

Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill

Commentary on the Bill

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Minister of Revenue

First published in August 2016 by Policy and Strategy, Inland Revenue, PO Box 2198, Wellington 6140.

Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill; Commentary on the Bill.
ISBN 978-0-478-42435-5

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Provisional tax: accounting income method

OVERVIEW

(Clauses 27 to 54)

The bill proposes a new method of paying provisional tax – the accounting income method (AIM).

Background

There are currently three methods for calculating provisional tax: the standard uplift, estimate and GST ratio methods. The proposed AIM is not replacing these methods; it introduces a fourth method. Most businesses meet their income tax liability by paying provisional tax in three instalments throughout the year. Use-of-money interest (UOMI) is charged as if income was earned evenly over an income year, which is not realistic for many taxpayers. Feedback to Inland Revenue has focused on the inflexibility of provisional tax and its lack of integration with the natural rhythms of running a business. The current dates for payment are independent of when income is earned, which does not work well for businesses with fluctuating incomes and tight budgets. New businesses benefit from not having to pay provisional tax in their first year of business but often struggle with making payments in their second year.

This proposed new measure was announced by the Government in Budget 2016 as part of a package focused on tax reform for small businesses. The package is designed to provide certainty and reduce compliance costs.

A growing number of small businesses are using accounting software. The introduction of AIM will offer software providers an incentive to extend the capability of their products to include the consideration of tax-related issues during the year rather than waiting for a year-end review.

Using upgraded software that includes income tax information would enable businesses to consider their tax adjustments throughout the year and seek input from their tax advisor at any time, rather than just at year-end. This would provide businesses with better visibility of their tax liability during the year. New businesses would be able to start paying tax when they start making a profit, educating them about, and supporting them to meet, their tax obligations in their first two years in business. There would be no tax surprise for them in their second year of business.

Proposed approach

Inland Revenue has previously worked with software providers to enable GST returns to be filed from accounting software. This has simplified meeting tax obligations and reduced the amount of time that businesses spend on compliance. AIM is another step in integrating tax into business processes.

Inland Revenue would continue to work with tax agents to ensure that their involvement in the reform of provisional tax, and in particular, the proposed AIM approach, continues. Their involvement in developing any proposed changes would ensure a practical perspective on the design of AIM and its use in business.

It is expected that it will take time for taxpayers to feel confident in using a new proposed provisional tax method. It is expected that the accuracy of payments made will gradually improve as corrections made at year-end are captured in software and flow through to future years, reducing the error rate.

What using AIM will mean for businesses

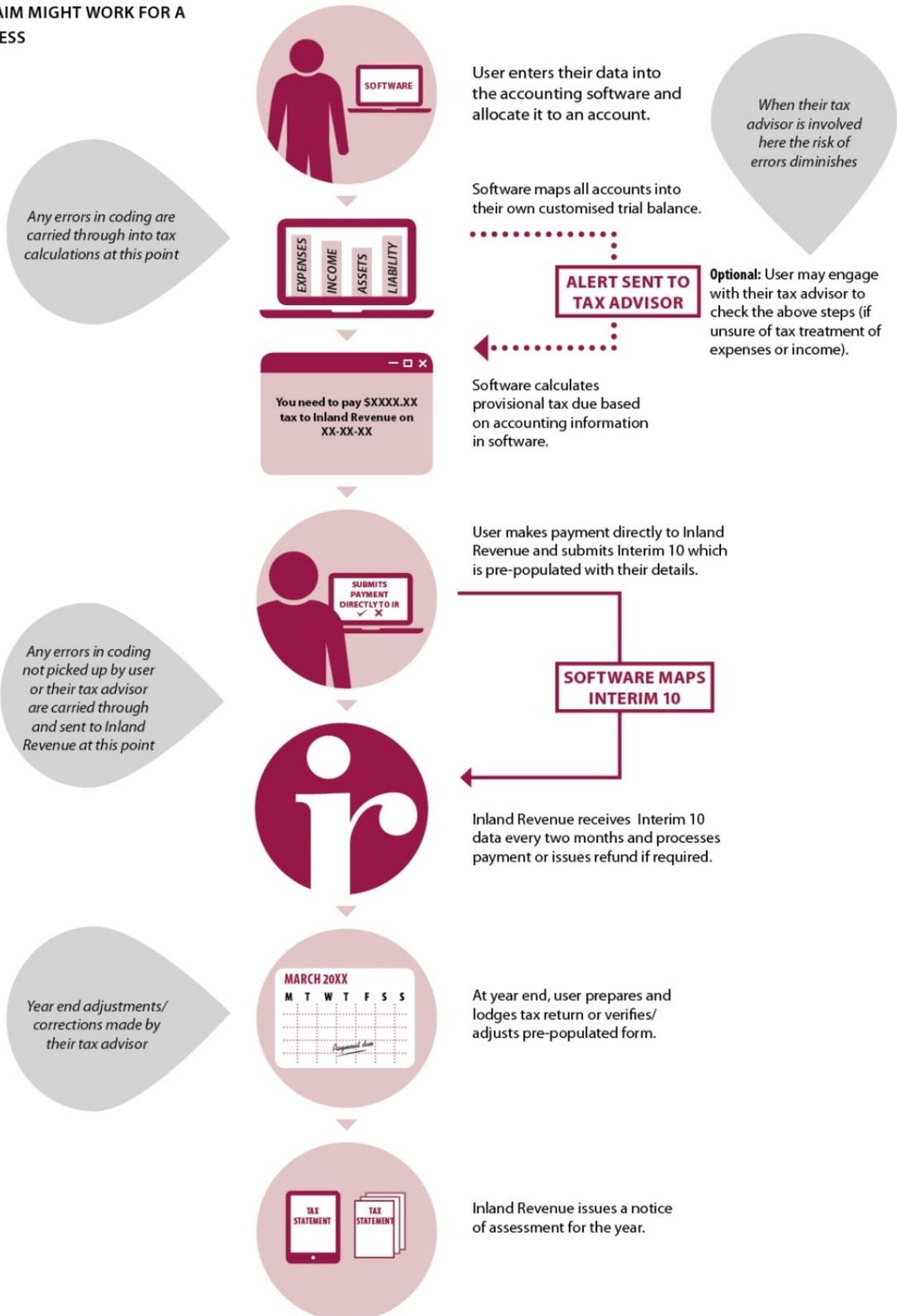
Under the proposed changes, provisional tax would be integrated into business processes and payment amounts would be based on current year tax-adjusted income. Businesses using AIM would have more certainty they are paying the right amount of tax as it will be paid as income is earned. This would increase businesses' confidence in their financial position at any particular time.

For those who keep their accounting packages up to date, calculating a business's provisional tax liability during the year would not require any significant additional work for businesses and their advisors. For those who currently leave most of their tax calculation until year-end, AIM would require more consideration of adjustments during the year; this should, however, be offset by a reduced year-end workload. The calculation of income tax would become integrated into the general operation of business accounts.

An AIM-capable software system must have a way of flagging entries or sending communication to a third party (usually the tax agent). This is not a compulsory review point but rather ensures there is always a way for the tax agent to stay involved in the process. The extent of the relationship between the taxpayer and their tax agent is at their discretion.

The following graphic shows how the AIM proposal would work for a business.

HOW AIM MIGHT WORK FOR A BUSINESS



The following examples illustrate how the proposed AIM would apply.

Example 1

Murphy Cliffe has recently finished a painting apprenticeship and intends to set up his own house painting business. He has no previous business knowledge and his parents suggest he meet with their accountant to get some advice. The accountant suggests Murphy sets up a company, starts using a basic accounting software package and elects into paying provisional tax using the AIM approach to help him budget in his first year of business. Murphy's company has a March balance date and will pay GST and provisional tax using the AIM approach on a two-monthly basis. Murphy does not make any profit in the first few months due to his set-up costs, but starts to make a profit towards the end of the year. He will pay provisional tax as follows:

GST & provisional tax payment dates	28-Jun 2018	28-Aug 2018	28-Oct 2018	15-Jan 2019	28-Feb 2019	7-May 2019	Total prov tax	Terminal tax due
Income earned during current year	Nil	Nil	Nil	20,000	30,000	50,000		28,000
Implied tax on taxable income	Nil	Nil	Nil	5,600	8,400	14,000	328,000	Nil

AIM will help Murphy budget for tax correctly in his first year of operation as he pays tax as he earns income. He decides to wait before he buys a new vehicle for his business.

If Murphy had decided against using AIM, he would have paid no provisional tax in his first year of operation and had his business continued into its second year, his tax payment schedule for his first and second year¹ would be as follows:

GST & provisional tax payment dates	28-Aug 2018	15-Jan 2019	7-May 2019	Total prov tax	Prov tax 1 28-Aug 2019	Prov tax 2 15-Jan 2020	Prior year terminal tax due April 2020	Prov tax 3 7-May 2020
First year of business	no provisional tax due in first year of business							
Tax due in second year of business	Nil	Nil	Nil	Nil	9,800	9,800	28,000	9,800

Unless Murphy had budgeted carefully he may not have set the right amount aside for his terminal tax due in the second year in one lump sum. He instead bought a new vehicle for his business. In his second year of operation his terminal tax from his first year of \$28,000 falls due and he also has to pay his provisional tax payments for his second year of \$9,800 each. If Murphy had not set the appropriate amount aside in his first year of business he may struggle to meet this payment schedule and his business could fail.

¹ Using the standard uplift method of 105% of his prior year residual income tax, which assumes his tax liability grows from \$33,000 to \$34,650.

Example 2

Benson Electrical Ltd is considering the use of AIM in their existing business. They currently use accounting software, pay GST every two months, and have a March balance date. Their accountant talks to them about using AIM due to the unpredictable nature of the contracts they are being awarded. The inability to plan in the past has resulted in exposure to use-of-money interest. They generally have a slow start to the financial year but business picks up in the latter half. Their business is steadily growing and their residual income tax is \$180,000 in 2017 and \$220,000 in 2018.

They ask their accountant to show them what their provisional tax liability would look like under different methods for the 2019 year and how exposure to use-of-money interest would differ.

In this scenario, their possible use-of-money interest² costs range between nil and \$6,594.

Provisional tax payment dates	28-Jun	28-Aug	28-Oct	15-Jan	28-Feb	7-May	Total prov tax		
Income earned during current year	108,000	Nil	178,000	250,000	178,000	143,000			
Implied tax on taxable income	30,240	Nil	49,840	70,000	49,840	40,040	239,960		
Provisional tax methods and due dates for payment	28-Jun	28-Aug	28-Oct	15-Jan	28-Feb	7-May	Total prov tax	Terminal tax due	UOMI incurred
AIM	30,240	0	49,840	70,000	49,840	40,040	239,960	0	0
Uplift 105%		77,000		77,000		77,000	231,000	8,960	682
Uplift 110%		66,000		66,000		66,000	198,000	41,960	3,194
Estimate		40,000		60,000		90,000	190,000	49,960	6,594
Uplift/Estimate switch		63,000		63,000		130,000	256,000	-16,040	224

² Calculation is based on UOMI rates of 8.27% and 1.62%. It also takes into account the new provisional tax rules of no use-of-money interest for residual income tax less than \$60,000 (extension of safe harbour rules), first two provisional tax instalments if using uplift and a taxpayer choosing to switch between methods will be subject to use-of-money interest from the first instalment date.

Proposed approach

To date, Inland Revenue has worked with representatives of the software and accounting industry in developing AIM to test concepts and identify opportunities. Their role was to help officials understand software capabilities and use by small businesses and identify opportunities for reducing businesses' compliance costs. Statistical and market data was provided by software providers to help Inland Revenue prepare its advice to Government. (Inland Revenue was not provided with access to the data or business systems of individual businesses only summarised and anonymous information was used in the development of this policy.)

Since April 2016, there has been extensive consultation on the technical details of the AIM proposals through written submissions, an online forum and workshops with small business owners, accountants and interested software providers.

In the upcoming year, it is proposed Inland Revenue would continue to work with interested software providers on incorporating AIM into their products.

Inland Revenue will continue to work with members of the accounting profession to provide a practical perspective on the design of AIM and its proposed use in business.

It is proposed that Inland Revenue drafts a technical Determination in relation to the changes proposed in the bill. This reflects the fact that AIM is first and foremost a tax collection method. Its provisional tax nature implies it is not a year-to-date method requiring exact tax liabilities to be calculated on a regular basis, but it does need to ensure reasonably accurate amounts of tax are collected during the year. For this reason, it is proposed that AIM requires a series of adjustments to calculate the amounts of provisional tax due. The proposed Determination would also outline what technical adjustments must be made within the software.

Having these technical matters contained in a Determination that all software providers must adhere to, would ensure commonality of treatment across different software products. A working group comprising representatives from the accounting and software professions, small business representatives and officials would develop these proposed Determinations. This will ensure the adjustments and information requirements are practical, relevant and as simple as possible, and that the software remains intuitive and effective to use. The proposed technical Determination is discussed in more detail later.

AIM PROVIDERS APPROVAL AND REVOCATION

(Clauses 40 and 44)

Summary of proposed amendments

The bill proposes a process of self-certification through statutory declaration before a software provider can offer a product that is deemed AIM-capable.

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

Proposed new section 15U of the Tax Administration Act 1994 states that AIM providers should apply to the Commissioner of Inland Revenue for approval for their AIM-capable accounting systems. The term approved “AIM provider” is proposed as a new defined term in section YA 1 of the Income Tax Act 2007. The Commissioner will approve the AIM provider, taking into consideration the integrity of the tax system, and the AIM provider will supply the Commissioner with a statutory declaration outlining the product, a commitment to regular updating and any other information the Commissioner has set out as required.

Providers can apply with a product that would either deliver AIM to businesses with gross income below \$5 million a year or for a defined class of taxpayers who have gross income over \$5 million a year.

New sections 15V and 15W of the Tax Administration Act 1994 state the Commissioner may revoke the above approval, after consultation with the AIM provider. It is proposed this would happen when the statutory declaration is held to be untrue and revoking the approval would positively affect the integrity of the tax system. The revocation would not take effect until the following tax year. An AIM provider may also notify the Commissioner of its choice to revoke. This would take effect in the following tax year and must be immediately communicated to all end-users of the AIM provider’s products.

New section 15X of the Tax Administration Act 1994 states the Commissioner may publish a notice regarding approvals or revocation if she chooses.

Detailed analysis

Self-certification is considered to be the most effective method of approving AIM providers. There are likely to be a large number of parties interested in providing AIM capacity, and consideration has been given to whether Inland Revenue would audit each software provider that applied. Possible issues with resourcing constraints and the negative business implications of delays in receiving Inland Revenue approval have resulted in self-certification being a more effective choice. It also reflects a long-term view of how Inland Revenue will engage and work with third parties in the future.

New section 15U of the Tax Administration Act 1994 states that AIM providers would need to apply to the Commissioner for approval for their AIM-capable accounting systems.

The Commissioner would approve the AIM provider with consideration to the integrity of the tax system, and the AIM provider themselves. Once the Commissioner was satisfied on these grounds, the AIM provider must supply the Commissioner with a written statutory declaration.

The statutory declaration would include an outline of the product itself, a commitment to keeping it updated, and any other information the Commissioner sets out as required. This information would be likely to relate to the technical aspects of AIM both in terms of tax policy and software requirements. The details of the declaration would be clearly outlined in the Technical Determination proposed in clause 46 (discussed later) and proposed to be released by Inland Revenue in early 2017.

A statutory declaration is a legal document which allows a person to declare something to be true for the purposes of satisfying a legal requirement. In this way statutory declarations are similar to affidavits. It is a crime under the Crimes Act 1961 (punishable by a term of imprisonment not exceeding three years) for a person to make a statutory declaration that is misleading or false. The specific procedure for making statutory declarations, coupled with the fact that false declarations can lead to imprisonment, give statutory declarations a special status.

New sections 15V and 15W of the Tax Administration Act 1994 state that the Commissioner may revoke an approval. It is proposed this would happen when the statutory declaration is held to be untrue and revocation would protect the integrity of the tax system.

The Commissioner would consult with a software provider before a revocation took effect, to give both parties a chance to work through any concerns and, where possible, remedy them. A revocation could be reversed by the Commissioner before it takes effect if the circumstances that gave rise to the revocation were remedied. This might occur when a provider accidentally fails in one of its obligations (if, for example, it missed a minor tax update).

The revocation would not take effect until the following tax year, to allow taxpayers using the software to finish the income year, and not disadvantage them in any way.

If an AIM provider no longer wished to provide AIM capability through their software, they must notify the Commissioner. Revocation would take effect in the following tax year and must be immediately communicated to all users of the AIM provider's products.

If a software provider had to cease business suddenly, the Commissioner would work with the affected taxpayers to ensure the integrity of the tax system was maintained.

The bill proposes that the Commissioner may publish a notice regarding approvals or revocation.

AIM-CAPABLE ACCOUNTING SYSTEM

(Clauses 32, 34 and 46)

Summary of proposed amendments

A software system that is designed to offer AIM to taxpayers must meet the proposed definition of an AIM-capable accounting system introduced in this bill in order to gain approval from the Commissioner to be used to calculate provisional tax payments using the AIM method.

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

Proposed new section RC 7B of the Income Tax Act 2007 explains the AIM method and defines what an AIM-capable accounting system must be in order to gain the Commissioner's approval. To meet the definition and be approved as an AIM-capable accounting system, the core software accounting package must have the ability to:

- generate and keep comprehensive financial accounts, including accounting income and expenditure, ledger accounts, trial balances, bank account reconciliations, and journals, on an on-demand basis, in accordance with good accounting and tax practices;
- calculate tax liabilities using tax adjustments in accordance with the Technical Determination as proposed in clause 46;
- for tax adjustments not included in the Determinations, ensure they work towards reasonably accurate assessments of tax liabilities;
- recalculate all financial accounts and liabilities retrospectively and produce reports as required by the Commissioner; and
- communicate electronically with Inland Revenue and provide the right level of help assistance to its users.

The amount calculated by the AIM-capable accounting system is the amount due to Inland Revenue on each instalment date as proposed in clause 34 in section RC 10B of the Income Tax Act 2007.

Detailed analysis

Only comprehensive software accounting packages would be able to offer AIM to ensure that taxpayers can use a package that is fit for purpose. Packages must work in accordance with good accounting and tax practice to ensure that reliable financial statements are produced. This implies routine examination of processes and calculations to ensure the efficiency and effectiveness of practices are improved over time.

This definition is not limited to cloud software and does include software packages that are generally desktop-based but can access the internet or prepare reports that can be sent to a third party for review (hybrid products). A desktop must also be kept up to date and the version of the software will be provided to Inland Revenue at the time of payment to ensure this is the case. The only software that is considered to be excluded from this definition is a home-prepared Excel spreadsheet. This is due to there being no controls or commonality over its preparation and treatment of tax adjustments.

The Determinations proposed in section 91 AAX of the Tax Administration Act 1994 set out the requirements for which expense and income items need to be adjusted for tax purposes. Therefore any accounting software system must be able to make these adjustments as required by the Commissioner. This will ensure that material adjustments are consistently treated by all software packages.

For any tax adjustments not defined in the proposed Determinations, the accounting software must provide reasonably accurate assessments of tax liabilities.

The software must be able to recalculate all financial accounts and liabilities retrospectively and produce reports as required by the Commissioner. This is to ensure that when an error is discovered – for example, a late invoice, the invoice can be entered into the system and the cumulative impact of that correction will flow through. Past periods will not need to be re-filed following the discovery of an error.

The software must also be able to communicate electronically with Inland Revenue and provide the right level of assistance to its users. It is expected that taxpayers will elect to use AIM through the software itself and that the Statement of Activity will be provided to Inland Revenue electronically. Inland Revenue understands that accounting software packages do not require a high level of internet capability to function, so those in remote areas with limited bandwidth can still use it successfully. As an exception, in the event of a software failure or internet failure, the Commissioner will accept a paper copy of the return.

Section RC 10B provides that the amount calculated by the AIM-capable accounting system is the amount due to Inland Revenue on each instalment date. This is the amount the provisional taxpayer must pay to Inland Revenue.

