Support Act to exclude from the scope of that definition full-time students who are in receipt of jobseeker student hardship support between academic years. The proposed change would allow sole–parent students who are on the student hardship benefit over the summer break to be treated as "off benefit" for child support purposes. This will significantly simplify compliance costs for these students and remove a potential discouragement to continuing study.

While the proposed change is expected to come into force on the day after the date of enactment, it would apply to benefits granted on or after 1 October 2015. When the bill was drafted, the rationale for a fixed future date was to provide the Ministry of Social Development time after the law had changed to make changes to the benefit data exchange between the Ministry and Inland Revenue. However, it is possible that the bill will be enacted after this date.

Officials recommend that to avoid retrospective administrative changes, that the law change apply to benefits granted on or after the first day of the month following enactment.

Recommendation

That the submission be accepted.

Issue: Definition of "child support debt"

Clause 61

Submission
(Matter raised by officials)

Officials recommend that the Child Support Amendment Act 2013 be amended to ensure that the legislation reflects the policy intent that the Commissioner may write off some or all of an amount of assessed child support and related penalties payable by:

- the estate of a liable person if the liable person has died and the Commissioner is satisfied that the liable person's estate is insufficient to pay the amount (section 180B);
- a liable person if the receiving carer has died and the Commissioner is satisfied that the amount is likely to be unable to be recovered (section 180C).

Comment

The Child Support Amendment Act 2013 introduced sections 180B and 180C with the intention of enabling the Commissioner of Inland Revenue to write off assessment and penalty debt when either the liable parent or receiving carer in a child support relationship is deceased and the debt is uncollectable. Both of these sections refer to writing off "child support debt", although this term is not defined.

"Child support" is defined in section 2 of the Child Support Act 1991 to mean "any payment required to be made under this Act by any person towards the support of a qualifying child, whether under a formula assessment or a voluntary agreement or an order of the court". This definition clearly does not include penalties.

The use of the term "child support debt" in sections 180B and 180C of the Child Support Amendment Act 2013 could be interpreted as relating to assessment amounts only rather than these amounts and penalties as the policy intended.

If the legislation is not amended, situations could arise where penalty debt cannot be written off despite the fact that the Commissioner has determined that the debt is uncollectable and has already written off the associated assessment debt. The remaining penalty debt would simply continue to accrue further penalties on a monthly basis unless the Commissioner could find some basis to write the debt off under an alternative provision at a later date.

Officials recommend that the Child Support Amendment Act 2013 be amended to ensure that the legislation reflects the policy intent that the Commissioner has the discretion to write off some or all of an amount of assessed child support and related penalties payable by:

- the estate of a liable person, if the liable person has died and the Commissioner is satisfied that the liable person's estate is insufficient to pay the amount (section 180B of the CSAA 2013 refers);
- a liable person, if the receiving carer has died and the Commissioner is satisfied that the amount is likely to be unable to be recovered from the liable person (section 180C of the CSAA 2013 refers).

Recommendation

That the submission be accepted.

FOREIGN INVESTMENT VEHICLE DEFINITION IN SECTION HM 3

No clause

Submission
(KPMG)

Section HM 3(2) currently states that:

> A trust that is, for Australian tax purposes, a managed investment trust under the Taxation Administration Act 1953 (Australia) is a foreign PIE equivalent if it meets the requirement in subsection (1)(a).

We understand that the definition of a "Managed Investment Trust" is to shortly be moved from the Taxation Administration Act 1953 (Australia) to the Income Tax Assessment Act 2007 (Australia). Once enacted, this will potentially make the above provision inoperative.

To "future proof" section HM 3(2), we recommend that the words "or successor Act" is added after Taxation Administration Act 1953 (Australia).

Comment

The approach suggested in the submission is not consistent with the Parliamentary Counsel Office's drafting practice. This is why the Income Tax Act 2007 does not include the phrase "or successor Act" in any existing provision. Furthermore, as the Taxation Administration Act 1953 is not being repealed, it is not clear that "or successor Act" would cover moving a provision from one existing Act to another. A suitable alternative would be to add "or a corresponding provision in another Act".

However, the approach typically taken in updating cross-references in tax legislation is to wait for the underlying enactment to be amended then update the cross-reference accordingly, rather than insert a general "or successor" terminology.

Officials have reviewed the proposed definition of Managed Investment Trust in Subdivision 275-A of the exposure draft of the Tax Laws Amendment (New Tax System for Managed Investment Trusts) Bill 2015. This definition is not exactly the same as that in the Taxation Administration Act 1953. Officials, however, consider it continues to be consistent with the policy intent of the foreign PIE equivalent requirements.