AIM APPROACH ELIGIBILITY CRITERIA

(Clauses 31, 32, 40 and 45)

Summary of proposed amendments

The bill proposes the criteria that must be met before a taxpayer can use the AIM approach to calculate their provisional tax, and proposes that a taxpayer can be removed from AIM in particular circumstances.

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

New subsection RC 5(5B) of the Income Tax Act 2007 introduces the AIM provisional tax method. It states that when a taxpayer has elected to use AIM, and is currently using an AIM-capable accounting system as defined in new section 7B (2) in the Income Tax Act 2007, they may use AIM, provided they meet the right annual gross income levels, which are in three income groups.

Section RC 5(5B)(c) proposes that those with a gross income of \$5 million and below can use AIM.

Proposed section 45D of the Tax Administration Act 1994 proposes that if a business has grown past this threshold and has been using AIM successfully, it can apply to the Commissioner to continue using AIM as a provisional tax method, assuming there is minimal fiscal risk to allowing this approval.

Proposed new section 45C of the Tax Administration Act 1994 provides that a business with earnings over \$5 million can use the AIM approach, provided it is a member of a class of taxpayers using software that has been approved for large AIM businesses. These businesses are defined as those using an approved Large Business AIM-Capable system. This is a proposed new defined term in section YA 1 of the Income Tax Act 2007.

In certain circumstances taxpayers will be excluded from using AIM. Section RC 5(5B)(d) of the Income Tax Act 2007 proposes that if a taxpayer has been liable in one of the last four years for a shortfall penalty, penalties in relation to its use of AIM, or members of a class of taxpayers mentioned in the Determination issued by the Commissioner under proposed section 91AAY of the Tax Administration Act 1994, they will be excluded from using AIM.

This section also proposes that taxpayers will be removed from AIM if their use of AIM has meant they have consistently and systematically inaccurately assessed their tax liabilities. An addition to this, if a taxpayer fails to provide Inland Revenue with the required information on two instalment dates they will be removed from AIM during the year as well.

When a taxpayer is removed from AIM under section RC 5 (5B)(d) of the Income Tax Act 2007, proposed section RC 5(5C) states upon removal from AIM, the taxpayer will be required to use the estimate method and be treated as having used that method all year.

Detailed analysis

Eligibility

Section RC 5(5B) of the Income Tax Act 2007 provides that before a taxpayer can use the AIM approach to calculate their provisional tax they must:

- elect to use it before their first payment date;
- use an AIM-capable accounting package that is up to date;
- have gross income below \$5 million or have approval from the Commissioner as a previous user of AIM if their income is over \$5 million; or
- be a member of the class of taxpayers with income over \$5 million using a software package the Commissioner has approved for AIM.

The majority of likely AIM users will be small-medium businesses as the tax adjustments required to accounting profit to calculate their taxable income are relatively small and simple. These smaller businesses also use standard accounting software packages purchased from software providers and are not using bespoke systems.

A provisional taxpayer does not have to be GST-registered to use AIM. Individuals, sole traders and companies are all eligible to use AIM, and if they chose to do so, must pay on a two-monthly basis.

While the initial focus is on small-medium businesses, there is also scope for larger classes of taxpayers to use AIM should a provider develop software that meets AIM requirements. Proposed new section 45C of the Tax Administration Act 1994 will enable AIM to be a provisional tax method available to larger businesses in the event that a software provider developed a package for a specific class of taxpayers who would not ordinarily use off-the-shelf software. They can apply under this proposed section to the Commissioner for approval of their systems to be used for a defined group of taxpayers. The Commissioner would have regard to the fiscal risks of allowing this class of taxpayers to use AIM.

Example

Winetrack Ltd creates accounting software specifically designed for large vineyards. It assists wineries with their management and reporting, dealing with specific issues like calculating an accurate real-time cost of goods sold using software that is designed specifically for wine-making processes.

As vineyards often have both seasonal income streams and unpredictability caused by weather and overseas exporting issues, many would benefit from using the AIM provisional tax method.

Winetrack approaches Inland Revenue to discuss and engage with Inland Revenue regarding their software and processes around major tax adjustments. Inland Revenue would consider the rigour of the software and whether or not taxpayers using Winetrack and AIM can make provisional tax payments that result in reasonably accurate assessments. Winetrack and Inland Revenue would work together to identify whether Winetrack would need to develop its software to deliver AIM capability. These requirements would be clearly stated in a Determination issued by Inland Revenue.

Following approval from Inland Revenue, Winetrack would offer AIM services to its subscribers and be subject to the same obligations as other AIM providers.

Exclusions

In certain circumstances taxpayers would be excluded from using AIM. Section RC 5(5B) of the Income Tax Act 2007 proposes this would happen if the taxpayer:

- has been liable in one of the last four years for shortfall penalties in relation to its use of AIM;
- is a member of a class of taxpayers excluded in the Determination issued by the Commissioner under section 91AAX of the Tax Administration Act 1994;
- has consistently and systematically used AIM to inaccurately assess its tax liabilities; and
- has failed to provide Inland Revenue with the required information on two instalment dates (Statement of Activity).

If a taxpayer is removed from AIM, it is proposed in section RC 5C that they be placed into the estimate method and be treated as having used that method all year and will have use-of-money interest applied.

The Statement of Activity is important because it demonstrates the robustness of the accounting system behind the amount paid as provisional tax. If this information is not provided to Inland Revenue, there would be no evidence that a comprehensive accounting system is being used by the business to calculate its accounting income results. As the Statement of Activity reports would be cumulative, if one is missed it could be supplied in the following period.

If a payment is missed, a taxpayer would not be immediately removed from AIM. The existing interest and penalties rules would apply to the underpaid amount.

DETERMINATIONS

(Clause 46)

Summary of proposed amendments

The bill proposes that the Commissioner of Inland Revenue has the power to issue Determinations with reference to AIM.

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

It is proposed to issue Determinations in two circumstances. A proposed amendment to section 91AAX of the Tax Administration Act 1994 provides that the Commissioner will issue a technical Determination that details the tax adjustments required for accounting income and expenditure under the AIM approach, and Inland Revenue's information requirements regarding AIM.

In making these Determinations the Commissioner would take into account the accuracy resulting from these adjustments, the compliance costs incurred by taxpayers and the resources available to AIM providers. The Determination must also set out the tax years for which the Determination will apply, and the requirement for the Commissioner to give at least 120 days notice for implementation to AIM providers and publish the Determination within 30 days of making it.

Section 91AAY of the Tax Administration Act 1994 proposes that the Commissioner also has power to issue an exclusion Determination to exclude a class of taxpayers from using AIM in circumstances when an accurate assessment of tax liabilities could not be made.

Detailed analysis

Technical Determination

AIM is a tax collection method. While it is not a year-to-date method that requires exact tax liabilities calculated on a regular basis, it does need to ensure that reasonably accurate amounts of tax are collected during the year. For this reason, AIM will require a series of adjustments to calculate the amounts of provisional tax due. Software providers delivering AIM will build these adjustments into their systems. To ensure commonality across taxpayers and systems, it is proposed this Determination contains the agreed treatment for the core adjustments required to reach the desired level of accuracy within AIM. Adjustments not defined by the Determination will be designed by software providers themselves, with the requirement they always calculate tax liabilities using tax adjustments that result in

reasonably accurate assessments of tax liabilities for taxpayers. These may include accruals or estimates for other matters that would typically be adjusted for in year-end review processes.

Proposed approach

The process of developing the Determination should be open and transparent. Therefore this Determination would be developed during 2016 by an Inland Revenue-led working group comprising interested public and private sector parties, including representatives from the software and accounting professions. This working group would identify the core tax adjustments that would be compulsory in the Determination and identify ways of accounting for these on an interim year basis. It would ensure that the core adjustments are kept to a minimum and their calculation is simple and practical for use, avoiding increasing compliance costs while working towards a goal of increased accuracy during the year. The adjustments are to work towards the calculation of reasonably accurate assessments of tax liabilities for the taxpayer. It would consider what current good accounting practice for these adjustments is and, where possible, keep close to this treatment.

This working group would report, on a regular basis, to a governance group of representatives from the business and accounting sectors. The group would provide oversight and a practical perspective on the design of AIM and its use in business.

It is proposed that this information be contained in a Determination rather than in this bill as it will be easier to update and account for future technology advancements, tax changes and allow further time for wider consultation and development. It is expected that there will be an early indication of what the core adjustments will be and the proposed Determination would be completed in time for AIM providers to use for the design of their systems in 2017. The Determination would not be complex in nature and would be designed for use by software providers to use when developing their software.

Consultation to date has outlined some adjustments that may be suitable for the Determination. Current thinking on possible treatment is outlined below.

Tax depreciation

It has been suggested that current software models would be enhanced to enable depreciation schedules to be calculated throughout the year in the taxpayers version of software (previously depreciation calculations were only included in tax agent version). A taxpayer could then claim depreciation to date. Most small businesses use Inland Revenue depreciation rates and as such no separate adjustment would be required.

Trading stock

Where a company has material movements in trading stock values, it is likely that it currently uses a perpetual inventory system to keep up to date figures for its accounting records, and these would suffice for AIM. Current thinking is that AIM would not require additional stocktakes for those using periodic inventory systems as they may be able to use their closing figure from the prior year.

Temporary timing differences

The intent of AIM is proposed to be on “reasonable accurateness” during the year. There will be, however, situations when timing differences are not captured by the accounting software system. Where this occurs, it has been suggested that Inland Revenue be tolerant where an amount is likely to balance out in the next period, and it may not need to be accrued. However, if it relates to longer than two provisional tax periods it may be accrued in the normal manner.

Provisions

Provisions have the ability to decrease accounting income during the year and then be reversed at year end, increasing the accounting income just prior to the tax return is filed. Current thinking is that while provisions are not overly common in the small business market, where they have been accounted for, they might be reversed out for AIM purposes.

Financial arrangements/foreign exchange

For taxpayers with an emphasis on exporting, foreign exchanges gains or losses and financial arrangements may be material for review for tax purposes. Good accounting practice and principles will be considered for these adjustments. Current Inland Revenue thinking is that keeping as close to accounting treatment and cashflow impacts as possible is important for taxpayers.

Shareholder salary accruals

These may be included in the Determination as an anti-avoidance measure. All shareholder salaries will be treated as non-deductible unless they have been paid out in the period the instalment relates to. Any overpaid provisional tax that relates to shareholder salary accruals can be transferred to the shareholder to meet their corresponding provisional tax liability.

User defined entry

There may be times when the accounting software does not give a fair reflection of likely taxable income. Initial thinking is that in this instance, a taxpayer may need to override the system and manually insert a new figure that will bring the system closer to a reasonably accurate figure. Current thinking is that these events will be identified on the Statement of Activity, and consultation will consider what circumstances these might occur in and what appropriate checks and balances will be needed.

In making these Determinations section 91AAX of the Tax Administration Act 1994 proposes the Commissioner must have regard to three areas: the accuracy resulting from these adjustments, the compliance costs incurred by taxpayers in making these adjustments and the resources available to the AIM software providers. It is important these factors are kept in balance to ensure a reduction in compliance costs for taxpayers. It is important that AIM itself is based on a “click, review, send” methodology. It is not intended to result in a series of mini tax returns throughout the year which would increase compliance costs for taxpayers.

Any tax adjustments the Commissioner considers necessary would be required to be built into software, which places costs upon the AIM software providers. When developing this, the Commissioner would consider the resources available to AIM providers to ensure that the drive for increased accuracy does not push them past the point of financial viability.

Exclusion Determination

Proposed section 91AAY of the Tax Administration Act 1994 provides the Commissioner with power to issue a Determination to exclude a class of taxpayers from using AIM in circumstances when an accurate assessment of tax liabilities could not be made.

This would occur when analysis shows that using the AIM approach is resulting in systematically inaccurate results for the particular class of taxpayers due to their use of accounting software – that is, specific income and expenses that cannot be calculated correctly by general software and more bespoke software is required.

PAYMENT DATES

(Clauses 29, 30, 33, 35, 41 and 49)

Summary of proposed amendments

The bill proposes new payment dates be created that support the AIM method.

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

Proposed section RC 9 (4B) of the Income Tax Act 2007 will require a taxpayer using AIM to make provisional tax payments more often, in line with GST filing dates. These payments will be 12 times a year for those registered for monthly GST and 6 times a year for those who have 6- or 2-monthly GST periods or those who are not registered for GST.

Background

AIM works with usual business processes. Research into the use of accounting software shows that peak usage for mid-year updating of accounts is in line with GST payment dates. These act as a driver to encourage businesses to keep their records up to date. For this reason, it is proposed to link AIM payment dates with GST dates. This will reduce compliance and assist with matching tax payments to cashflow.

It is expected that paying smaller amounts more often will assist with matching tax payments to the cashflow of taxpayers. If a taxpayer has no accounting profit for a period, then no AIM provisional tax payment is required. Inland Revenue would still require the Statement of Activity to be provided, via the software, however, to show the current accounting income status of the company. This would show it had no profit and therefore required no payment to be made.

REFUNDS

(Clauses 36 and 52)

Summary of proposed amendments

The bill proposes that the Commissioner must refund overpaid amounts of provisional tax paid through AIM to the taxpayer upon their request before year-end.

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

Section RM 6B of the Income Tax Act 2007 provides that upon receiving the required information from the taxpayer, the Commissioner can refund amounts of overpaid AIM provisional tax throughout the income year where the AIM payments to date are greater than the AIM calculation of tax liability year-to-date. An AIM taxpayer can only request a refund of actual provisional tax paid in the current year.

Proposed section 120VB of the Tax Administration Act 1994 provides that no use-of-money interest is payable by the Commissioner on overpaid AIM provisional tax.

Background

As overpaid provisional tax represents working capital of a business held by Inland Revenue, it is important this is returned to the taxpayer in a timely manner. This is one of the major benefits to taxpayers using AIM. An imputation credit account return will not be required to access a refund mid-year.

A taxpayer would need to contact Inland Revenue in the prescribed manner to demonstrate overpaid provisional tax – likely to be through the software itself. It is proposed that an overpayment of AIM provisional tax can be refunded directly to the taxpayer, be transferred across to another tax type or remain as overpaid provisional tax to be offset against a future liability.

The Commissioner cannot refuse to refund amounts owing under AIM due to an outstanding tax liability in another area such as PAYE or GST.

PROVIDING DATA TO INLAND REVENUE – THE STATEMENT OF ACTIVITY

(Clause 45)

Summary of proposed amendments

The bill proposes that AIM taxpayers provide Inland Revenue with an agreed set of information on or before each instalment date (the Statement of Activity), and that AIM providers provide Inland Revenue with an agreed set of aggregated data within six months of the end of the tax year. This information will not include taxpayer-specific information.

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

Proposed new section 45 of the Tax Administration Act 1994 will require taxpayers using the AIM approach to provide information to the Commissioner on or before each AIM instalment date.

Section 45B requires approved AIM providers to also provide information to Inland Revenue when and if requested in relation to their AIM capable software system products. This does not include any taxpayer-specific information.

Detailed analysis

It is proposed data be provided to Inland Revenue in two types: from the AIM taxpayer and the AIM providers.

Taxpayer-specific information

Proposed section 45 sets out the information it is proposed Inland Revenue receives on each instalment date from the taxpayer. An AIM-capable accounting system will have the ability to map the ledger accounts of the company into an agreed Statement of Activity form.

Some accounting software already maps business accounts into the current IR10 Summary of Financial Statements so this process is familiar to AIM providers. The Statement of Activity would be automatically mapped into an agreed form and be submitted to Inland Revenue by the software itself. Inland Revenue would not have access to the software system at all and would only receive the agreed aggregated data sent by the system.



The Statement of Activity is important as it demonstrates the robustness of the accounting system behind the amount paid as provisional tax. If this is not provided, Inland Revenue would have no evidence that a comprehensive accounting system is being used by the business to calculate its accounting income results.

The Statement of Activity data is a summary of what is in the accounting software at that date. It is not intended to be seen as a mini tax return; rather it is a simple snapshot of the data held within the accounting software at the time the payment was calculated. It would not need to be re-filed should an error be retrospectively discovered.

What information is proposed to be sent to Inland Revenue will be confirmed by the working group made up of representatives from public and private (accounting and software) sectors.

The information received will enable the Commissioner to discharge her duties through reviewing the information for key ratio data, industry outliers, targeted services, further policy design, statistical purposes and determining audit selection criteria. Regular provision of this information to Inland Revenue on a cumulative basis throughout the year is intended to simplify year-end processes.

Aggregated provider information

Proposed section 45B provides that approved AIM providers must also provide information to Inland Revenue when and if requested in relation to their AIM-capable software products. This does not include any taxpayer-specific information. It is only for aggregated statistical data to assist Inland Revenue with further policy development and improvement of the AIM approach itself.

It is likely this would include information on the use of the software itself, the timing of interactions in the software and any “pain” points the software is encountering to assist with further policy development and improvements in accuracy.

INTEREST AND PENALTIES

(Clauses 31, 43, 45, 47, 48, 50, 52 and 54)

Summary of proposed amendments

The amendments outline the circumstances when a taxpayer using AIM would be liable for use-of-money (UOMI) interest and shortfall penalties.

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

Proposed new section 120 KBC of the Tax Administration Act provides that when a taxpayer makes the payments as calculated by their AIM-capable software, they will not have any UOMI exposure should the year-end residual income tax result in a different tax liability. If a taxpayer pays less than what the AIM-capable software calculates, then UOMI will be imposed between the time of underpayment and terminal tax date. This also requires that the taxpayer has not engaged in a provisional tax interest avoidance arrangement.

The definition of “tax position” in section 3(1) (kb) of the Tax Administration Act 1994 is being amended to include the use of the AIM approach and the software product of an approved AIM provider.

The “reasonable care” provisions still apply to AIM taxpayers but proposed amendments to section 141B of the Tax Administration Act 1994 will mean that a taxpayer does not take an unacceptable tax position by merely using the AIM approach and an approved AIM-capable accounting system. They may still be subject to an unacceptable tax position penalty in other areas of their tax affairs. Those who are paying AIM provisional tax using a large business AIM-capable system or who have been approved to continue using AIM as their income has grown over \$5 million, will continue to be subject to the unacceptable tax position.

Proposed section RC 5C provides that where an AIM provisional taxpayer has been removed from AIM they will be required to use the estimate method and will be subject to UOMI charges.

Section 119 of the Tax Administration Act 1994 is being amended to insert paragraph (cb) to allow the Commissioner to determine the amount of provisional tax due if the tax liabilities calculated were not “reasonably accurate” assessments of the tax liabilities for the taxpayer’s relevant income and expenditure.

No UOMI will be payable by the Commissioner on overpaid provisional tax under section 120VB of the Tax Administration Act 1994.

Detailed analysis

Exposure to UOMI can be seen by businesses as unfair. Even if a business ends up paying the right amount of provisional tax during the year they can still incur UOMI. AIM will remove this possibility.

If a business using AIM to calculate and pay provisional tax does not pay the total tax liability for the year in full during the year, UOMI will not be applied unless the business has failed to pay the instalments as calculated under AIM.

It is expected that businesses who use AIM will either no longer have terminal tax liabilities (on the basis that their tax payments will be made in near real-time, and based on actual results), or there will be a small difference between their provisional tax payments and their final liability. As the last provisional tax payment date is after balance date, this may allow any shortfall to be identified and paid by the final instalment.

However under AIM, if the taxpayer pays less than the amount calculated by the software for any instalment, UOMI will apply on the shortfall between what the software calculated and what they paid.

Late payments of tax may also attract late payment penalties as applied under the current rules. If there is a large variation between provisional tax paid under AIM and a taxpayer's year-end terminal tax liability, Inland Revenue will consider whether or not reasonable care has been taken in the preparation of the provisional tax payments throughout the year. Amendments to section 141B provide that AIM taxpayers are not liable for unacceptable position penalties unless they are a larger taxpayer using a large business AIM-capable system. This reflects the greater fiscal risks associated with this larger taxpayer group.

It is not intended that Inland Revenue will penalise taxpayers as they come to understand a new provisional tax calculation method but rather that the accuracy of the method and its users will grow over time.

Example 1

Tussock Ltd has been paying its provisional tax using AIM. On its third AIM provisional tax payment date, the software calculated that Tussock Ltd owed \$500 in provisional tax to Inland Revenue and submitted the Statement of Activity showing this amount to be due. Instead of paying \$500 to Inland Revenue, Tussock Ltd only paid \$100.

Tussock Ltd will be liable for UOMI and shortfall penalties on the \$400 underpayment until it is paid or the business's terminal tax date, whichever falls first.

Example 2

Cameo Ltd is a small jewellery company using AIM to pay its provisional tax. It calculates its provisional tax payments using software, and makes the payments accordingly. At year-end the company meets with its accountant who discovers their depreciation was calculated incorrectly and a bad debt had not been written off, resulting in additional income tax due of \$300. Cameo Ltd pays this amount of terminal tax and has no UOMI or shortfall penalty applied. As these errors are simple oversights it is likely Cameo has taken reasonable care in the calculation of its tax liability.

Example 3

Tiger Corporation is a large fishing company that uses specialised Inland Revenue-approved fishing industry software. It has discovered that if it categorises its catch in different fish quantities and qualities it can lower its income tax liability. Upon receipt of the company's Statement of Activity and audit queries, this misuse of the company's software is brought to Inland Revenue's attention.

Tiger Corporation (as a large AIM-capable taxpayer) would be removed from AIM, placed in the estimate method, be subject to UOMI and late payment penalties on what the company's income was determined to be by the Commissioner. It is also likely the company would be considered to have taken an unacceptable tax position in the calculation of its tax liability.

TAX POOLING

(Clauses 37, 38 and 39)

Summary of proposed amendments

The bill proposes that AIM provisional tax payments be excluded from tax pooling provisions.

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

Section RP 17 of the Income Tax Act 2007 is being amended to exclude AIM from the tax pooling provisions. This is based on the premise that tax pooling is intended in circumstances where a taxpayer faces uncertainty and AIM is based on known amounts.

TRANSFERS OF OVERPAID PROVISIONAL TAX

(Clauses 28 and 51)

Summary of proposed amendments

The bill proposes that overpaid provisional tax in the AIM taxpaying company may be transferred to the AIM company shareholders to meet their provisional tax liabilities on the dates that their provisional tax is due (regardless of when it is paid in the AIM company).

Application date

The proposed amendments will apply for the 2018–19 and later income years.

Key features

New section LA 6(2)(db) of the Income Tax Act 2007 enables a company using AIM to transfer a tax credit to its shareholders. Section 120 LB of the Tax Administration Act 1994 provides that this amount does not give rise to a tax credit for the shareholder but is treated as transferred tax paid for the year that the provisional tax credit relates to. The transfer is treated as a refund for the purposes of the AIM company's imputation credit account.

New section LA 6 (2C) of the Income Tax Act 2007 provides that the amount transferred is capped at the lesser of the amount the company chooses, the net amount of the shareholder's tax credit or the company's net amount of their tax credit.

Detailed analysis

There is a risk that accounting income for AIM purposes could be manipulated through the accrual of shareholder employee payments. To ensure this does not occur, it is proposed that the calculation of AIM payments be based on accounting income before shareholder salaries are accrued and deductions for such payments can only be taken for the salary paid within the two-month period that the tax payment relates to. This treatment of shareholder salaries will be confirmed as a required adjustment in the Determination proposed in section 91AAX of the Tax Administration Act 1994.

Proposed section LA 6 of the Income Tax Act 2007 will allow overpayments of provisional tax that relate to shareholder employee salary accruals to be transferred to meet the shareholders tax liability on that salary at the end of the income year.

The proposal provisional tax attribution will not apply to AIM provisional taxpayers, as the mechanism within AIM will assist with achieving the same outcome.

The transfer of overpaid provisional tax from the AIM company to its shareholders is simpler when the two parties have aligned balance dates, as the tax paid at the company level will be paid in time to meet the shareholders' provisional tax liability.

When an AIM shareholder has an early or late balance date, an amendment enables the AIM company's provisional tax to be pro rated against all instalment dates for the year regardless of the mismatch in provisional tax payment dates to the AIM company.

Example 1

Bogart Ltd is a retailer that sells musical instruments, owned equally by John and Lynn Bogart. They elect to use AIM for their businesses and in the income year ending 31 March 2019 make the following overpayments in AIM. All parties have a March balance date.

Provisional tax payment dates	28-Jun 2018	28-Aug 2018	28-Oct 2018	15-Jan 2019	28-Feb 2019	7-May 2019
Bogart Ltd AIM overpayments	\$100	\$100	\$100	\$100	\$100	\$100
Shareholder provisional tax liability due dates		\$200		\$200		\$200

In this instance, Bogart Ltd can easily transfer its overpaid provisional tax at year-end to John and Lynn to meet their provisional tax liabilities. As the dates align there will be no UOMI charges on John and Lynn.

Example 2

Murray Ltd is a dog breeding operation owned by Sarah and Gareth Murray. Murray Ltd has an agreed July balance date, as is common in the dog breeding industry. Sarah and Gareth have standard March balance dates. The payment schedule for the 2019 income year would look as follows:

Provisional tax payment dates	28 Aug 2018	28 Oct 2018	15 Jan 2019	28 Feb 2019	7 May 2019	28 June 2019	28 Aug 2019
Murray Ltd AIM overpayments		\$100	\$100	\$100	\$100	\$100	\$100
Shareholder provisional tax liability due dates	\$150		\$150		\$150		

In this instance, Murray Ltd would be able to transfer its excess provisional tax payments to Sarah and Gareth despite there being a mismatch in their provisional tax dates. These transfers would be calculated and transferred at Murray Ltd's year-end.

Murray Ltd's transfer is limited to the amount of overpaid tax in Murray Ltd – that is, the company cannot transfer more than \$450 as the transfer cannot be more than Sarah and Gareth's provisional tax underpayment for the year. Payments can be transferred to Sarah and Gareth at their 2019 provisional tax dates, negating any UOMI exposure.

Other business tax

SAFE HARBOUR FOR ALL PROVISIONAL TAXPAYERS USING STANDARD UPLIFT METHOD

(Clauses 80, 109 and 114)

Summary of proposed amendment

The amendments modify the calculation of use-of-money interest (UOMI) for taxpayers who use the standard uplift method to calculate their provisional tax.

The effect of the proposed changes will be to remove UOMI for the first two provisional tax instalments for these taxpayers, allowing them to pay their entire provisional tax liability for the year by the third instalment, with no UOMI charge.

Application date

The amendments will apply from the beginning of the 2017–18 income year.

Key features

New section 120KBB of the Tax Administration Act 1994 provides a new method of calculating UOMI for taxpayers who use the standard uplift method of calculating their provisional tax. When a taxpayer makes the instalments required by the standard uplift method for the first two provisional tax payments, no UOMI will apply to those instalments. Instead, UOMI will apply from the date of the third instalment. Given the third provisional tax instalment is almost one month after a taxpayer's balance date, it will be possible for a taxpayer to square up their tax liability for the year at the third instalment date and have no UOMI charge.

When a taxpayer does not make the required instalments under the standard uplift method for the first two instalments, UOMI will apply on the lowest amount of the difference between the:

- the standard instalment amount due and the actual payment; or
- one-third of a taxpayer's residual income tax for the year and the actual payment.

There are also two base protection measures included in section 120KBB. To be able to use the new calculation rule in section 120KBB, all associated persons must use the standard uplift method (or the GST ratio method) to calculate provisional tax and there must be no provisional tax interest avoidance arrangement. (A provisional tax interest avoidance arrangement is where one or more amounts of residual income tax have been manipulated with the purpose or effect of defeating the intent and application of the UOMI rules.)

A further base maintenance measure is proposed to section RC 5 of the Income Tax Act 2007, to prevent taxpayers from switching to the estimate method after a taxpayer has paid the first two instalments based on the standard uplift method.

Background

The standard uplift method of calculating provisional tax is the easiest method for taxpayers to calculate and pay. It assumes a standard “uplift” based on the taxpayer’s prior year’s residual income tax (or the year before the prior year if a taxpayer has not filed their prior year return). The standard uplift method is the most commonly used method to calculate provisional tax and is used by 92 percent of provisional taxpayers.

However, using the standard uplift method can leave taxpayers in a position of having to pay UOMI when their current year income exceeds the 5% growth rate from the prior year (10% for the year before the prior year). This can seem unfair to taxpayers who have used the best information available to them to calculate provisional tax.

The amendments seek to reduce the impact of UOMI to taxpayers who have committed to, and paid, provisional tax based on the standard uplift method calculation.

When UOMI is removed from provisional tax payments the ability to manipulate incomes between associated persons can increase. At the extreme this could lead to taxpayers not being exposed to UOMI and no provisional tax payments being made by using different provisional tax methods. The amendments contain some base maintenance mechanisms to reduce the ability to enter into such arrangements.

Detailed analysis

Clause 109 introduces a new section 120KBB to the Tax Administration Act 1994. Subsection (1) defines which taxpayers may use the new standard uplift calculation method as those who:

- are not new provisional taxpayers;
- do not fall within the safe harbour rule in section 120KE (that is, the taxpayer’s residual income tax is over the proposed new \$60,000 threshold or they have not made the instalments required to use the safe harbour); and
- use the standard uplift method to calculate provisional tax instalments.

All standard method associates must also use either the GST ratio method or the standard method and there must be no provisional tax interest avoidance arrangement in relation to the taxpayer.

Subsection 120KBB(4) defines a standard uplift method associate as “a person who is associated with the taxpayer” (person A), using the general association tests in section YB 3 of the Income Tax Act 2007, with some modifications.

Under the proposed new rules, a standard uplift method associate is:

- a company which is in the same wholly owned group of companies as person A (if person A is a company); or
- another person that is associated with person A treating section YB 3 as requiring 50% voting interest rather than 25% (if person A is a company or not).

Example

Charger Limited is owned equally and run by its two shareholders Macintyre and Alistair Craig. Both draw shareholder-employee salaries from the company from which no PAYE is deducted. Charger chooses to use the standard uplift method to calculate provisional tax.

Macintyre and Alistair will be required to use the same provisional tax calculation method as Charger for that income year.

Subsection 120KBB(4) also defines a “provisional tax interest avoidance arrangement” as an arrangement that involves the manipulation of one or more amounts of residual income tax, including a zero amount of residual income tax, with the purpose or effect of defeating the intent and application of the interest rules in Part 7 of the Tax Administration Act 1994.

This is an overriding anti-avoidance section, which has the aim of ensuring that any remaining opportunities to manipulate income to avoid UOMI or the payment of provisional tax can be nullified. The consequence of not being able to use the proposed new calculation method in section 120KBB is to leave the taxpayer exposed to UOMI as they currently are from the first instalment of provisional tax.

Taxpayers who meet the criteria to use section 120KBB will apply the proposed modified UOMI calculation rules in subsection 120KBB(2) and (3). Which subsection applies will depend on whether the taxpayer has made the first two instalments required under the standard uplift method in full or not.

For taxpayers who make the first two required instalments on the instalment dates, subsection 120 KBB(2) will apply. This subsection moves the due date for the person’s residual tax less the two instalment payments made to the date of the third instalment for the purposes of calculating UOMI. This means the person will only be exposed to a UOMI charge from the third instalment date.

Example

Thunderbolt Limited, a manufacturer of clapping devices for sports fans, has residual income tax of \$250,000 in the 2017 year. Thunderbolt has trouble estimating its provisional tax due to volatility in its income. Sales volumes are highly dependent on the success of local sports teams – the more successful the teams, the more clapping devices are sold. Therefore Thunderbolt decides to use the standard uplift method to calculate its provisional tax payments, reducing the risk of UOMI applying if its estimate is incorrect.

For the 2018 year Thunderbolt makes two provisional tax payments of \$87,500 per payment. At the third instalment date Thunderbolt has calculated that its actual annual liability is \$300,000, due to the success of the local football team, the Fords.

Because Thunderbolt has made the two required instalments under the standard uplift method on time, section 120KBB(2) will apply and Thunderbolt's residual income tax for the year, \$300,000 less the two instalments made (\$175,000), is due and payable on the date of the third instalment. This means that if Thunderbolt pays \$125,000 as a third instalment it will have satisfied all its residual income tax and Thunderbolt will incur no UOMI.

Thunderbolt could just pay the required third instalment amount of \$87,500, but will incur UOMI on the shortfall of \$37,500 from the third instalment date until the outstanding tax and interest is paid.

For taxpayers who do not make the required instalments in full or on time, the timing rule in section 120KBB(3) will apply. These instalments are referred to as “failed instalments”.

If a taxpayer has a failed instalment, interest will apply to that instalment. The amount on which interest will apply is the lowest amount of:

- one-third of their residual income tax less the amount paid in relation to the failed instalment; or
- the amount they are liable to pay as an instalment amount under the standard uplift method less the amount paid in relation to the failed instalment.

This provision means that a person who does not pay the standard uplift amount in full or on time will incur UOMI on the lowest amount of the difference between one-third of their residual income tax and the payment in relation to that instalment, or the amount due as the instalment and the amount paid.

Example

Challenger Limited uses the standard method for calculating provisional tax for its June year-end. Its residual income tax for the 2017 year is \$20,500,000. This means its standard uplift method instalments will be 105 percent of that amount, being \$21,525,000, and each instalment required to be \$7,175,000.

Instead of making those first two instalments, Challenger makes a first instalment of \$5,700,000 on 28 November 2017 and a second instalment of \$6,800,000 on 28 March 2018. At the end of the income year Challenger calculates its residual income tax as \$24,000,000, and makes a final instalment of \$11,500,000 and an amount of \$91,242 in UOMI. The total instalments made equal Challengers residual income tax payable.

Because Challenger has not made the required instalments under the standard uplift method they will fall within section 120KBB(3). Challenger will be charged interest on the lesser of one-third of its residual income tax for the year, less the instalment payment made or the instalment amount less the instalment payment made.

As one-third of Challenger's residual income tax of \$8,000,000 is greater than the standard method instalment of \$7,175,000 the "lesser" amount in section 120KBB(3) will be the standard instalment amount.

Using this as the basis of the UOMI calculation, Challenger will be subject to UOMI on:

- \$1,475,000 of the first instalment (\$7,175,000 less payment of \$5,700,000) from the due date for the first instalment to the date the amount was paid (the date of the third instalment). This UOMI amount is \$80,876;
- \$375,000 of the second instalment (\$7,175,000 less payment of \$6,800,000) from the due date of the second instalment until the date the amount was paid (the date of the third instalment). This UOMI amount is \$10,366.

Challenger will not incur any UOMI from the date of the third instalment as all its residual income tax and the associated UOMI charge has been paid on that date.

For taxpayers who use the standard uplift method and make the first two instalments in full and on time, no UOMI will apply. This also means that if a taxpayer is overpaid no UOMI will be payable by the Commissioner until the third instalment.

Currently, taxpayers who use the standard uplift method can switch to the estimate method at any time before the third instalment of provisional tax. By removing UOMI from the standard uplift method, taxpayers who are overpaid prior to the third instalment could switch to the estimation method and have credit UOMI paid to them earlier. This would be contrary to the intention of the amendments, which is to reduce the impact of UOMI on taxpayers.

Consequently, an amendment to section RC 5(1) (clause 80) is proposed, to prevent a person who uses the standard uplift method and pays provisional tax equal to the amounts specified in section RC 10 for the first two instalments, from choosing the estimate method for the year.

This will only allow taxpayers who start using the standard uplift method to switch to the estimate method if they have not paid the second instalment under the standard uplift method.

Example

Viper Limited has calculated their provisional tax liability for the 2017–18 income year using the standard method which requires instalments of \$350,000 at each instalment date. Viper has made the first instalment but due to an unexpected downturn in sales realises that its total tax liability for the year will only be \$100,000. Before payment of its second instalment Viper decides to switch to the estimate method so it doesn't have to tie up working capital in tax payments. Also, it will be able to earn credit UOMI on its overpaid tax.

If Viper had made the second instalment based on the standard uplift amount it would not be permitted to switch to the estimate method.

CHANGES TO UOMI SAFE HARBOUR THRESHOLD

(Clauses 80, 109 and 110)

Summary of proposed amendment

As part of proposed changes to the provisional tax rules, the bill increases the current “safe harbour” threshold at which use-of-money interest applies, from \$50,000 to \$60,000, and extends the safe harbour to non-individuals (for example, companies). Currently the safe harbour only applies to individual taxpayers.

Application date

The amendments will apply from the beginning of the 2017–18 income year.

Key features

Section 120KE of the Tax Administration Act 1994 currently allows individual taxpayers a safe harbour from the imposition of use-of-money interest when the taxpayer has residual income tax of less than \$50,000. The proposed amendment increases this threshold to \$60,000 and also removes the requirement that a taxpayer be a natural person (an individual) to apply the safe harbour.

The amendments also add three additional requirements to tighten application of the safe harbour rules. These amendments will:

- require a taxpayer to actually make the three instalments required under the standard method to enable them to use the safe harbour;
- prohibit a taxpayer who has a provisional tax interest avoidance arrangement from using the safe harbour; and
- prohibit a taxpayer who has paid the first two instalments under the standard method from changing to the estimation method.

The first two amendments are found in section 120KE and the third in section RC 5 of the Income Tax Act 2007.

For taxpayers who do not pay the required instalment amounts, the general standard method rules will apply.

Background

Provisional tax is an area that businesses find difficult to get right. This is particularly so for smaller businesses. The current rules require a taxpayer to either base their provisional tax amount on a GST ratio method, an uplift from the prior year's residual income tax (or two years prior when a tax return for the prior year has not been filed) or an estimate of income for the year. Under the latter two options use-of-money interest (UOMI) will apply if a taxpayer's actual residual income tax differs from payments made. This result can seem unfair when a taxpayer is basing their provisional tax on an uplift from the prior year.

The current safe harbour was introduced to reduce the impact of UOMI to a subset of taxpayers. In particular, individuals other than those on very high incomes were removed from the application of UOMI to reduce the impact of those rules. The proposed amendments will bring more taxpayers into the safe harbour by increasing the threshold to those taxpayers with a residual tax liability of \$60,000 or less, and extend application of the safe harbour to non-individual taxpayers.

The amendments also seek to tighten some deficiencies in the current safe harbour rules.

First, an amendment seeks to ensure that taxpayers must make required payments under the standard uplift method to use the safe harbour.

Secondly, the ability to switch from the standard to the estimation method has been limited so a taxpayer can only switch methods up to the payment of the second instalment.

Finally, a base maintenance provision will also apply to the safe harbour when a taxpayer has entered an arrangement to manipulate income to defeat the intention of the provisional tax rules.

PROVISIONAL TAX ATTRIBUTION

(Clauses 72, 73, 77, 78, 79, 82, 92(8)-(10), 96, 102 and 111)

Summary of proposed amendment

The bill proposes a new way of simplifying provisional tax liabilities on untaxed salaries received by shareholder-employees of close companies. Under this proposal, the shareholder-employee and the company can agree that the shareholder-employee's provisional tax payment obligations on their shareholder salary are transferred to the company. At the end of the year, the company can transfer a tax credit, out of its provisional tax payments, to the shareholder-employee.

A shareholder-employee whose only income not subject to tax at source is their salary will be able to use these rules to completely remove themselves from provisional tax.

Application date

The amendments will apply from the beginning of the 2018–19 income year.

Key features

The proposed new rules will create a mechanism by which a shareholder-employee's provisional tax payment obligations in relation to their salary can be transferred to a company which uses either the uplift or estimate method for provisional tax. (A different method is provided within the proposed AIM rules for AIM companies.) The company's obligations to pay provisional tax on various instalment dates will be increased by the amount transferred from the employee.

At the end of the year, the company can choose to transfer some of the provisional tax it has paid to the shareholder-employee. The shareholder-employee will receive it as a tax credit. If insufficient tax has been paid by either the company or the shareholder-employee, use-of-money interest may be payable, depending on the size of the shortfall and the provisional tax method used.

The proposals will be the most useful in situations where there is a close relationship between the company and its shareholder-employees, and where one accountant prepares the tax returns for both at the end of the year.