Until Australia enacts changes to this definition no certainty can be obtained in the final definition, or even whether any changes will occur. Officials consider the appropriate cross-reference can be more clearly drafted once any Australian amendments have been enacted. This should instead be added as a remedial item to the tax policy work programme.

Recommendation

That the submission be declined.

REINSTATEMENT OF SECTION 68C

Clause 228

Submission
(Matter raised by officials)

The bill repeals a number of provisions in the Tax Administration Act 1994 that relate to the earlier research and development tax credit scheme, as they are no longer necessary. A drafting error would result in the incorrect repeal of section 68C which is situated next to the sections that were intended to be repealed. Section 68C relates to the processes supporting the payment of member tax credits for KiwiSaver members. We recommend that the clause which repeals section 68C be deleted.

Recommendation

That the submission be accepted.

FINANCIAL ARRANGEMENTS – IFRS FINANCIAL REPORTING METHOD

Clauses 121 and 146

Submissions
(Corporate Taxpayers Group)

An amendment to section EW 15D of the Income Tax Act is proposed which would require amounts associated with a financial arrangement that are taken directly to equity for financial reporting purposes to be recognised as taxable income. A catch-up will be required in respect of past income years.

The Group wishes to raise a point of clarification in respect of this amendment. The question is whether there is supposed to be a distinction drawn between "equity reserves" and "equity or other comprehensive income" as proposed to be used in sections EW 15D and EW 15G respectively.

Comment

Officials agree that clarification is required and have proposed amendments accordingly.

Recommendation

That the submission be accepted.

BAD DEBTS – LIMITED RECOURSE ARRANGEMENTS

Clause 84

Submissions
(Chapman Tripp, Russell McVeagh)

The remedial amendments to ensure the tax rules are effective in limiting bad debt deductions to the actual economic loss are supported but may need to be further amended to deal effectively with bad debts funded by certain limited recourse arrangements.

Clauses 84(1) to (3), as currently crafted, are arcane and very difficult to understand, even for tax lawyers. Furthermore, it is quite likely that they do not fully achieve their intended objective. We propose to address this further with officials in advance of appearance at the Select Committee to see whether a better outcome can be proposed. *(Chapman Tripp)*

In summary:

- We agree with the need to clarify, with retrospective effect, amendments enacted by the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014 intended to limit bad debt deductions to reflect a person's true economic loss.
- A further remedial amendment is necessary as the provisions as drafted may not in all cases achieve a correct matching of the deduction for the bad debt loss to the income year in which income is recognised under the limited recourse arrangement.

Comment

Tax rules for bad debts introduced in 2014 were largely designed to limit bad debt deductions to the amounts of the debts excluding amounts funded by limited recourse arrangements. The amounts funded by limited recourse arrangements are obviously not an economic loss to the creditor/lender. This approach was supported by submitters to the original bill and is supported by submitters to this bill. The remedial amendments in the bill help to ensure that the 2014 amendments work effectively, and the changes were signalled as being necessary in the *Tax Information Bulletin* (Volume 26, No 4) which discussed those 2014 changes.

Both submissions concern one aspect of the rules introduced in 2014 for bad debts funded by limited recourse arrangements. A bad debt deduction that is otherwise allowable in an income year may be deferred until the related limited recourse arrangement matures. However, there may be income from the limited recourse arrangement in the earlier income year when the bad debt deduction was otherwise allowable. In this case a taxpayer would have income for a tax year and no deduction for the related bad debt until a subsequent year. This may cause significant timing disadvantages and even permanent disadvantages in some cases.

Officials agree there may be inappropriate results for some taxpayers in some situations when debts/loans are funded by limited recourse arrangements. The accounting and tax rules in these situations are complex and officials have been analysing them and discussing the impacts with some taxpayers and their advisers over the past few months. The final outcome of the analysis is not yet completed and it is proposed that it continue to identify a complete solution to the issue.

Recommendation

That the submissions be noted but that officials complete their current analysis of the issue with a view to proposing remedial amendments in the next appropriate tax bill. This will include consideration of the appropriate application date of any further remedial amendments.

Issue: Application dates

Submission
(EY)

The timing commencement and application aspects relating to clause 84 and the proposed new section DB 31(3) should be reviewed and revised, if necessary, to achieve full effectiveness.

Comment

Irrespective of the commencement date, all provisions have a clear application date. However, we agree that each of clauses 84(1), (2), (3), (5) and (6) are addressing the same policy matters and the question of commencement should be reviewed to ensure drafting consistency.

Recommendation

That the submission be accepted.