Background

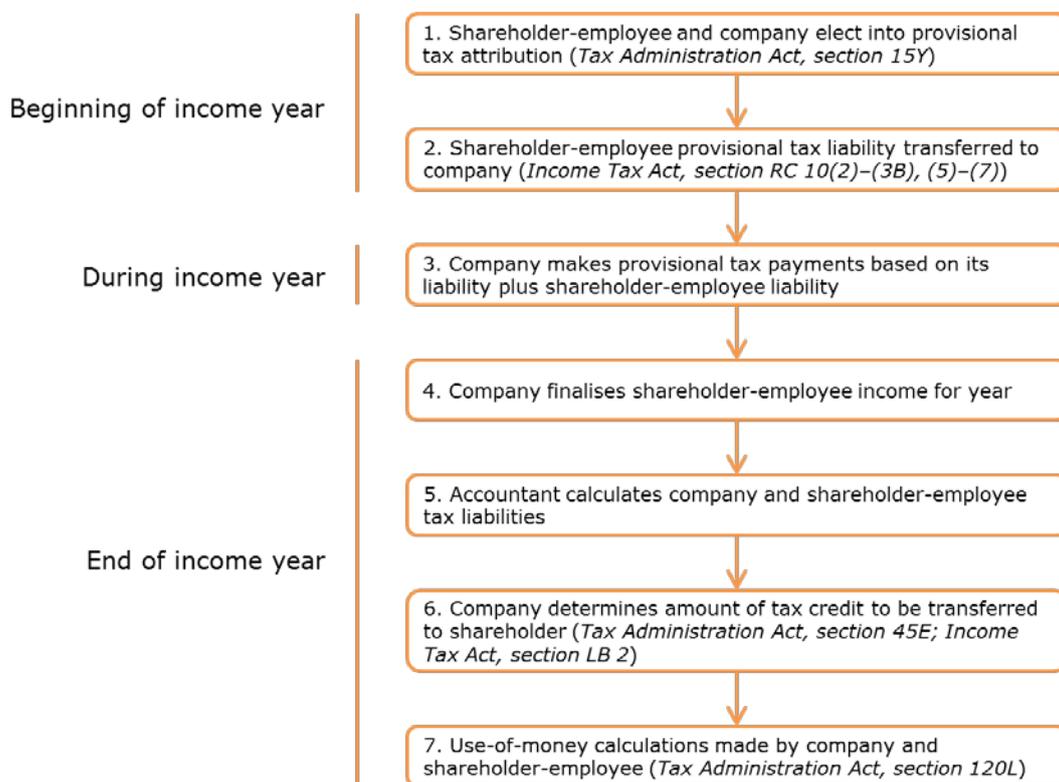
In a typical small company scenario, the company exists as a vehicle for the controlling shareholders to carry on their business activity with the protection of limited liability. The income the company derives will be split between being retained by the company and being distributed to the shareholders, with the final decision typically being made at the end of the year once the final results are known.

While the shareholders and the company are legally separate, from an economic perspective the split is much less clear.

Current tax law follows the legal form. Salary amounts paid to shareholder-employees of close companies are typically not subject to PAYE. If the income tax on these salary amounts exceeds \$2,500, the shareholder-employee will be required to pay provisional tax in the subsequent year. So, while there is one true stream of income (that which the company receives from external sources), and the decision about the allocation is made at the end of the year, during the course of the year, often two separate provisional taxpayers have calculated their provisional tax liabilities and are making payments to Inland Revenue.

Detailed analysis

The following diagram illustrates how the proposed new rules would apply.



Beginning of the income year

Electing-in

When a company and a shareholder-employee want to use the provisional tax attribution (PTA) rules for the first time, they must elect to do so in accordance with proposed section 15Y of the Tax Administration Act 1994. The election must be made before the company's first provisional tax instalment date.

The PTA rules can only be used if both the company and the shareholder-employee agree. A company can choose to use the PTA rules for some, but not all, of its shareholder-employees, and a person who is a shareholder-employee of more than one company can choose to elect in for some, but not all, of those companies.

Once a shareholder-employee and a company have elected into the PTA rules, they will remain in the rules in subsequent years, until they elect out in accordance with proposed section 15Y(2), again prior to the company's first provisional tax instalment date. Inland Revenue will prescribe the methods for electing in and electing out closer to the beginning of the 2018–19 income year when the new rules are proposed to come into effect.

Adjustments to provisional tax liabilities

The key initial effect of electing into PTA is the adjustments made to both the shareholder-employee's and the company's provisional tax payment obligations in proposed section RC 10.

Under proposed subsection (2), the shareholder-employee's provisional tax obligation will be reduced by the amount "shareholder attributed", which is their "shareholder attributed tax" from earlier years uplifted by 5% or 10% as appropriate, or their estimate of their shareholder attributed tax. Shareholder attributed tax is defined in section RC 10(6) and (7) as either 28%, or the amount of tax paid, on their shareholder salary.

Under proposed section RC 3(4), where a shareholder-employee elects into the rules and their residual income tax for the previous year less the tax on the shareholder salary in the previous year is less than \$2,500, the shareholder-employee has no obligation to pay provisional tax in the current year.

Under proposed section RC 10(2), the company's payment obligations are increased by the amount "company attributed". This is defined in proposed section RC 10(3)(c) as the total of the shareholder attributed tax amounts transferred by employees.

Example 1: Transfer of entire provisional tax payment obligation

Joe is the sole shareholder of J Contracts Ltd. In 2017–18, Joe received \$100,000 in untaxed salary from the company, which is his sole income. The tax on this income is \$23,920.

In that same year J Contracts Ltd had net income of \$200,000, and the tax on that income was \$56,000.

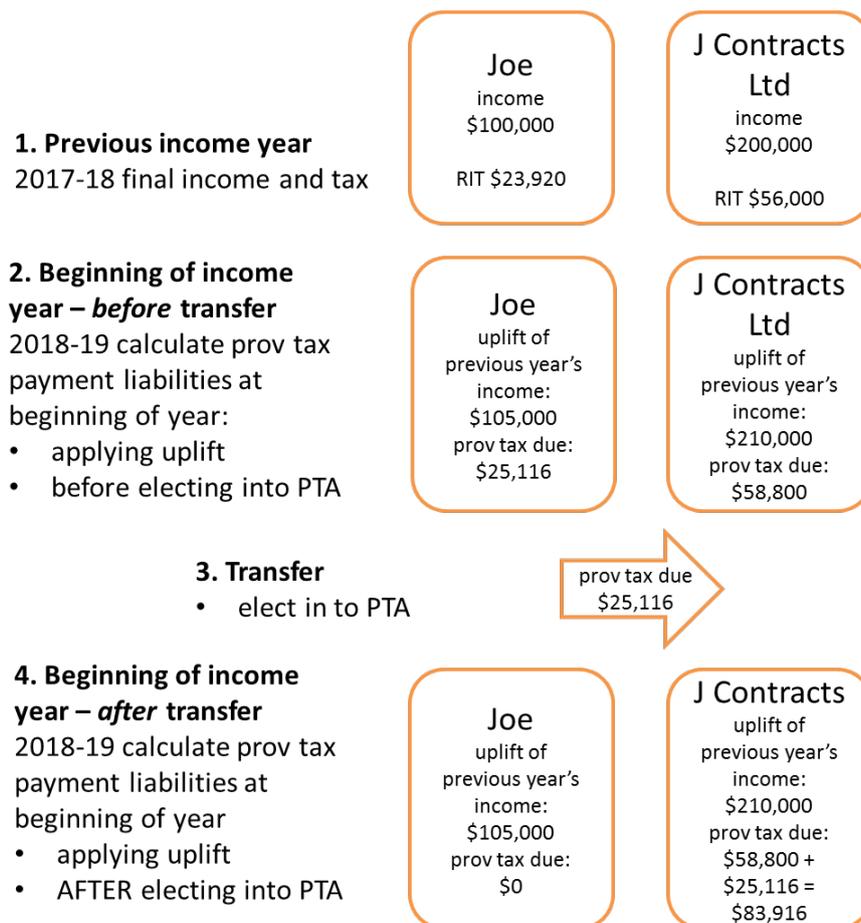
In the absence of using PTA, Joe would have a provisional tax liability for 2018–19 of 105% of \$23,920, which is \$25,116, and J Contracts Ltd would have a provisional tax liability of 105% of \$56,000, which is \$58,800, assuming both use the uplift method.

Joe and J Contracts Ltd agree to use the PTA method for 2018–19.

Joe’s shareholder attributed is \$23,920 x 105%, which is \$25,116. This is deducted from the payment liability he would otherwise have had, of \$25,116, leaving a payment liability of nil. The residual income tax for the previous year of \$23,920, less the tax on his salary for that year of \$23,920, is nil. This means that Joe has no obligation to pay provisional tax in the 2018–19 income year.

The company’s liability to pay provisional tax in 2018–19 of \$58,800 is increased by the amount transferred from Joe of \$25,116, giving it a total liability to pay provisional tax of \$83,916.

This is illustrated as:

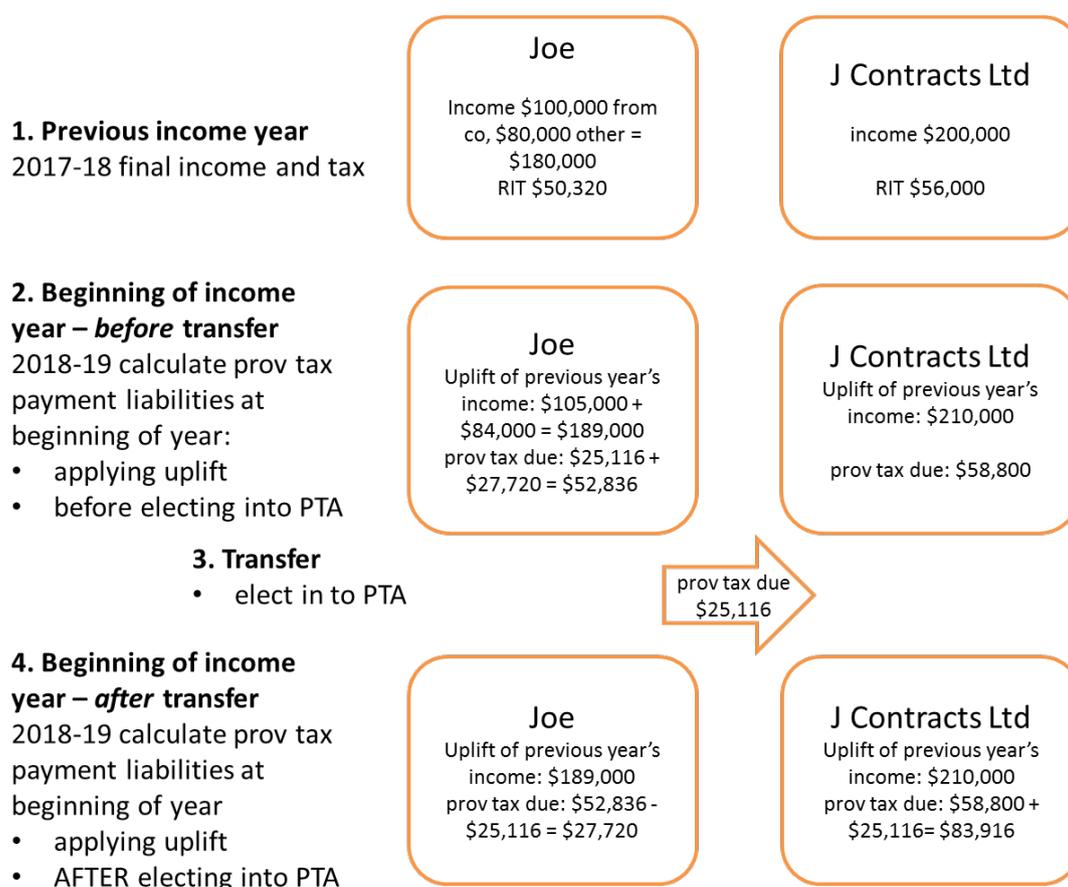


Example 2: Transfer of part of provisional tax payment obligation

The facts are the same as for Example 1, except that Joe also has other income in 2017–18 of \$80,000. Total tax on his income of \$180,000 is therefore \$50,320. The definition of “shareholder attributed” treats Joe’s salary of \$100,000 as the first part of his income, so tax on it is \$23,920, and is uplifted in the following year to \$25,116.

This is deducted from the payment liability he otherwise would have had, of 105% of \$50,320, which is \$52,836. \$52,836 less \$25,116 is \$27,720. This is Joe’s provisional tax liability for the 2018–19 year. (He will not be a provisional taxpayer at all if his liability to make payments is less than \$2,500, but here it clearly is.)

This is illustrated as:



During course of income year

The company will be required to pay provisional tax payments, under its chosen method, of the combined total of its own liability and the liability it has assumed on behalf of shareholder-employees. It will not be required to notify Inland Revenue of the make-up of each payment; the total payment amount constitutes provisional tax paid by the company.

End of income year

Allocation of tax credit to shareholder-employees

At the end of the income year, in the ordinary course of business, the company's accountant will calculate the following amounts:

- the amount the company will pay to the shareholder-employee by way of salary;
- the shareholder-employee's tax liability for the year; and
- the company's tax liability for the year.

At that point, the company's accountant can determine how the amount paid as provisional tax by the company will be allocated between the company and the shareholder-employees who elected into the provisional tax attribution rules.

The amount of tax credit the company can transfer to its shareholder-employees is not related to the amount the company paid on their behalf during the income year. The company can allocate to its elected-in shareholder-employees:

- all of the provisional tax it paid;
- some of the provisional tax it paid; or
- none of the provisional tax it paid,

except that a company cannot claim a refund unless it has first transferred to shareholder-employees an amount equal to their tax liability on their shareholder salaries (proposed section LA 6(2)(cb)).

The amount transferred by the company to its shareholder-employees will be treated as a tax credit by them under proposed amendments to section LB 2. This type of tax credit is applied after residual income tax is determined, in accordance with the existing definition in section YA 1. This is the same approach as that taken for provisional tax credits, and differs from the approach to other kinds of tax credits such as PAYE, RWT and tax paid by trustees on behalf of beneficiaries.

The amount transferred by the company will be deducted from the tax credits available to it, also under proposed amendments to section LB 2. Proposed section 45E of the Tax Administration Act sets out a process for the company providing information to Inland Revenue and to the shareholder-employee of the amount transferred by way of tax credit.

Example 3: Tax payments match total liability

In Example 1, at the beginning of the 2018–19 year Joe transferred his provisional tax payment liability of \$25,116 to J Contracts Ltd.

J Contracts Ltd paid the new combined liability during the year of \$83,916.

Both Joe and J Contracts Ltd had net income of exactly their uplift amounts – \$105,000 for Joe and \$210,000 for J Contracts Ltd, with a tax liability of \$25,116 for Joe and \$58,800 for J Contracts Ltd.

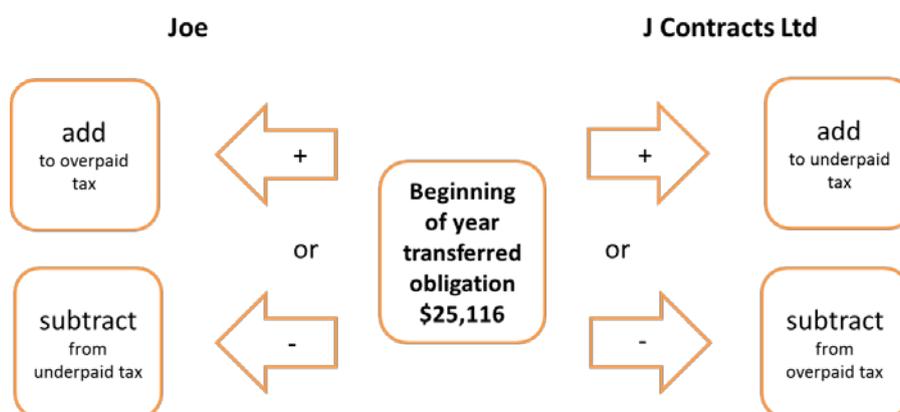
J Contracts Ltd has a tax liability of \$58,800, but has paid provisional tax of \$83,916. It therefore has excess tax credits of \$25,116. It must transfer these excess tax credits to Joe. J Contracts Ltd could transfer *more* than \$25,116 to Joe if it wished; it would then need to make up any shortfall as terminal tax.

UOMI adjustments

When a company and a shareholder-employee use the provisional tax attribution rules, use-of-money interest adjustments must be made at the end of the year. These adjustments reflect that, as a result of entering into the provisional tax attribution rules, the company accepted an obligation to meet the shareholder-employee's provisional tax payment obligations.

For taxpayers outside the provisional tax attribution rules, use-of-money interest is payable on the difference between the amount of provisional tax paid and the taxpayer's residual income tax. When provisional tax exceeds residual income tax, the excess is an overpayment (on which the taxpayer may be paid interest); when provisional tax is less than residual income tax, the shortfall is an underpayment (on which the taxpayer may be required to pay interest).

When shareholder-employees and companies have entered into the provisional tax attribution rules the payment liability transferred from the shareholder-employee to the company is *added* to the amount on which the company is potentially liable to pay UOMI, and *deducted* from the amount on which the shareholder-employee is potentially liable to pay UOMI. This is done by proposed section 120L(1B), which variously adds and subtracts the amount of liability transferred at the beginning of the year to the year-end underpaid and overpaid amounts. The following diagram sets out these adjustments in the context of the examples used above:



If the amount to be subtracted from underpaid tax is greater than the amount of underpaid tax, the difference is overpaid tax, and if the amount to be subtracted from overpaid tax is greater than the amount of overpaid tax, the difference is underpaid tax.

UOMI is calculated after the additions and subtractions described above have been made.

Example 4: UOMI calculations

In this example, both Joe and J Contracts Ltd are using the uplift method.

As in Example 2, at the beginning of the 2018–19 year Joe transferred his provisional tax payment liability in relation to his company salary of \$25,116 to J Contracts Ltd, while remaining responsible for the provisional tax on his income from other sources (previously \$80,000).

J Contracts Ltd paid the new combined liability during the year of \$83,916.

At the end of the year, both Joe and J Contracts Ltd had net income significantly greater than their uplift amounts. Joe earns \$84,000 from other sources, on which the tax is \$27,720. During the year, Joe made his own provisional tax payments of \$27,720, so he met the liability on his \$84,000 of other income. But Joe's income from the company has increased to \$250,000, so Joe's tax liability in relation to this amount is \$73,420 giving him a total tax liability of \$101,140.

J Contracts Ltd's income was \$500,000, so its liability is \$140,000.

One option is for J Contracts Ltd and Joe to make an additional payment at P3 which meets their shortfalls. If this happens, then under the proposed changes to the uplift method made elsewhere in this bill, no use-of-money interest will be payable by either J Contracts Ltd or Joe.

The remainder of this example proceeds on the basis that any shortfalls are not paid until terminal tax date, which means that use-of-money interest calculation adjustments must be made.

J Contracts Ltd decides to transfer \$10,000 of the provisional tax payments it made of \$83,916 to Joe. This reduces Joe's shortfall to \$63,420, which Joe will need to pay. J Contracts Ltd will need to pay its tax shortfall which is now $\$140,000 - \$73,916 = \$66,084$.

Use-of-money interest adjustments must be made.

Joe calculates his underpayment amount, which is his total tax liability less provisional tax payments made by him, so $\$101,140 - \$27,720 = \$73,420$. (The amount transferred as credit to him is not relevant here.) But because he and J Contracts Ltd had agreed that the company would pay \$25,116 on his behalf, this is deducted from his underpayment amount, reducing it to \$48,304. This is the amount on which Joe must pay UOMI from P3.

J Contracts Ltd makes a similar underpayment calculation. Its total liability was \$140,000, and it paid \$83,916 during the year, so its underpayment amount is $\$140,000 - \$83,916 = \$56,084$. But of the \$83,916 it paid, it had agreed to pay \$25,116 on behalf of Joe, so this is added to its underpayment amount. This makes its total underpayment amount $\$56,084 + \$25,116 = \$81,200$. This is the amount on which J Contracts Ltd must pay UOMI, from P3.

The calculations can be checked as follows:

UOMI adjusted underpayment amounts above: Joe \$48,304 + J Contracts Ltd \$81,200 = \$129,504

Total tax liabilities: Joe \$101,140 + J Contracts Ltd \$140,000 = \$241,140

Total provisional tax paid to IR (before transfers): Joe \$27,720, J Contracts Ltd \$83,916 = \$111,636.

Difference between total liabilities and total provisional tax paid to IR: $\$241,140 - \$111,636 = \$129,504$.

Total shortfall amounts to pay: Joe \$63,420, J Contracts Ltd \$66,084 = \$129,504.

These transactions can be summarised as follows:

Tax calculations:

	Joe	J Contracts Ltd
2017-18 tax return		
2017-18 income	\$100,000 company \$80,000 other \$180,000 total	\$200,000
2017-18 tax liability	\$50,320	\$56,000
2018-19 provisional tax		
2018-19 uplift amount	\$52,836	\$58,800
Transfer of prov tax on company income from Joe to J Contracts Ltd	-\$25,116	\$25,116
2018-19 prov tax liability after transfer	\$27,720	\$83,916
2018-19 prov tax paid	\$27,720	\$83,916
2018-19 tax return		
2018-19 income	\$250,000 company \$84,000 other	\$500,000
Tax on 2018-19 income	\$101,140	\$140,000
Tax shortfall	\$73,420	\$56,084
Transfer of prov tax previously paid by J Contracts Ltd to Joe	\$10,000	\$10,000
Terminal tax liability	\$63,420	\$66,084
2018-19 UOMI calculations		
Initial calculation of underpayment amounts	\$73,420	\$56,084
Deduct initial prov tax liability transfer from Joe	-\$25,116	
Add initial prov tax liability transfer to J Contracts Ltd		\$25,116
Amount on which UOMI payable	\$48,304	\$81,200

Additional rules in proposed sections 120L(1C) and (1D) apply when either the company or the shareholder-employee is using the uplift method, and is potentially only liable to UOMI from their third instalment date.

As noted above, where a shareholder-employee has elected into PTA and has no other income, the shareholder-employee will no longer be subject to provisional tax under proposed section RC 3(4). That person will also no longer be subject to use-of-money interest. Where the company was liable to use-of-money interest and its tax liability exceeded its tax payments, the non-application of use-of-money interest to the shareholder-employee might encourage the company to reduce its income and so its use-of-money interest liability by paying a larger salary to the shareholder-employee. Proposed section 120L(1E) and (1F) addresses this situation by adding the shareholder-employee's residual income tax to the company's residual income tax for use-of-money interest purposes, where the shareholder-employee's residual income tax exceeds \$60,000.

ALLOWING CONTRACTORS TO ELECT THEIR OWN WITHHOLDING RATE

(Clauses 87, 88, 92(2)–(6), 93(1)–(18), 98, 99 and 114)

Summary of proposed amendment

The proposed amendment will allow contractors who are subject to the schedular payment rules to elect their own withholding rate without having to apply to Inland Revenue for a special tax code.

Application date

The proposed amendment will come into force on 1 April 2017.

Key features

The proposed amendment will allow contractors who are subject to the schedular payment rules to elect their own withholding rate without having to apply to Inland Revenue for a special tax code.

Under the proposed amendments there will be some situations when a contractor will not be able to elect their own rate. These include:

- when a contractor has not provided their name and IRD number, a 45% rate of withholding applies;
- when a contractor has not met a liability under an Inland Revenue Act, the Commissioner can prescribe a rate of withholding;
- a minimum rate of withholding applies to contractors. For non-resident contractors and contractors with temporary work visas this minimum rate is 15%, for all other contractors this is 10%;
- if a contractor has changed their rate twice in a 12-month period, they require the consent of the payer to any further changes.

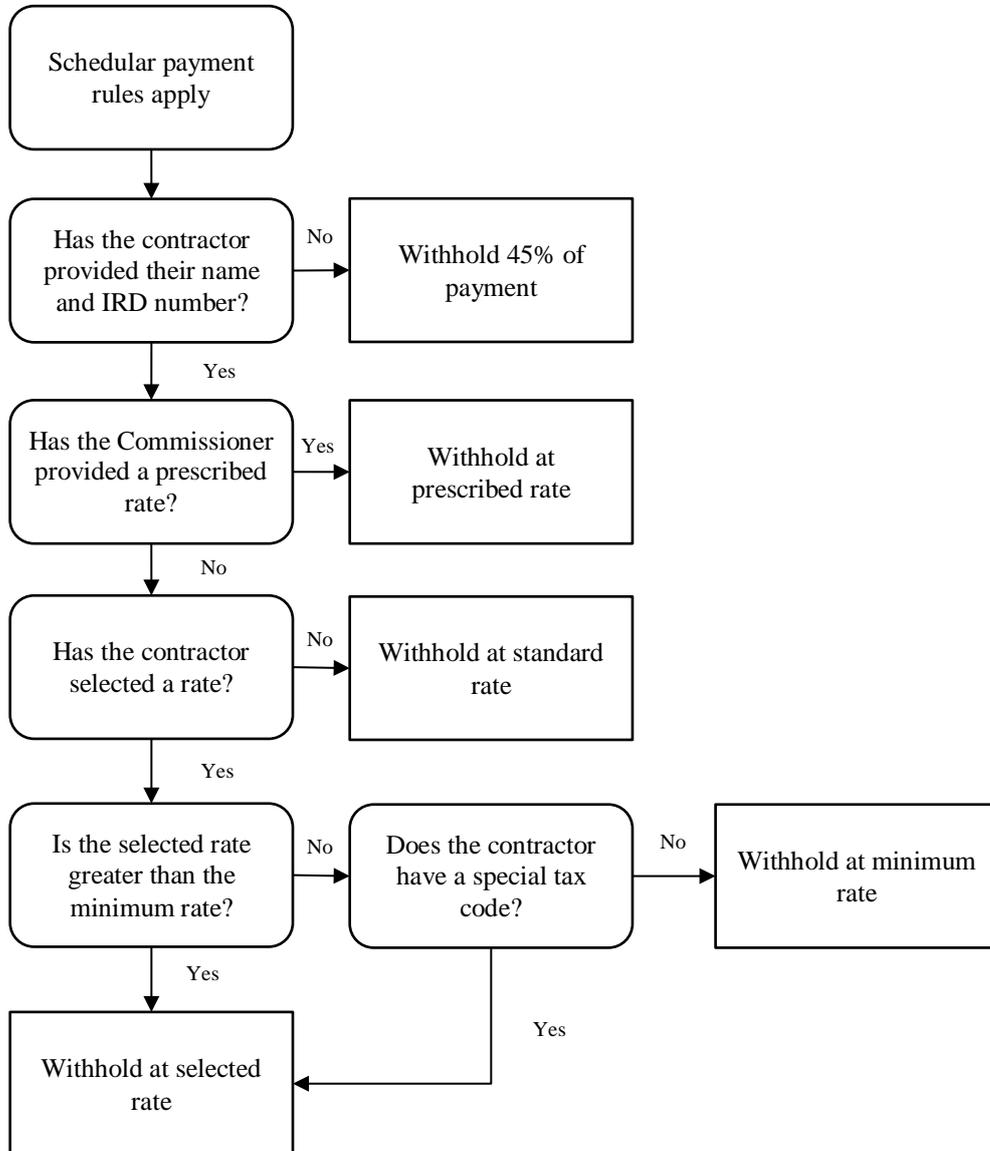
If a contractor has not selected a rate, a “standard rate” applies. This standard rate is the relevant rate listed in schedule 4 of the Income Tax Act.

Background

Currently, when a contractor is subject to the schedular payment rules, a flat rate of withholding applies. This rate will often not accurately match the contractor’s actual income tax liability. Contractors can obtain a special tax code to alter their rate, but the process can be cumbersome, requiring them to apply to Inland Revenue and supply supporting information.

Detailed analysis

Proposed new section RD 10B of the Income Tax Act 2007 sets new rules for what rates would apply for contractors subject to the schedular payment rules. The flowchart below summarises these rules:



Overview of different rate types

	Description	Rate
Elected rate	Chosen by the payee.	10% – 100% (15% – 100% for non-residents and holders of temporary visas)
Special rate	Payee can request from Commissioner.	Only necessary if the payee wants a rate lower than 10% (or 15% as above)
No notification rate	Where payee does not provide name or IRD number to the payer.	45%
Prescribed rate	Set by Commissioner where the payee has not met a liability under the Inland Revenue Acts.	Cannot exceed 60%
Non-resident entertainer rate	This rate must be used by non-resident entertainers.	20%
Standard rate	The rate for the activity or arrangement set out in Schedule 4, which will apply if none of the rates set out above apply.	Vary between 10.5% and 33% depending on the type of activity or arrangement

Elected rate

Proposed sections RD 10B(3)(a) of the Income Tax Act 2007 and 24LB of the Tax Administration Act 1994 provide that contractors subject to the schedular payment rules may elect the withholding rate that is to apply to payments to them.

To elect a rate of withholding, the contractor must notify the person making the payment of the rate to apply and this notification must be made in a form approved by the Commissioner.

Minimum rate

To address the risk that contractors may attempt to defer or avoid paying their tax by choosing an artificially low withholding rate, proposed section 24LB(2) provides that contractors must elect a rate of withholding that is greater than the minimum rate.

For non-resident contractors and contractors who are holders of temporary entry class visas, the minimum rate is 15%. For all other contractors, the minimum rate is 10%.

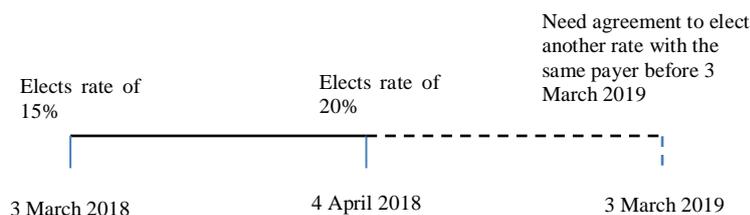
Special tax rate

A contractor may have a rate lower than the 10% minimum if they obtain a special tax rate certificate under section 24N of the Tax Administration Act 1994.

Repeatedly changing withholding rates

If a contractor has previously elected a withholding rate twice in a 12-month period to the same payer, they require the consent of the schedular payer to make any further changes in their withholding rate.

Example



On 3 March 2018 Caroline starts work as a building contractor for Small Builders Ltd. Payments from Small Builders to Caroline are subject to the schedular payment rules and Caroline initially selects a withholding rate of 15%.

On 4 April 2018, Caroline wishes to change her withholding rate and notifies Small Builders that she wishes to have a withholding rate of 20% apply to her. Caroline does not require the consent of Small Builders to this change as she has only elected a withholding rate once within the last 12 months. However, if Caroline wishes to make any further changes to her withholding rate for payments made by Small Builders up till 3 April 2018, she will require the consent of Small Builders.

On 5 August 2018, Caroline starts work for Large Builders Ltd. Caroline can elect a new withholding rate without the consent of Large Builders Ltd. as she has not previously elected a withholding rate with Large Builders.

No notification rate

Proposed section RD 10B(2) provides that when a contractor does not give their name and IRD number to their payer, then payments to them must have tax deducted at a 45% rate.

This replaces the current “no notification” rate for schedular payments in section RD 18 of the Income Tax Act. This is intended to provide a simpler “no notification” rate for schedular payments that is aligned with the rate that applies to employees.

Prescribed rate

Proposed sections RD 10B(4) of the Income Tax Act 2007 and 24LC of the Tax Administration Act 1994 provide that when a contractor has not met a liability under the Inland Revenue Acts the Commissioner has the ability to prescribe a withholding rate.

The proposed process for the prescribed rate is similar to the one for deduction notices under section 157 of the Tax Administration Act 1994, and requires a notice to be provided to the payer or the contractor that a different rate should be applied. If a notice is provided to the payer, the payee must also be provided a notice, unless after making reasonable enquiries the Commissioner does not have a valid address for the contractor.

Under the proposed amendments the Commissioner can require two different types of prescribed rate deductions. These are:

- standard schedular payment deductions under the ordinary PAYE rules (which provide PAYE tax credits for the contractor);
- additional deductions, which are used to meet the contractor's tax debts or other liabilities.

The additional deductions would generally be required to be recorded on a separate line in the employer monthly schedule and under a different tax code. This is similar to how additional deductions are currently done for student loans. Where additional deductions are paid in this way, the initial late payment penalties charged on the original debt are not applied.

The Commissioner does not intend to use this prescribed rate notice to require additional deductions to meet a contractor's other tax debts until schedular payments are administered in Inland Revenue's new computer system.

Example

Ben is a building contractor. He earns \$120,000 each year from his building contracts with several major building companies. Ben elects a withholding rate of 10% and \$12,000 is withheld from him for the year.

Ben predominantly provides labour services and has minimal deductions. His end of year tax liability is \$30,000 and so Ben has a terminal tax bill of \$18,000. Ben does not pay his terminal tax bill and so ends up with a tax debt.

The Commissioner prescribes a new rate of withholding to Ben and his payers. This new rate is:

- 25% under the standard schedular payment code (WT). Ben receives PAYE credits for these amounts and these amounts are intended to ensure that Ben does not have an end of year income tax liability and further tax bills; and
- an additional 15% under a new tax code and recorded on a new line in the employer monthly schedule. Amounts withheld under this code are used to pay Ben's tax debt for the previous year.

Standard rates

If a contractor does not elect a rate of withholding under section 24LB, proposed section RD 10B(3)(b) provides that the standard rate of withholding applies to them.

The standard rate is the relevant rate set out in schedule 4 of the Income Tax Act 2007. For contractors working for labour-hire firms and those under voluntary withholding agreements the proposed standard rate is 20%.

For other contractors the proposed standard rate in schedule 4 is the same as the rate that currently applies to those payments. This means that if a contractor that was previously subject to the schedular payment rules does not elect a different withholding rate when the proposed amendments come into force, their withholding rate remains unchanged.

Non-resident entertainers

The proposed amendments do not apply to non-resident entertainers. Non-resident entertainers will continue to have a flat withholding rate of 20% apply to them. These entertainers can continue to have withholding treated as a final tax and will not have to file returns.

EXTENDING WITHHOLDING TO LABOUR-HIRE FIRM CONTRACTORS

(Clauses 93 (19) and 100(2))

Summary of proposed amendment

The proposed amendment extends the schedular payment rules to contractors that work for labour-hire firms.

Application date

The proposed amendment will come into force on 1 April 2017.

Key features

The proposed amendment adds payments by labour-hire firms to their contractors to the list of payments that are subject to the schedular payment rules.

As a result, labour-hire firms will be required to withhold from all payments made to their contractors. They will be required to withhold at the relevant rate as described under the proposed amendments outlined in “Allowing contractors to elect their own withholding rate”.

Labour-hire firms will have an obligation to deduct withholding tax when they make payments to companies used by contractors. Labour-hire firm contractors will not be eligible to receive certificates of exemption from withholding.

A labour-hire firm is defined as “an entity which has as one of its main activities the business of arranging for a person to perform work or services directly for clients of the entity.”

Background

The current withholding rules are out of date and do not cover changing employment practices and modern industries. Over the last two decades there has been a large growth in the labour-hire firm industry. However, the withholding rules do not adequately address contractors working for this industry.

Labour-hire firms provide workers to perform services to clients. The labour-hire firm can engage these workers either as employees or contractors. The current withholding rules do not generally apply to contractors engaged by labour-hire firms. This means these contractors are required to manage their own tax obligations and have to deal with provisional tax. It also means that these contractors have opportunities for non-compliance (whether deliberate or accidental).

In addition, using a company structure has become increasingly popular with contractors. Payments to companies are generally not subject to withholding tax under the schedular payment rules.

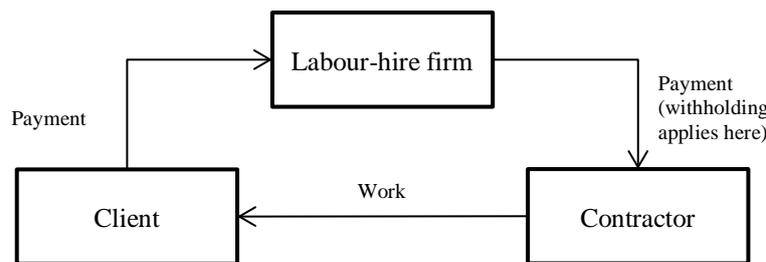
Detailed analysis

The amendments propose to insert Part J to Schedule 4 of the Income Tax Act, which adds payments made by labour-hire firms to contractors under a “labour-hire arrangement” to the schedular payment rules.

Under proposed Part J, payments are covered by the schedular payment rules when:

1. The payment is made under a labour-hire arrangement (as defined).
2. One of the main activities of the entity making the payment is providing labour-hire arrangements (that is, the labour-hire arrangement is not incidental to the main business of the entity).

1. The payment is made under a labour-hire arrangement



A labour-hire arrangement is an arrangement which in whole or part involves the performance of work or services by a person directly for the client of the entity, or directly for a client of another entity. The entity receives payment from the client and pays the worker themselves.

Directly for a client of another entity

A labour-hire arrangement also includes situations when there are chains of labour-hire firms involved. This can happen if a labour-hire firm arranges for another labour-hire firm to provide workers for their client.

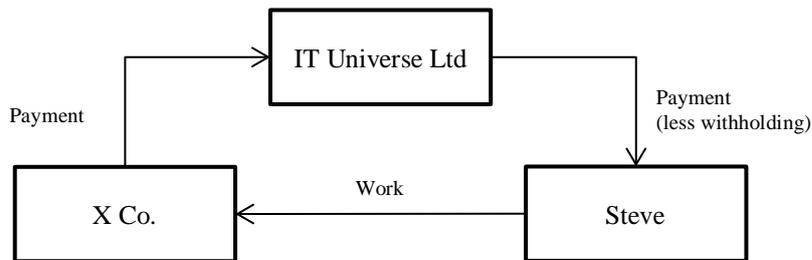
2. One of the main activities of the entity making the payment is providing labour-hire arrangements (that is, the labour-hire arrangement is not incidental to the main business of the entity)

The proposed amendment only applies when one of the main activities of the entity making the payment is providing labour-hire services. This means that withholding under the amendment only applies if the entity is carrying on a labour-hire business. It is not necessary for the labour-hire activities to be the sole business, or even the main business of the payer. However, a merely incidental business is not sufficient to require withholding.

The proposed amendment is similar to Australia's Pay As You Go withholding rules.

Example 1: Labour-hire

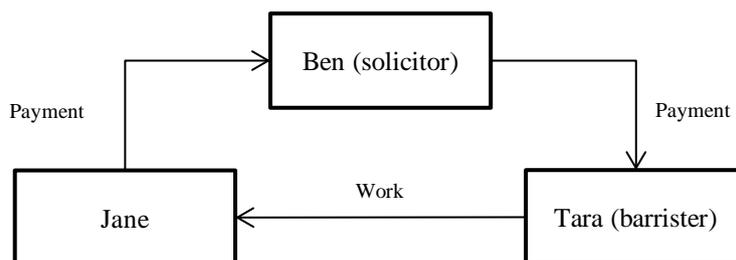
IT Universe Ltd provides contractors to other businesses to help with their IT projects. X Co. asks IT Universe Ltd for IT contractors to help with an upgrade of their systems. IT Universe Ltd provides one of their contractors (Steve, a New Zealand resident) to assist X Co.



IT Universe Ltd is arranging for a worker (Steve) to provide work directly for their client (X Co.). As a result, they are in a labour-hire arrangement with Steve and X Co. and this arrangement is part of their labour-hire business. IT Universe Ltd is required to withhold tax from any payments to Steve. The rate will be the applicable rate as set out in the earlier section *Allowing contractors to elect their own withholding rate*. If he does not specify a rate then the standard rate for labour-hire firm contractors of 20% will apply.

Example 2: Solicitor and barrister

Ben is Jane's solicitor. Jane is engaged in litigation and requires a barrister to represent her in court. For this purpose, Ben instructs Tara and pays Tara on Jane's behalf.