COMPLYING TRUSTS

Clauses 167 and 170

Submissions
(Crowe Horwarth, EY)

1. The amendment does not necessarily ensure that all trustee income is subject to tax in New Zealand at the trustee rate. *(Crowe Horwarth, EY)*
2. Clarification of the drafting may be necessary, particularly in relation to the making of elections and references to "income tax liability" criteria, to ensure the proposed provisions apply as intended. *(Crowe Horwarth, EY)*
3. Trusts that have previously identified their settlors as being non-resident and have chosen not to be a complying trust should be able to elect to become complying trusts by retrospectively paying tax on the world-wide trustee income. *(Crowe Horwarth)*
4. Previous income tax legislation should also be amended so the amendments clearly apply for pre-2008–09 income years. *(EY)*

Comment

Submissions 1 and 2

The proposed amendment seeks to ensure that trustees of complying trusts are not disadvantaged if a settlor of a trust migrates from New Zealand:

- resulting in the trust not having a settlor resident in New Zealand from that time; and
- the trustee is unaware that the settlor has migrated from New Zealand.

The submission states that if a trust does not have a settlor resident in New Zealand, the proposed amendments do not ensure that the taxable income derived by the trustees is liable for tax at the trustee rate if all trustees are non-resident and the income includes interest, dividends or royalties derived from New Zealand.

The submitter considers the non-resident withholding tax (NRWT) rules may continue to cap the income tax payable on that income to the NRWT rates. This would occur if the NRWT was a final tax. We also note that a double tax agreement may limit New Zealand's taxing right on interest, dividends or royalties, even if the NRWT is not a final tax.

The policy intention is that a complying trust is one on which the worldwide trustee income of the trust is taxed (after taking into account allowable deductions) at the trustee rate. This means that if NRWT on interest, dividends or royalties is a final tax or relief is available under a DTA, a trust would not pay tax on its worldwide trustee income at the trustee rate.

We agree with the submitter that:

- the amendments do not ensure that a trustee's income is subject to tax at the trustee rate; and
- the proposed amendment requires clarification to ensure the policy intention is achieved.

We agree with the submission that these concerns would be substantively addressed by ensuring that the election to be a complying trust requires:

- the trust to pay tax on its worldwide trustee income at the trustee rate; and
- the trust to be treated as if it had a settlor and a trustee resident in New Zealand.

Submission 3

The main benefit of a trust being a complying trust is that distributions to the trust's beneficiaries are not taxed to the beneficiary unless the distribution is beneficiary income (distribution of the current year's earnings of the trust).

We agree that the proposed amendment would apply when the trustee has continued to pay tax at full rate in the mistaken belief the trust is a complying trust.

The submission seeks a change in policy in relation to trustees who, at some time in the past, had knowledge that no settlor of the trust was then resident in New Zealand. The trustee has a period of time in which to choose to pay tax on worldwide trustee income at the trustee rate or be treated as a foreign trust or a non-complying trust.

Given that these trustees have considered these options at the time the settlor becomes non-resident, we consider that this submission raises a policy question that goes beyond the scope of the current amendment.

Submission 4

EY considers that the retrospective application to the beginning of the 2008–09 income year may not fully protect the treatment of distributions and the New Zealand income tax position of beneficiaries. In particular EY focuses on whether distributions from a trust enjoy the exemption given to distributions from a complying trust.

A distribution from a trust to a beneficiary is exempt from income tax if the trust has been a complying trust at all times, from the time the trust was either settled or a settlor migrates to New Zealand, until the distribution was made.

We agree with EY's submission that, under the proposed amendment, a trust may not be a complying trust from the 2008–09 year if:

- the trust did not have a New Zealand resident settlor prior to the 2008–09 year; or
- the proposed amendment does not apply to a trust prior to the 2008–09 year.

We agree that the drafting of the proposed amendment should be clarified so that it achieves the policy intention.

Recommendation

That submissions (1) and (2) be accepted.

That submission (3) be declined.

That submission (4) be accepted.

REMOVAL OF DUPLICATE PROVISIONS

No clause

Submission
(Matter raised by officials)

Section 147 of the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014 (2014 Act) amended schedule 20 of the Income Tax Act 2007 (which relates to expenditure on agricultural improvements). This was intended to replace section 104 of the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Act 2013 (2013 Act) which had made the same amendment but with an incorrect application date. However, the 2014 Act did not repeal the amending provision in the 2013 Act.

Likewise section 60 of the 2014 Act amended section DO 5 of the Income Tax Act 2007 (which relates to horticultural replacement planting) and was intended to replace section 33 of the 2013 Act which had made the same amendment but with an incorrect application date. The 2014 Act did not repeal the amending provision in the 2013 Act.

Comment

Sections 33 and 104 of the 2013 Act are redundant as they were intended to be replaced by sections 60 and 147 of the 2014 Act. Two identical provisions with different application dates should not be maintained, and therefore sections 33 and 104 of the 2013 Act should be repealed.