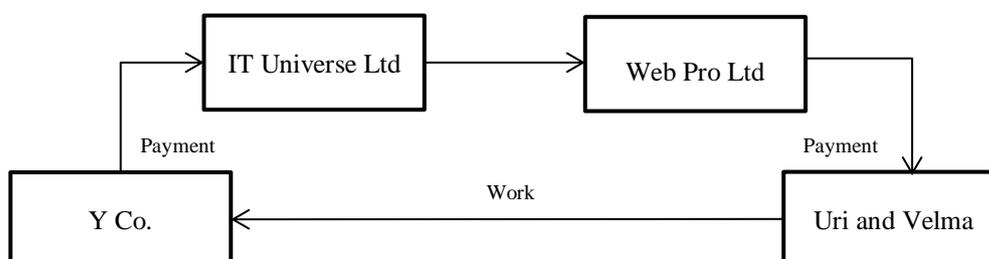


Ben is arranging for a contractor (Tara) to provide work directly for their client (Jane). However, Ben is not required to withhold from these payments because arranging for people to work for his clients is not one of his main activities. The payment is incidental to his business of providing legal services.

Example 3: Chain of labour-hire firms

Y Co. asks IT Universe Ltd for web designers to help them build a new website. IT Universe agrees to provide a number of web designers to Y Co. but is unable to find enough suitable people.

IT Universe Ltd goes to Web Pro Ltd (another labour-hire firm) and arranges for some of Web Pro's contractors (Uri and Velma) to perform work for Y Co.



Web Pro Ltd. is arranging for contractors (Uri and Velma) to perform work directly for the client (Y Co.) of another entity (IT Universe Ltd.). As a result, they are in a labour-hire arrangement and this arrangement is part of their labour-hire business. Web Pro is therefore required to withhold from any payments it makes to Uri or Velma.

Example 4: Subcontractors

Paul is a builder and contracts to build a house for Susan. He subcontracts another contractor, Bruce to do the plumbing work for the house. Paul is not required to withhold from payments to Bruce because he is not arranging for workers to perform work directly for clients, nor is providing labour-hire arrangements one of his main activities.

Company exception

The amendments provide that the general exception to the schedular payment rules for companies will not apply to payments under labour-hire arrangements.

That means labour-hire firms will be required to withhold from payments in the circumstances outlined above regardless of the type of legal entity the payments are made to.

A company that finds it is being over-withheld as a result of this, can apply for a special tax code to reduce their withholding rate below the minimum rate. This can include applying for a withholding rate of 0%.

Example 5: Chain of labour-hire firms continued

As in the earlier example, IT Universe Ltd. has agreed to provide web designers for Y Co. IT Universe arranges for Web Pro Ltd to provide workers for Y Co.

IT Universe is arranging workers to provide work directly to clients. As a result, they are in a labour-hire arrangement and this labour-hire arrangement is part of their labour-hire business. As a result IT Universe Ltd is required to withhold from any payment made to Web Pro.

Web Pro may apply for a special tax code to reduce their rate of withholding (including applying for a rate of 0%).

Certificates of exemption

Under the proposed amendments, contractors working for labour-hire firms cannot obtain certificates of exemption to exempt themselves from the schedular payment rules. These contractors may still apply for a special tax rate if withholding is inappropriate, which includes being able to apply for a 0% rate.

This means that all contractors working for labour-hire firms must have payments to them recorded on the Employer Monthly Schedule even if a 0% rate of withholding applies to them.

VOLUNTARY WITHHOLDING AGREEMENTS

(Clause 93(19))

Summary of proposed amendment

The proposed amendment will allow contractors not covered by the schedular payment rules to opt in to the rules with the consent of their payer.

Application date

The proposed amendment comes into force on 1 April 2017.

Key features

Contractors that are not subject to the schedular payment rules will be able to enter into voluntary withholding agreement with their payers. If an agreement is entered into, the contractor becomes subject to the schedular payment rules and the payer will be required to withhold from payments made to them.

The proposed amendments insert Part W into Schedule 4 of the Income Tax Act.

Part W sets out that a payment to a person is a schedular payment when:

- There is no obligation to withhold from the payment under the Income Tax Act 2007 or the Tax Administration Act 1994.
- The contractor and their payer have agreed to treat the payment as a voluntary schedular payment, and have recorded their agreement in a document.

If the above two criteria apply, then the schedular payment rules apply and the payer is required to withhold from the contractor at the rate selected by the contractor (as per the proposed amendments outlined in “Allowing contractors to elect their own withholding rate”).

Payments covered by voluntary withholding agreements are excluded from the definition of employer and employee for the purpose of the FBT rules. This means that fringe benefit tax does not apply when fringe benefits are provided to contractors under voluntary withholding agreements.

Background

Currently contractors not covered by the schedular payment rules are not able to have tax withheld on a payday basis. Many of these contractors may prefer to pay their tax through the schedular payment rules.

LATE PAYMENT PENALTY

(Clause 114)

Summary of proposed amendment

The proposed amendment specifies that Inland Revenue will no longer impose a 1% monthly incremental late payment penalty on unpaid tax from Goods and Services Tax (GST), income tax and Working for Families tax credits overpayment. This amendment states that this will only apply to future tax periods.

Application date

The amendment will come into force on 1 April 2017.

Key features

Proposed section 139B(2) of the Tax Administration Act 1994 provides that a taxpayer that does not pay by the due date an amount of tax, would no longer incur the 1% incremental late payment penalty, if the unpaid tax resides in one of the described tax periods.

If the unpaid tax liability does not reside in one of the described tax periods, there would be no change and the taxpayer would continue to incur the incremental late payment penalty as imposed by the current rules.

This amendment identifies the relevant tax types and tax periods as follows:

- GST tax periods ending after the 24 March 2017;
- provisional tax and income tax for the 2017–18 or later income years; and
- Working for Families tax credit overpayments for the 2017–18 or later income years.

Most taxpayers have a GST taxable period that ends on the last day of a month. However, under section 15E(2) of the Goods and Services Tax Act 1985, some taxpayers may be approved by the Commissioner to have a GST taxable period that may end up to seven days before or after the last day of the month. The proposed amendment looks to include taxpayers that have a GST taxable period that may end up to seven days before 31 March 2017. This is to ensure that these taxpayers benefit from this amendment.

The proposed amendment includes overpayments of Working for Families tax credits when the instalments have been determined to be overpaid and recoverable under sections MF 5 and MF 6 of the Income Tax Act 2007, or when the overpayment was by way of the taxpayer having their Working for Families tax credit entitlement later reviewed and reassessed.

Background

Currently, when a taxpayer has failed to pay their tax liability by the tax period's due date, the taxpayer will incur late payment penalties, from the first day after the due date. The unpaid tax is imposed with an initial late payment penalty consisting of a 1% penalty one day after the due date, and another one-off 4% penalty seven days later. One month after, a 1% incremental late payment penalty will be imposed. This incremental late payment penalty will be imposed repeatedly each additional month the tax remains unpaid. As a result, the late payment penalties accrue incrementally and indefinitely thereafter. Use-of-money interest (UOMI) is also imposed from the day after the original due date.

The longer the tax is outstanding, the more late payment penalties and UOMI are imposed. After two years, the combined penalties and UOMI can aggregate to more than 50 percent of the original tax owed. While late payment penalties encourage timely payment, there is a point at which the accumulated penalties and UOMI can overwhelm taxpayers.

The proposed amendment to section 139B(2) means taxpayers who fail to pay their GST, Working for Families tax credit overpayment or income tax liability by the due date, for the described tax periods will continue to incur an initial late payment penalty and continue to incur UOMI.

Many Working for Families tax credit recipients receive their entitlement in instalments throughout the year, based on an estimate. Sometimes that estimate is found to be inaccurate, resulting in the recipient receiving more than they are entitled to. These overpayments are treated as tax payable. Therefore, at the end of each tax year, after the due date, they incur late payment penalties and UOMI. Many recipients are on low incomes, and would struggle to repay debt that accumulates quickly due to the recurring imposition of the incremental late payment penalty.

DISCLOSING REPORTABLE UNPAID TAX TO CREDIT REPORTING AGENCIES

(Clauses 103 and 104)

Summary of proposed amendment

The proposed amendment to the tax secrecy rules will allow the Commissioner to disclose a taxpayer's information and their significant tax debt to approved credit reporting agencies. Before the Commissioner of Inland Revenue can disclose the information, the Commissioner must determine that the taxpayer's circumstances meet a prescribed criteria and threshold. Once the Commissioner has begun to disclose the taxpayer's information, the Commissioner (in most circumstances) may continue to do so until the tax debt has been resolved.

While the proposed amendment includes all taxpayers, currently the practical effect of this amendment is that it would be limited to non-individuals (that is, non-natural persons such as registered New Zealand companies). This is because personal information about individuals is regulated by the *Credit Reporting Privacy Code of Practice* (enabled by the Privacy Act). This code currently prevents credit reporters from receiving tax information about individuals.

The Government's intention is to apply this amendment to all taxpayers and officials will work with the Office of the Privacy Commissioner on the interaction of the proposed amendment and the *Credit Reporting Privacy Code of Practice*.

Application date

The amendment will come into force on 1 April 2017.

Key features

It is proposed that section 81 of the Tax Administration Act 1994 be amended to introduce an exception to tax secrecy for the purpose of communicating certain taxpayer information to approved credit reporting agencies.

In addition, it is proposed that new section 85N is inserted into the Tax Administration Act 1994 to describe items including the type of unpaid tax that would be considered for disclosure, the criteria that establishes whether a taxpayer would be selected for disclosure, the level of information the Commissioner would exchange and how the Commissioner would authorise an entity to receive this information.

For the purposes of the proposed section, the taxpayer must owe an amount of reportable unpaid tax. This is defined as an unpaid amount that is a liability or excess refund of income tax (excluding Working for Families tax credit overpayments), Goods and Services Tax and amounts required to be deducted under the Pay-As-You-Earn rules (including KiwiSaver, student loan and child support deductions, ESCT³ and RSCT⁴). These amounts would include any civil penalties and use-of-money interest already imposed. This definition would exclude amounts that are under dispute or challenge under the Tax Administration Act 1994.

Before the Commissioner can consider initially disclosing the taxpayer's information to an approved credit reporting agency, a set of requirements must be met. This criteria includes:

- the reportable unpaid tax is not being considered for relief or remission, or included in an instalment arrangement;
- that the taxpayer has been served a formal notice and at least 30 days have passed; and
- the Commissioner has previously made reasonable efforts to collect the reportable unpaid tax.

In addition, the taxpayer must owe the required quantum of reportable unpaid tax. This threshold is defined as owing a reportable unpaid tax amount of either \$150,000 or the amount is more than a year old and the amount is more than 30 percent of the taxpayer's gross income.

The Commissioner would be required to serve the taxpayer personally, with a formal notice advising them of the amounts of reportable unpaid tax, and provide a 30-day notice period before deciding whether to disclose the taxpayer's information. This notice would also include information about how the taxpayer can seek relief or remission of the debt. The Commissioner would not issue this notice unless she was confident the taxpayer would continue to meet the criteria and thresholds after the 30-day notice period. The purpose of this notice is to ensure that the taxpayer is made aware that the Commissioner is considering disclosing their information to an approved credit reporting agency. If the taxpayer is a company, the Commissioner would serve the notice on all directors listed with the Registrar of Companies.

Under proposed subsection 85N(3), the Commissioner would also have the option to disclose the taxpayer's information when the taxpayer has received three notices in a year, and the first two notices were ineffective due to the taxpayer subsequent to receiving the notice making sufficient payments to the reportable unpaid tax to remove themselves from the significant reportable unpaid tax threshold. This section is intended to address the potential issue of a taxpayer avoiding their reportable unpaid tax being disclosed, despite over time the amount of reportable unpaid tax debt continually exceeding the threshold.

³ Employer Superannuation Contribution Tax.

⁴ Retirement Scheme Contribution Tax.

Once the taxpayer's circumstances have met or exceeded the criteria and threshold, the Commissioner may disclose taxpayer information to an approved credit reporting agency.

Under subsection 85N(4), the Commissioner may communicate taxpayer information for the purposes of enabling the approved credit reporting agency to include the tax information on the credit report, and maintain the accuracy of the data held on the credit report.

The Commissioner would disclose key elements about the taxpayer's reportable unpaid tax. This includes the total amount outstanding for each tax type (expressed within a narrow band) and the age of each tax debt by tax type. Also, the status of the reportable unpaid tax as being under instalment arrangement, if the taxpayer enters into an arrangement subsequent to the initial disclosure.

As part of including the debt information on the taxpayer's credit report, the Commissioner would need to initially disclose certain taxpayer identification information to enable the approved credit reporting agency to match the taxpayer to their particular credit report. This information would be disclosed for identification and matching purposes only and would not be retained by the approved credit reporting agency after its use.

After the initial disclosure, to maintain the accuracy of the debt information on the credit report, the Commissioner would continue to routinely disclose the current tax debt information. This includes when the amount outstanding falls below the significant reportable unpaid tax threshold, when the taxpayer has submitted an application for relief or remission, or has entered into an instalment arrangement. This subsection is to address the issue that if the Commissioner was to abruptly stop disclosing this information, the last transaction held would quickly become inaccurate.

In addition, the Commissioner may need to disclose taxpayer information for the purpose of evidencing the information held on the credit report. This is because if the taxpayer were to lay a formal complaint with the approved credit reporting agency about the information held about them, the agency may need to approach Inland Revenue and request the taxpayer's information to support the investigation of the complaint. This may include information that substantiates the reportable unpaid tax debt or that shows the taxpayer was made aware that their debt could be disclosed.

Under subsection 85N(8) and (9), the Commissioner would have authority to approve an appropriate organisation to become an approved credit reporting agency. The Commissioner would either grant or revoke the approval when it would positively affect the integrity of the tax system. An approval would be given after the Commissioner is satisfied that the organisation has the capable systems, processes and safeguards to appropriately handle any taxpayer information furnished by the Commissioner to the organisation. Likewise, an approved credit reporting agency could choose to no longer receive this information and duly notify the Commissioner and request that their approval be revoked. Any approval or revocation would be publicly notified.

Under section 85N(7), the Commissioner is required to annually publish the number of taxpayers who have been subject to action under this provision in the previous year, including the number of taxpayers served and the number of taxpayers who have had their information disclosed, as well as any other items relating to this section the Commissioner considers should be published.

Background

Currently, information about a taxpayer's tax debt is subject to the rule in section 81 of the Tax Administration Act 1994 that requires Inland Revenue officers to keep secret all matters relating to the Inland Revenue Acts. The Commissioner is therefore unable to disclose this information to third parties unless an exception to the secrecy rule exists. The proposed amendment inserts an exception to these secrecy rules.

The proposed amendment will likely have a positive revenue benefit to the Crown, as potentially affected taxpayers will likely to be reluctant to have their tax debt information disclosed to their creditors. Consequently, the potential action of disclosure may motivate some taxpayers to promptly resolve their tax debt and voluntarily comply with their tax obligations.

Through this disclosure, other businesses will become aware of some taxpayers owing a significant amount of tax debt, and consequently these businesses will receive a more comprehensive view of the taxpayer's financial position when they are making important commercial decisions.

Whether the debt is enforced by the Commissioner or another trade creditor, the consequences for the indebted business's other creditors are the same. If Inland Revenue recovers its tax debt, there are fewer funds to repay other creditors. If Inland Revenue enforces its tax debt, the possible wind up of the indebted business affects all creditors. For creditors of a tax-indebted business, unpaid tax debt can represent a similar risk as if the debt was owed to another trade creditor.

In order for businesses to operate, they must regularly enter into commercial arrangements with other businesses. These relationships can bring a certain level of risk. To help mitigate this risk, prudent businesses undertake risk assessments of potential or existing commercial partners, including determining how much debt their potential commercial partner may owe to others. Businesses use this information to help determine whether they are comfortable with the level of risk attached to the commercial partner.

The impact of tax secrecy is that these other businesses that regularly assess the creditworthiness of potential commercial partners are currently unaware of the existence of any tax debt, with some only becoming aware later on when Inland Revenue is enforcing the debt. When the amount of tax debt is significant compared with the size of the business, the impact can be severe.

The proposed amendment represents a trade-off between taxpayer secrecy and reducing the opportunity for compliant businesses to be unexpectedly trading with significantly tax-indebted taxpayers. Certain credit reporters (approved credit reporting agencies) would be provided with limited taxpayer information, so the approved credit reporting agencies could provide this information to potentially affected third parties. This exchange is so only requesting third parties that are undertaking related commercial activities will be aware of the tax debt, and consequently these third parties can use this information to help make better commercial decisions. This approach is considered a less intrusive method of achieving the desired outcome than general publication of the tax debtor information.

Credit reporters are the best vehicle to deliver this information to potentially affected third parties, given that the credit reporters already have established processes, safeguards and mechanisms to ensure that any confidential information and data is carefully managed.

Memoranda of Understanding would be entered into with the approved credit reporting agencies. These agreements would outline the mechanism for securely exchanging taxpayer information, secure information storage, appropriate access by agency staff, and a requirement that approved credit reporting agencies can only hold disclosed tax debt information for five years after the last update placed onto the credit report. This last detail is important as it represents a trade-off between a business's needs to understand a taxpayer's credit worthiness, with the taxpayer resolving their reportable unpaid tax and remaining compliant. These items would be further discussed with the approved credit reporting agencies and confirmed in the contractual agreements.

Following enactment, Inland Revenue would implement this policy in a phased approach. In the next few years, the Commissioner would disclose approximately 500 taxpayers a year. This will allow Inland Revenue to firmly establish robust processes and mechanisms while working with modest volumes. In the future, once the Commissioner has a better understanding of the effect of the policy, and having regard for future technology, the Commissioner's resources and the anticipated behavioural change as a consequence of this policy, the Commissioner may then consider whether, in the long run, these volumes should be revised.

The proposed amendment provides the Commissioner with a proportionate response to the risk that significant reportable unpaid tax has on the wider business community. Where the debt is in the process of being reasonably resolved or is a proportionally small amount, the risk to other businesses is also reduced, so disclosing this information to others would not be considered to outweigh the importance of keeping taxpayer information confidential. In addition to contributing to economic efficiency, the proposed section will potentially incentivise taxpayers to comply with their tax obligations.

In exercising the proposed discretion the Commissioner will, as is the usual course, have regard to her obligation to protect the integrity of the tax system.

Detailed analysis

Proposed section 85N outlines the required quantum of outstanding reportable unpaid tax, in order for the taxpayer to be considered for disclosure, and when the Commissioner would consider initially disclosing the taxpayer's information to an approved credit reporting agency.

Significant reportable unpaid tax threshold

Before the taxpayer's information can be considered for disclosure, the taxpayer must first owe the required quantum of reportable unpaid tax.

The required quantum is the greater of either:

- \$150,000 and there is a significant risk that the taxpayer is unable to pay this amount; or
- the unpaid amount has been outstanding for more than a year, and the proportion of the unpaid amount exceeds the taxpayer's annual gross income for the previous year by 30 percent or more.

The first threshold would allow the Commissioner to disclose reportable unpaid tax that is significant in size. To provide some proportionality, the Commissioner would only consider cases where the taxpayer does not have the financial ability to resolve the debt in the foreseeable future. The proposed provision allows for a different amount to be prescribed by an Order in Council. This flexibility is required to ensure this part of the threshold can be quickly amended if there is a sudden change in the market, and that change would need to be reflected in a revised threshold. The usual Order in Council safeguards would apply, including the 28-day rule and publication.

The second threshold would allow the Commissioner to consider taxpayers when the debt is significant in relation to the size of the taxpayer and has been unpaid for some time. To determine the taxpayer's annual gross income, the Commissioner will exercise judgement and use available information (including previously filed tax returns and other financial information) to reasonably determine the taxpayer's gross income for the previous year.

A natural consequence of using the second threshold is that others may be able to indicatively determine the taxpayer's gross income. The benefit of using this type of threshold is that it can be reasonably targeted towards taxpayers that owe an amount of reportable unpaid tax that is sufficiently significant, compared with the size of their business. This benefit is considered to outweigh the risk.

The inclusion of percentage and fixed dollar thresholds would allow disclosure only in the most significant of circumstances, given the particular taxpayer's debt and the risk the debt represents to other businesses.

Criteria for initial disclosure

The proposed section requires the taxpayer to owe the required quantum of reportable unpaid tax as well as meet other criteria before the Commissioner can consider initially disclosing the taxpayer's information.

Under section 85N(2)(c), the Commissioner would only disclose the taxpayer's information when the Commissioner has already made reasonable efforts to recover the reportable unpaid tax. These reasonable efforts include when the Commissioner has been in recent, meaningful and sustained communication with the taxpayer. These actions would also include when both Inland Revenue and the taxpayer have explored various options to resolve the reportable unpaid tax, without success. These options could include Inland Revenue reviewing the taxpayer's financial position to determine whether the taxpayer is eligible for relief or when the taxpayer has explored financing options with third-party lenders, without success.

The formal notice would only be issued when the Commissioner is confident that the taxpayer's circumstances meet the criteria and threshold, and when the Commissioner is confident that the taxpayer would continue to meet the criteria and threshold at the end of the 30-day period. In addition, immediately before the Commissioner initially discloses the taxpayer's information, the Commissioner will review the taxpayer's circumstances to ensure that the taxpayer continues to meet the criteria and threshold.

When the taxpayer is in the process of securing finance, or is conducting an ordinary windup of their business, and the Commissioner is confident that it will be successful, these actions would be considered ongoing reasonable efforts.

The Commissioner would be responsible for ensuring the criteria and thresholds are applied consistently.

Example

Bary's Bricks Limited has over-expanded in recent years and is experiencing significant cashflow problems. With late payment penalties and use-of-money interest, the tax debt of GST and PAYE has grown to over \$65,000.

Over the last 15 months, Inland Revenue has worked with the directors to try and resolve the debt; this has included repeatedly talking to the directors to arrange an instalment arrangement or borrow funds to settle the debt. The company's other creditors are likely to be unaware of the tax debt and may be considering extending their lending or trade credit to the company, to fund further expansion of the company believing that it can be sustainably repaid.

The Commissioner is considering disclosing the taxpayer's tax debt to the approved credit reporting agencies so other creditors are made aware of the debt and will be able to make more informed commercial decisions. The debt is reportable unpaid tax as it consists of GST and PAYE that is not being disputed, not under arrangement and the Commissioner is not considering an application for relief or remission. Inland Revenue has made reasonable efforts to resolve the tax debt.

The tax debt meets the significant reportable unpaid tax threshold as the company's annual gross income is only \$150,000, giving a percentage of 43 percent.

The directors are personally served the formal notice, giving the company 30 days to attempt to resolve the debt. After 30 days, the company's circumstances remain unchanged. Inland Revenue subsequently discloses the taxpayer's information to approved credit reporting agencies.

The Commissioner continues to periodically disclose the taxpayer's tax debt information in order to maintain the accuracy of the information contained in the credit report.

INFORMATION SHARING WITH THE REGISTRAR OF COMPANIES

(Clauses 103 and 104)

Summary of proposed amendment

Amendments to the tax secrecy rules are proposed to enable Inland Revenue to share information with the Registrar of Companies, for the purpose of enforcing certain serious offences against the Companies Act 1993.

Application date

The amendments will apply from 1 April 2017.

Key features

The amendments will allow Inland Revenue to share information with the Registrar of Companies in relation to several serious offences against the Companies Act, including:

- a serious breach of a director's duty to act in good faith and in the best interests of company (section 183A(1));
- false statements (section 377);
- breaches of various orders and prohibitions from directing, promoting and/or managing companies (section 382(4), section 383(6), section 385(9), and section 385AA(9));
- breach of restrictions on involvement with phoenix companies (section 386A(2)).

These offences are punishable by a term of imprisonment of up to five years, or a fine of up to \$200,000. These particular offences were considered to be the most appropriate (in terms of both seriousness and potential benefits of obtaining Inland Revenue information) by the Ministry of Business, Innovation and Employment, the Companies Office and Inland Revenue.

The amendments will provide the Commissioner of Inland Revenue with the discretion to share information relating to these offences when:

- either agency reasonably suspects the offence has been, is being, or will be committed; and
- the Commissioner considers the information is relevant to the prevention, detection, investigation or prosecution of the offence; and

- the Commissioner is satisfied the information is readily available, is reasonable and practicable to communicate, and that communication is in the public interest.

Background

The Companies Office oversees important regulatory requirements which ensure business accountability and responsibility. It aims to promote confidence in the New Zealand business environment and hold to account those who abuse the privileges of the corporate structure. The Registrar of Companies is responsible for administering the Companies Act, and has the power to collect information to verify compliance and detect breaches of the Act.

In the course of its regular activities Inland Revenue will, on occasion, hold information that would assist in the detection and enforcement of serious offences against the Companies Act.

Tax secrecy obligations contained in the Tax Administration Act 1994 are broad, covering all matters relating to legislation administered by Inland Revenue. Communication of these matters is not normally permitted other than for the purpose of carrying into effect that legislation. While a number of exceptions have developed for cross-agency information sharing to support wider government objectives, there are no exceptions that would allow Inland Revenue to share the information described above with the Registrar of Companies.

Information sharing under the new amendments will allow more efficient enforcement of the Companies Act, and help prevent harm to the business community and wider public that stems from seriously non-compliant directors and other persons breaching their corporate responsibilities.

MOTOR VEHICLE EXPENDITURE OF CLOSE COMPANIES

(Clauses 56, 58, 59, 60, 61, 63 and 64)

Summary of proposed amendment

The proposed amendment will extend the motor vehicle expenditure rules in subpart DE of the Income Tax Act 2007. Currently sole traders and partnerships can use these rules to measure the business use of a motor vehicle. The proportion of business use of a motor vehicle is used to calculate the amount of the deduction for motor vehicle expenditure. These rules are being extended to allow certain close companies to use these rules as an alternative to paying FBT on a motor vehicle benefit provided to shareholder-employees.

Currently close companies who provide a motor vehicle for the private use of shareholder-employees are required to register and pay FBT on the value of the benefit provided. The value is based on the availability of the motor vehicle rather than the actual private use by the shareholder-employee. This approach can result in compliance costs being higher than they need be for these close companies as they are required to register and pay FBT.

The proposed amendment allows certain close companies to elect to use the motor vehicle expenditure rules instead of paying FBT on the value of the benefit provided to shareholder-employees.

Application date

The amendment will apply for the 2017–18 and later income years.

Key features

The proposed amendment provides an alternative to FBT for certain close companies by inserting a new exclusion into section CX 17. Section CX 17 is the section in the FBT rules that deals with benefits provided to shareholder-employees. Under the proposed new exclusion, section CX 17 will not apply when the close company makes a motor vehicle available to a shareholder-employee for their private use and elects to apply subpart DE for the motor vehicle and the shareholder-employee. The election will apply only to new motor vehicle arrangements between close companies and shareholder-employees, and will continue to apply until the close company stops using the motor vehicle for business use or until the close company disposes of the motor vehicle.

The proposed amendment applies to close companies where the only fringe benefit provided is the provision of one or two motor vehicles to shareholder-employees for their private use. These close companies qualify for the close company FBT option in section RD 60 and consequently may be filing and paying FBT annually. If they elect to apply the proposed motor vehicle expenditure rules, the close company will not be required to account for FBT on the benefit provided to their shareholder-employees.

Under the proposed amendment, when a close company has made the appropriate election, it will apply the motor vehicle expenditure rules in subpart DE. Subpart DE provides methods for calculating the proportion of business use of a motor vehicle. This proportion forms the basis for the amount of motor vehicle expenditure that can be deducted. Section DE 1 is being amended to enable a close company who makes an election under section CX 17 to use the methods in subpart DE to measure the business use of the motor vehicle by its shareholder-employee. The close company will use the proportion of business use by the shareholder-employee to calculate the amount of their deduction for motor vehicle expenditure.

Section DE 2 is being amended to include interest on amounts used to fund, directly or indirectly, the business of a motor vehicle as part of the motor vehicle expenditure subject to the rules in subpart DE. This amendment applies only to close companies that have elected to use the motor vehicle rules in subpart DE and is needed because of the automatic interest deduction rules for companies in sections DB 7 and DB 8. These sections are also being amended consequentially.

When a close company uses this proposed new option and transfers the value of the private non-deductible portion of the motor vehicle expenditure to the shareholder-employee – for example, by debiting their shareholder current account, the value of the private use of the motor vehicle by the shareholder-employee will not be a dividend. Proposed changes to section CD 32 account for this.

In some circumstances a GST adjustment may be required to reflect any difference between the actual proportions of business and private use of the motor vehicle and the intended proportions of business and private use of the motor vehicle.

Example

Mary is the controlling shareholder of Mary's Home Interiors Ltd which has a 31 March balance date. Mary's Home Interiors Ltd is a close company. Mary is the only employee of her company. On 1 April 2016, the company provides Mary with a new vehicle for both business and unlimited private use. During the 2017 income year, it is expected that Mary's business use of the vehicle will be 60 percent and the total motor vehicle expenditure for the year is estimated to be \$4,250. This includes an amount of interest on the loan that the company used to finance the cost of acquiring the new vehicle. The cost price of the vehicle was \$20,000.

The company will have the choice of paying FBT on the availability for private use of the vehicle using the cost price of the vehicle as a basis and multiplying by 20% to get the value of the fringe benefit (\$4,000) and pay FBT of \$1,970.

Alternatively, the company could make an election under amended section CX 17(4B) to use the motor vehicle expenditure rules in subpart DE. The company could use the proportion of business use of the vehicle by Mary to apportion the motor vehicle expenditure. Mary maintains a logbook where she records details of her business use of the vehicle. This would result in the business not claiming 40 percent of the total motor vehicle expenditure of \$4,250 (\$1,700).

At end of the income year, a debit entry is made to Mary's current account for the value of the motor vehicle expenditure that relates to Mary's private use of the motor vehicle.

If the company uses the logbook records to estimate the percentage of intended use and actual use of the motor vehicle for GST purposes, no GST change of use adjustments should be required.

Background

Close companies that provide their shareholder-employees with a motor vehicle for private use are required to register and pay FBT for that benefit, subject to certain exemptions. Sole traders and partners in a partnership who use a motor vehicle in a similar way are not required to register and pay FBT. Instead these taxpayers apportion their motor vehicle expenditure between business and private use under the motor vehicle expenditure rules in subpart DE. These differences in treatment for what is essentially the same benefit (the private use of a motor vehicle) arise because of the different entities involved. The proposed amendment provides an option for certain close companies to elect to have the same treatment as sole traders and partnerships.

Conceptually, denying deductions for private expenditure should have a comparable overall tax outcome for the shareholder-employees to allowing deductions and applying FBT to the value of the benefit, once attribution of profits is taken into account. This is why the proposed change will not apply to motor vehicle benefits provided to those who are just employees of close companies.

INCREASED THRESHOLD FOR TAXPAYER SELF-CORRECTIONS OF MINOR ERRORS

(Clause 105)

Summary of proposed amendment

The proposed amendment increases the self-correction threshold for minor errors from \$500 to \$1,000. This will allow taxpayers to correct simple errors of up to \$1,000 in their next tax return.

Application date

The proposed amendment will come into force on 1 April 2017.

Key features

Section 113A of the Tax Administration Act 1994 allows a taxpayer to self-correct a minor error in a tax return if the tax difference is below the specified threshold. The error is corrected by the taxpayer making the appropriate adjustment in their next tax return. The proposed amendment increases the threshold for self-correction from \$500 to \$1,000 and is intended to reduce compliance and administrative costs.

Background

Currently if a taxpayer makes a minor error in their tax return with a tax effect of less than \$500, they can self-correct the error in their next tax return. However, if the error results in more than a \$500 tax difference, the taxpayer must request the Commissioner to correct the error. Interest and penalties will usually be payable on the shortfall corrected by the Commissioner.

The proposed amendment will remove the compliance costs of having to apply to the Commissioner for an adjustment for minor errors resulting in less than a \$1,000 tax difference. It will also reduce the administration costs, as Inland Revenue will not have to manage these low-value items.

SIMPLIFIED CALCULATION OF DEDUCTIONS FOR DUAL USE VEHICLES AND PREMISES

(Clauses 62, 64, 65, 66, 67, 68 and 71)

Summary of proposed amendment

The proposed amendment allows taxpayers to use a simplified method for the calculation of deductions for premises and vehicles that are used for both business and personal purposes. This will reduce compliance costs for taxpayers.

Application date

The proposed amendment will apply for the 2017–18 and later income years.

Key features

Vehicles

Subpart DE of the Income Tax Act 2007 is being amended to modify and extend the current per kilometre rate method for determining a taxpayer's deductions for a vehicle used for both business and private purposes (the current rules only allow the method to be used if the business use is less than 5,000 km).

Under the modified per kilometre method in section DE 12, taxpayers will deduct a fixed amount per kilometre travelled for business purposes based on rates published by Inland Revenue. This is instead of deducting any actual costs.

The rates will be:

- set by reference to industry figures, and based on the average per kilometre cost for the average vehicle;
- divided into 2 tiers. The first tier will provide for the recovery of both the vehicle's fixed costs and its per kilometre costs. The second tier will provide for the recovery of the per kilometre costs only (as the fixed costs of vehicle ownership would be over-deducted with increasing usage if a single fixed rate were used); and
- published by Inland Revenue and updated each year to ensure the rates are accurate.

The first tier of rates will apply to the total distance travelled (including for both business and personal purposes) up to a specified limit. To calculate the deduction for this tier, taxpayers will multiply the total kilometres travelled (to which the first tier applies) by the proportion of business use for the vehicle and the income year. The product of that calculation will then be multiplied by the rate for the first tier to produce the deductible amount.

The calculation will be repeated for the second tier of rates. That is, the total kilometres travelled (to which the second tier of rates applies) will be multiplied by the proportion of business use for the vehicle and the income year. The product of this calculation is then multiplied by the rate for the second tier to give the deductible amount. The deductible amounts for the first and second tiers of rates are then added together to determine the taxpayer's total deduction for their business use of the vehicle.

Under the existing legislation, taxpayers may keep a logbook for a three-month representative test period to determine a vehicle's proportion of business use for the next three years.

The new method is optional, and taxpayers may elect to use it on a per-vehicle basis. However any election must be made when the tax return is filed for the year in which the vehicle is acquired. The election is non-revocable, so taxpayers cannot switch between methods for the same vehicle (although they may apply different methods to different vehicles). This is because it would be too complex to account for depreciation if a taxpayer switched methods, given that separate depreciation deductions are not claimed under the new method and no depreciation recovery income arises on sale.

Taxpayers who own a vehicle which they use partly for business purposes may switch to the new method for the 2017–18 income year, when the new method is introduced. This is provided they do not dispose of the vehicle in that income year.

Amendments to subpart DE and section EE 49 are also proposed, to clarify some aspects of how the per kilometre method is intended to operate.

Example 1

Mr Smith is a real estate agent who uses his personal car for business purposes.

Mr Smith buys a new car and elects to use the per kilometre method to calculate his deductions when he files his tax return. Mr Smith has kept a log book for the first three months of the year, which shows a proportion of business to total kilometres of 0.55. Over the entire year Mr Smith has driven 30,000km.

The rates that Inland Revenue has published are 75 cents per km for the first 10,000km and 25 cents for every km thereafter (these rates are indicative only).

Mr Smith needs to calculate his deductions for each tier of rates, and then add them together.

The formula to calculate his deductions for each tier is:

$$\text{Total kilometres travelled (to which the tier applies)} \times \text{business proportion} \times \text{tier rate}$$

Applying this formula, Mr Smith makes the following calculations:

$$\text{First tier: } 10,000 \text{ km} \times 0.55 \text{ business use} \times \$0.75/\text{km} = \$4,125$$

$$\text{Second tier: } (30,000 \text{ total km} - 10,000\text{km}) \times 0.55 \text{ business use} \times \$0.25/\text{km} = \$2,750$$

Adding the results for each tier together gives $\$4,125 + 2750 = \$6,875$. Therefore Mr Smith can claim deductions of \$6,875.

Premises

The proposed amendment inserts a new section DB 18AA into the Income Tax Act 2007. The proposed new section provides an optional alternative method for calculating the deduction for premises that are used for both business and personal purposes. The “premises” for this purpose includes only the relevant building and not any curtilage.

The new method first requires the taxpayer to determine the area of their building (in square metres) that is both separately identifiable and used primarily for business purposes. This area is then multiplied by a single rate to give the first amount of the deduction. The rate will be:

- set by Inland Revenue, based on the average cost of utilities per square metre of housing, but excluding mortgage interest and rates or rent;
- updated each year; and
- reasonably accurate for most taxpayers.

Taxpayers using this proposed new method will be able to claim a second deduction for their actual mortgage interest and rates or rental costs. This second deduction is calculated by multiplying the amount of these actual costs by the fraction of the premises that is both separately identifiable and used primarily for business purposes. The reason this deduction is calculated separately is because mortgage interest, rates and rental costs are too variable to be included in a single representative rate.

No other deduction in relation to the premises is permitted for taxpayers who use this method.

Taxpayers may elect to use the proposed new method for an income year by using it to calculate their deductions in their income tax return. There are no restrictions on the ability of a taxpayer to choose the method.

Example 2

Mr Smith has a room in his house which is set aside as an office. Mr Smith uses the office primarily for business purposes. Mr Smith decides to calculate his deductions for this office using the new method. The office has an area of 10m², while Mr Smith’s house has an area of 100m². Inland Revenue has set the fixed rate for premises at \$100/m² (this amount is indicative only).

Mr Smith calculates his first deduction using the fixed rate. To do this he simply multiplies the area of his office (in square metres) by the fixed rate. Accordingly, Mr Smith’s first deduction is:

$$10m^2 \times \$100/m^2 = \$1,000.$$

Mr Smith next calculates his second deduction for his mortgage interest and rates (as Mr Smith owns his house). To do this, he calculates the fraction of his house occupied by his office. He then multiplies his actual mortgage and interest costs by that fraction.

The fraction of Mr Smith’s house that is occupied by his office is: 10m² office ÷ 100m² house = 0.10 (or 10%).

Mr Smith’s mortgage interest for the year is \$20,000 and his rates are \$3,000. Therefore Mr Smith’s second deduction is: (\$20,000 + \$3,000) x 0.10 office fraction = \$2,300.

Adding the two deductions together, Mr Smith has a total deduction for his office of \$1,000 + \$2,300 = \$3,300. Accordingly he can claim a deduction for his home office of \$3,300.

Background

Small business owners often use their vehicles and premises for both business and private purposes. This can create a large compliance obligation compared with the amount of tax at stake, as there are numerous expenses for these items, all of which must be recorded and apportioned between business and personal use. The proposed amendment will simplify taxpayers' compliance obligations for these items.

REMOVE THE REQUIREMENT TO RENEW RWT EXEMPTION CERTIFICATES ANNUALLY

(Clause 101)

Summary of proposed amendment

The proposed amendment to section 32H of the Taxation Administration Act 1994 will legislatively require most resident withholding tax (RWT) exemption certificates to be issued for an unlimited period. This will remove the compliance costs of having to reapply for RWT exemption certificates.

Application date

The proposed amendment will come into force on 1 April 2017.

Key features

RWT exemption certificates will be required to be issued for an unlimited period. This will apply for all the available grounds of exemption, except for the taxpayer income estimation option (in section 32E(2)(j) of the Tax Administration Act 1994). Inland Revenue will still have the discretion to issue exemption certificates for a limited period in exceptional circumstances.

Background

Currently some taxpayers who hold a certificate of exemption from RWT must renew the certificate annually.⁵ This was an operational decision made by Inland Revenue. Taxpayers have argued that this is creating relatively large compliance costs for those required to renew for relatively little value. It is also creating an administrative burden for Inland Revenue, as all the annual exemption certificates must be renewed at the same time each year. The proposed amendment will reduce these compliance and administrative costs.

Taxpayers will still be required to surrender their exemption certificates when they fail to meet the basis for eligibility on which they were granted. Inland Revenue will also retain its ability to cancel an exemption certificate. Taxpayers will also be required to indicate in their income tax returns for the 2017–18 and later tax years whether they are still eligible to hold their exemption certificates on the basis on which they were granted.