Recommendation

That the submission be accepted.

TREATMENT OF DUAL RESIDENT BY DOUBLE TAX AGREEMENT – STANDARDISING DESCRIPTION

Clauses 71, 192, 213(23), (24) and (26)

Submission
(Matter raised by officials)

Several clauses in the bill contain amendments with taxation effects on a person who is a dual resident. The effects may depend on whether there is a double tax agreement treating the person as being resident in New Zealand or on whether there is a double tax agreement treating the person as being resident in a foreign country or territory. The references to the relevant treatment differ in detail between the clauses and should be standardised.

Comment

Reference to the tax treatment of a dual resident under a double tax agreement should be standardised in the current bill.

There is also some variation between such references in existing provisions of the Income Tax Act 2007. It is proposed that those provisions be standardised in a future bill.

Recommendation

That the submission be accepted

SUPPLEMENTARY ORDER PAPER NO.77 – CHILD SUPPORT DEBT

Two submissions were received on Supplementary Order Paper No. 77. Overall the submissions are supportive of the proposals to address child support legacy debt. Submitters have raised issues which can be categorised as follows:

- discretion for write-off of penalty debt where "fair and reasonable";
- apply "fair and reasonable" to other tax types; and
- reduction in penalty rates.

Issue: Discretion for write-off of penalty debt where "fair and reasonable"

Clauses 44A, 44B and 55

Submission
(Chartered Accountants Australia and New Zealand)

The submitter supports the rationale for the proposed amendments: that the penalty regime should support rather than discourage the payment of child support. In regards to the proposal to introduce a discretion to write off penalty where it is "fair and reasonable" the submitter encourages a "fair, large and liberal" interpretation of the phrase "fair and reasonable" to ensure the desired effect is achieved.

Comment

The proposed penalty debt write-off provision is a Commissioner discretion where doing so would be "fair and reasonable" and will replace the current "inefficient use of resources"-based test.

As this is a discretionary measure it will be for the Commissioner to determine when a circumstance is fair and reasonable. Guidelines will be developed for what is "fair and reasonable" covering what the Commissioner will consider when determining what is "fair and reasonable" and therefore whether or not a penalty will qualify for write-off.

Development of the guidelines will draw on the depth and breadth of experience of Inland Revenues child support staff who understand the range of circumstances that can affect a parents ability to repay debt. It will also consider the objectives of the Child Support Act 1991.

Adopting a "fair and reasonable" test would enable penalty relief to be applied in circumstances when it makes sense to do so but where the current "inefficient use of resources"-based test would not allow relief.

Recommendation

That the submission be noted.

Issue: Apply "fair and reasonable" to other tax types

Clauses 44A, 44B and 55

Submission
(Chartered Accountants Australia and New Zealand)

That the "fair and reasonable" test for a write-off of debt be considered for application more widely to other tax areas such as income tax, student loans and Working for Families tax credits.

Comment

The "fair and reasonable" phrase is used in some parts of the Student Loan Scheme Act 2011. Applying the phrase more widely to other areas such as income tax and Working for Families would require comprehensive consideration within the context of those areas. The submitter's comments have been noted by officials.

Recommendation

That the submission be declined.

Issue: Reduction in penalty rates

Submission
(Baucher Consulting Limited)

Further changes should be made to penalty rates to align the initial late payment penalty for child support with income tax and GST, and further reduce the incremental monthly late payment penalty from 2% to 0.5%.

The submitter provides a number of reasons for suggesting penalty rate reductions, including: the extent of essentially uncollectable debt resulting from the current penalty rules; the higher penalty rates for child support than income tax and GST, low incomes of many child support debtors and compliance costs for tax agents.

Comment

Reduction to penalty rates for child support was considered as part of the comprehensive review of the child support scheme, which has resulted in the penalty rate reductions to come into effect on 1 April 2016. These reductions focus on penalty rates looking forward and can be summarised as follows:

- a two-stage late payment penalty with an immediate 2% late penalty, with the remainder of the current 10% penalty only being charged if the debt remains unpaid after seven days; and
- a reduction in the on-going monthly penalty rate from 2% to 1% after a year.

These changes had majority support through consultation on the review of the child support scheme. The review did not recommend aligning rates across child support and income tax on the basis of differences between the regimes, such as use-of-money interest for income tax and the collection of payments for receiving carers rather than the Crown.

Any further review of the penalty rates could be considered following a post-implementation review of the proposed measures and as part of the Generic Tax Policy Process at the appropriate time. Officials have noted the submitter's comments in this context.

Recommendation

That the submission be declined.