⁵ Annual renewal is currently required by Inland Revenue if the applicant is applying for a RWT exemption certificate on the grounds that it has tax losses, a refund of over \$500 RWT or estimated annual gross income of over \$2 million. Applications on other grounds (such as annual gross income over \$2 million in the prior year) do not require annual renewal.

INCREASED THRESHOLD FOR ANNUAL FBT RETURNS FROM \$500,000 TO \$1 MILLION OF PAYE/ESCT

(Clauses 90 and 91)

Summary of proposed amendment

The bill proposes that the threshold for calculating and returning FBT on an annual basis be increased from \$500,000 to \$1 million of PAYE/ESCT. This will reduce compliance costs for taxpayers.

Application date

The proposed amendment will apply for the 2017–18 and later income years.

Key features

Proposed amendments to sections RD 60 and RD 61 of the Income Tax Act 2007 will increase the threshold for calculating and returning FBT on an annual basis. The new threshold will be \$1 million of gross tax for PAYE income payments and employers' superannuation cash contributions withheld under sections RA 5(1)(a) and (c).

Background

Most businesses are required to calculate and return FBT on a quarterly basis. However businesses that have combined PAYE and ESCT obligations of no more than \$500,000 per year are currently allowed to calculate and return FBT on an annual basis. As a smaller business becomes larger and employs more staff, it may exceed the \$500,000 threshold. Consequently the business will be required to calculate and pay FBT on a quarterly basis. This can impose compliance costs that are still significant compared with the size of the business.

Allowing a business with combined PAYE and ESCT of between \$500,000 and \$1 million to continue accounting for FBT annually will simplify its compliance obligations and lower compliance costs. It will also simplify administration, as there will be fewer FBT returns for Inland Revenue to process.

MODIFYING THE 63-DAY RULE ON EMPLOYEE REMUNERATION

(Clause 70)

Summary of proposed amendment

The proposal will allow taxpayers to choose whether to apply the existing rule in section EA 4 of the Income Tax Act 2007 for the timing of the deduction for an amount of expenditure on employment income paid within 63 days after the end of the income year. If a taxpayer chooses not to apply the existing rule, they can deduct expenditure on employment income that is paid in that income year.

Application date

The proposed amendment will apply for the 2017–18 and later income years.

Key features

Section EA 4 is being amended to provide taxpayers who incur expenditure on employment income a choice over what basis they calculate the amount of the deduction claimed in an income year.

Taxpayers who wish to continue using the existing 63-day rule can still claim a deduction for amounts of expenditure on employment income paid within 63 days of the end of the income year.

Taxpayers who do not wish to incur the compliance cost involved with tracking payments paid within 63 days of the end of the income year can claim a deduction for expenditure on employment income paid within the income year.

Background

Under the existing rule in section EA 4, all taxpayers need to track payments of expenditure on employment income paid within 63 days of the end of the income year. This requirement results in increased compliance costs for taxpayers because they need to track and determine these amounts.

The proposed amendment removes the compliance costs for taxpayers who do not wish to track payments of expenditure of employment income paid within 63 days of the end of the income year. These taxpayers will be allowed a deduction for amounts of expenditure on employment income paid in that income year.

Automatic exchange of information

OVERVIEW

(Clauses 4, 6, 8, 9 and 12 to 26)

The bill proposes the legislative amendments needed to implement the G20/OECD standard for *Automatic Exchange of Financial Account Information in Tax Matters* (the Automatic Exchange of Information or “AEOI”) in New Zealand.

The AEOI standard was developed as part of a global initiative to address offshore tax evasion. That is, evading tax by hiding wealth in offshore accounts.

The AEOI standard

Broadly, jurisdictions implementing the AEOI standard must impose obligations on their financial institutions:

- to conduct specified **due diligence** procedures in relation to their financial accounts to identify those held or (in certain circumstances)⁶ controlled by non-residents; and
- to **report** specified identity (including tax residence) and financial information (such as account balances and interest earned) on those accounts to their local tax administration.

The tax administrations must then transmit the reported information to applicable jurisdictions under tax treaty exchange of information provisions.

The exchanged information will be used by the receiving jurisdiction to verify that its residents have correctly reported their offshore activities and income for tax purposes.

International context

The exchanged information will be used to detect offshore tax evasion. Worldwide implementation of the AEOI standard is also expected to have a strong deterrent effect on offshore evasion.

However, the success of the global AEOI initiative depends on jurisdictions implementing consistent rules, on a similar implementation timeline. Otherwise there is a high risk of the offshore tax evasion problem relocating to jurisdictions that lag behind or implement to a lesser standard.

⁶ As explained below, a “look-through” rule applies in the case of entity accounts that meet the criteria of a “Passive NFE”.

To ensure consistency, the OECD's global tax body, the Global Forum on Transparency and Exchange of Information for Tax Purposes (Global Forum), will lead peer reviews and other forms of monitoring to ensure that jurisdictions correctly implement the AEOI standard. The Global Forum reports directly to the G20, which is positioned to apply sanctions against non-complying jurisdictions, if necessary.

All G20 and OECD member countries are required to implement the AEOI standard with a view to completing first exchanges by 30 September 2018 at the latest. Any other jurisdiction that has or that operates as an international finance centre is required to implement the AEOI standard to the same timeline. In total, 101 jurisdictions are currently subject to the 30 September 2018 deadline.

Jurisdictions other than those identified above can implement the AEOI standard, but will not be subject to implementation deadlines (unless identified by the Global Forum as an emerging tax risk).

Of the 101 jurisdictions, 55 have committed to complete their first exchanges by 30 September 2017 (a year ahead of the general deadline). These are generally referred to as "early adopters". The 46 other jurisdictions are generally referred to as "second wave adopters".

As an OECD member country, the New Zealand Government has committed to meeting the 30 September 2018 deadline. New Zealand is a second wave adopter.

The start date to which the New Zealand Government has committed, and from which obligations under the AEOI standard will apply in New Zealand, is 1 July 2017.

Key elements of the AEOI standard

The rules for due diligence and reporting that are to be imposed on financial institutions are set out in an element of the AEOI standard known as the *Common Standard on Reporting and Due Diligence for Financial Account Information* (Common Reporting Standard).

The Common Reporting Standard is supplemented with an official commentary, developed by the OECD (the OECD Commentary) to ensure consistent interpretation and application of the rules.

The other elements of the AEOI standard relate to the exchange of AEOI information between jurisdictions, and include model competent authority agreements and the data schema to be used for exchanges.

A common IT solution for encrypting and transmitting data between jurisdictions, referred to as the "Common Transmission Standard", is also being developed by the OECD.

All exchanges of information with other jurisdictions will be made under New Zealand's tax treaties.

The principal tax treaty to be used for this purpose will be the joint *OECD/Council of Europe Multilateral Convention on Mutual Administrative Assistance in Tax Matters* (the Multilateral Convention),⁷ which New Zealand signed in 2012.

As the legislation primarily concerns the implementation of the Common Reporting Standard, references in this document will be to the Common Reporting Standard (and OECD Commentary) rather than the AEOI standard.

The Multilateral Convention authorises automatic exchanges of information, subject to detailed terms to be agreed between competent authorities. (Broadly, “competent authorities” are persons nominated to administer treaty provisions. The competent authority under New Zealand’s tax treaties is the Commissioner of Inland Revenue or an authorised representative.)

To facilitate automatic exchanges of financial account information under the Multilateral Convention, the OECD developed a Multilateral Competent Authority Agreement (MCAA)⁸. New Zealand signed the MCAA in 2015.

Summary of proposed amendments

The legislation proposed will enable New Zealand to give effect to the New Zealand Government’s international commitment to implement the Common Reporting Standard, and has been framed to reflect the following policy decisions:

- The New Zealand reporting period for Common Reporting Standard purposes will align with the New Zealand tax year (that is, the period ending 31 March).
- The annual reporting deadline for financial institutions for each reporting period will be the following 30 June. The information that must be reported in relation to each account in relation to each reporting period is:
 - **identity information** (including tax residence) of the account holders and (where applicable) controlling persons; and
 - **financial information**, including the account balance or value as at the end of the reporting period, and defined income earned and distributions made during the reporting period.
 - If a financial institution is unable to determine the status of a pre-existing account⁹ it will be required to report the account as an “**undocumented account**” in certain circumstances.

⁷ Referred to as “MCMAA convention” in the bill.

⁸ Referred to as “MCA agreement” in the bill.

⁹ In broad terms, a pre-existing account will be an account in existence as of 30 June 2017.

- From 1 July 2017, financial institutions will be required to apply the specified due diligence procedures for all new accounts.¹⁰
 - This will generally involve determining the identity and tax residence of account holders and (where applicable) controlling persons, on the basis of self-certifications obtained on account opening.
- From 1 July 2017, financial institutions will be expected to begin due diligence reviews of all pre-existing accounts.
 - The due diligence procedures specified in the Common Reporting Standard for pre-existing accounts differ, depending on the status of the account. In general, however, financial institutions will often be able to rely on documentation/information that they have already obtained for regulatory or customer relationship purposes.¹¹
- The due diligence for pre-existing individual accounts that are high value accounts (generally, accounts with an account balance exceeding US\$1 million) is to be completed by 30 June 2018, taking into account the following:
 - The period between 1 April 2018 and 30 June 2018 is effectively a three-month grace period.
 - Given the 1 July 2017 start date, the grace period will effectively allow financial institutions 12 months to complete their due diligence reviews of high value accounts.
 - Importantly, any high value accounts identified as reportable during the grace period must be reported with respect to the reporting period of 1 July 2017 to 31 March 2018.
 - The due diligence and reporting must also **both** be completed by the 30 June 2018 deadline.
- The due diligence for all other pre-existing accounts (that is, pre-existing individual accounts that are lower value accounts, and pre-existing entity accounts) is to be completed by 30 June 2019, taking into account the following:
 - The period between 1 April 2019 and 30 June 2019 is effectively a three-month grace period.
 - Given the 1 July 2017 start date, the grace period will effectively allow financial institutions 24 months to complete their due diligence reviews of accounts other than high value accounts.
 - Importantly any entity or lower value accounts identified as reportable during the grace period must be reported with respect to the reporting period of 1 April 2018 to 31 March 2019.

¹⁰ In broad terms, a new account will be an account opened on or after 1 July 2017.

¹¹ In particular, this includes information obtained from compliance with Anti-Money Laundering/Countering the Financing of Terrorism “know-your-customer” laws.

- The due diligence and reporting must also **both** be completed by the 30 June 2019 deadline.
- Some optionality is contemplated under the Common Reporting Standard and OECD Commentary. Financial institutions will generally be allowed at their discretion to adopt the option that best suits their circumstances.
- However, the option of a reporting period ending 31 March will be mandated for all financial institutions. In addition, the use of the “wider approach” to due diligence will be mandated for all financial institutions. These matters, including an explanation of the wider approach, are addressed further below.
- There are also some options that will be withheld. These excluded options are also addressed further below.
- The Common Reporting Standard requires implementing jurisdictions to introduce rules for ensuring compliance. These include a requirement for anti-avoidance rules and effective sanctions. Therefore, the proposed legislation includes a compliance framework with penalties and an anti-avoidance rule.
- This compliance framework will cover financial institutions and also extend to cover other persons and entities that hold or control accounts with such institutions or that otherwise act as intermediaries in relation to accounts. This reflects the fact that effective implementation of the Common Reporting Standard in New Zealand requires a chain of information effectively flowing from account holders, controlling persons, and intermediaries to financial institutions and then to Inland Revenue. These information flows, if effective, will ensure that Inland Revenue obtains the information about foreign tax residents that New Zealand is required to exchange for AEOI purposes.

Application dates

The legislation proposed in this bill to section BH 1, clarifying that the section applies in the case of multilateral treaties, will have retrospective application beginning on 21 October 2013. As explained below, this is to put beyond doubt that section BH 1 can apply to multilateral treaties (despite wording that, on the face of it, suggests it only applies to bilateral treaties).

Otherwise, the legislative amendments proposed in this bill will come into force on 1 July 2017.

Key features

The due diligence and reporting rules in the Common Reporting Standard are broadly similar to those imposed on financial institutions under the United States’ (US) Foreign Account Tax Compliance Act (FATCA) rules. However, they have been adapted for a non-US, multilateral context, and they have also been supplemented with a comprehensive OECD Commentary.

To ensure that errors do not arise in translating these rules into New Zealand law, the legislation proposed in this bill will largely incorporate the Common Reporting Standard and OECD Commentary into New Zealand domestic law by reference.

The Common Reporting Standard and OECD Commentary will also have ambulatory effect. That is, the reference in the legislation is to the Common Reporting Standard and OECD Commentary “as amended from time to time”, which effectively means that any future changes to the Common Reporting Standard and OECD Commentary will automatically flow through into New Zealand law.

The Common Reporting Standard rules include criteria for identifying the **financial institutions** that will be subject to due diligence and reporting obligations in a particular jurisdiction.

The term “financial institution” is defined broadly, and covers depository institutions, custodial institutions, specified insurance companies, and investment entities. This definition extends beyond typical financial institutions such as banks to cover a number of types of entities that would not normally be considered to be financial institutions (such as many professionally managed trusts).

Importantly, the financial institutions that will be subject to Common Reporting Standard obligations in New Zealand will be those that are resident in New Zealand (excluding branches located overseas) or that have branches in New Zealand. Residence will generally be determined by where the institution is resident for tax purposes. However, the Common Reporting Standard has special residence rules for trusts and transparent entities.

Some financial institutions that pose a low risk of facilitating tax evasion and satisfy other criteria, are excluded from the Common Reporting Standard requirements (**non-reporting financial institutions**).

An entity that meets the Common Reporting Standard financial institution criteria, that has the required residence or branch nexus to New Zealand, and that is not a non-reporting financial institution, will be a New Zealand **reporting financial institution**. References in this document to “financial institution” should be read as meaning reporting financial institution unless the context otherwise requires.

The Common Reporting Standard also has criteria for identifying the accounts that will be subject to due diligence (**financial accounts**).

For this purpose, the term “financial account” is defined to apply in the context of entities that would not normally be considered to be financial institutions. It extends beyond typical accounts such as depository accounts to include custodial accounts, cash value insurance contracts, annuity contracts, equity and debt interests.

For example, for an investment entity (such as a trust) that is a financial institution under the Common Reporting Standard, its financial accounts will be its debt and equity interests. The term “equity interest” is further defined as including any settlor or beneficiary of all or a portion of the trust, or any other natural person exercising ultimate effective control over the trust.

The Common Reporting Standard also provides scope for implementing jurisdictions to define accounts as “excluded accounts” if these entities and accounts pose a low risk of facilitating tax evasion and otherwise satisfy other defined criteria.

The due diligence procedures set out in the Common Reporting Standard differ depending on when the account is opened.

More stringent obligations will apply to new accounts (accounts opened on or after 1 July 2017), with self-certifications generally being required to be obtained by the financial institution on account opening.

For pre-existing accounts (accounts in existence on 30 June 2017), the due diligence procedures typically involve the review of documentation/information already held for regulatory or customer relationship purposes. This includes information obtained under Anti-Money Laundering/Countering the Financing of Terrorism “know your customer” requirements. However, more stringent record search procedures will apply to, for example, high value pre-existing individual accounts (with a balance exceeding US \$1 million) than for lower value pre-existing individual accounts.

Importantly, financial institutions that maintain accounts held by passive non-financial entities (**passive NFEs**) will, as part of these procedures, need to “look through” those entities to determine the natural persons that are the ultimate controlling persons. In some cases, particularly for trusts, certain persons are considered to be controlling persons irrespective of whether or not they actually have or exercise control over the entity.

The aim of the due diligence procedures is for financial institutions to identify accounts that are held or (for passive NFEs) controlled by foreign tax residents.¹²

Financial institutions will be required to report an account that is held or controlled by one or more reportable persons (**reportable accounts**).¹³

A **reportable person** as defined is generally a tax resident¹⁴ of a jurisdiction that New Zealand has agreed to provide AEOI information to (**reportable jurisdictions**). Certain exclusions apply, such as for certain listed companies and their related entities, governmental entities, international organisations and persons that are themselves financial institutions.

For each reportable person, the financial institution must report specified identity (including tax residence) and financial information. This includes tax residence, account balances, and defined income and distributions.

¹² As explained below, this is based on the proposed approach of financial institutions applying the “wider approach” for to due diligence.

¹³ As explained below, this is subject to the application of the “wider approach” to reporting, whereby the financial institution may choose to report all foreign tax residents rather than only reportable persons.

¹⁴ For this purpose, an entity such as a partnership or similar legal arrangement that has no residence for tax purposes is treated as resident in the jurisdiction in which its place of effective management is situated.

Background

AEOI is a stand-alone initiative, but is related to other international developments aimed at improving transparency frameworks and tax compliance. In particular, the Common Reporting Standard reflects (and is largely based on) the US FATCA initiative, which New Zealand implemented in 2014.

The Common Reporting Standard builds off FATCA in a number of ways. For example, both regimes have broadly similar types of financial institutions and other entities, financial accounts, due diligence procedures (including sometimes allowing financial institutions to rely on Anti-Money Laundering/Countering the Financing of Terrorism “know your customer” procedures and other account information that they already hold), and reporting requirements. However, there are some differences between the regimes. Some of the most significant differences are:

- FATCA contains a number of de minimis exclusions from due diligence. The Common Reporting Standard generally does not have any such exclusions. The one exception to this is for pre-existing entity accounts, where the threshold exemption is US\$250,000, unless the financial institution chooses to elect out of the threshold.
- FATCA due diligence is focused on identifying “US persons”. The Common Reporting Standard due diligence is much broader and focuses on identifying foreign tax residents.¹⁵
- FATCA compliance is buttressed by a 30% withholding tax to apply to US-sourced income for non-compliance. This does not apply to the Common Reporting Standard. However, the Common Reporting Standard does require implementing jurisdictions to have a legal and operational compliance framework in place to verify compliance and to penalise non-compliance.

FATCA implementation involved the due diligence and reporting rules (which are set out in a treaty-level instrument)¹⁶ being incorporated into New Zealand law using regulations. Some primary legislation was also necessary to establish a framework for FATCA obligations, and this is located at Part 11B of the Tax Administration Act 1994.

Because of the similarities between the Common Reporting Standard and FATCA, the proposed amendments incorporating the Common Reporting Standard into New Zealand law will also primarily be located in Part 11B. However, as explained below, the proposal is that some provisions will apply solely to FATCA, some will apply solely for AEOI purposes, and some will apply for both FATCA and AEOI purposes.

¹⁵ As explained below, this is based on the proposed approach of financial institutions applying the “wider approach” to due diligence.

¹⁶ An Intergovernmental Agreement between New Zealand and the United States. See details on the tax policy website at: <http://taxpolicy.ird.govt.nz/sites/default/files/2014-other-iga.pdf>.

The proposed update to Part 11B will result in provisions that will apply solely to FATCA, in existing sections 185F to 185M. Proposed provisions that apply solely to AEOI will be located in new sections 185N and 185O. Provisions that apply to both FATCA and AEOI will be located in new sections 185P to 185R. Section 185E, which sets out the purpose of Part 11B, will be updated to include references to AEOI and to set out the new structure. Proposed penalty provisions that relate to these obligations will also be set out in sections 142H and 142I.

Detailed analysis

The legal instruments for exchange

MCMAA convention

Although any form of tax treaty can potentially be used to make AEOI exchanges, the G20 and OECD have promoted the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters* (the **MCMAA convention**) as the principal treaty to be used for this purpose.

New Zealand signed the MCMAA convention in 2012. It was given legal effect in New Zealand on 21 October 2013 by an Order in Council made under section BH 1 of the Income Tax Act 2007.¹⁷

Section BH 1 authorises the making of an Order in Council to give legal effect to a “double tax agreement”. As that term is defined, and under statutory legal principles, the reference to “double tax agreement” in section BH 1 is considered sufficiently broad to apply to other types of tax treaty, including multilateral treaties. However, this is not immediately obvious on the face of wording. This, in turn, has led to some claims that the MCMAA convention has not been correctly given legal effect in New Zealand.

Although a legal challenge to the validity of the Order in Council giving effect to the MCMAA convention is unlikely to be successful, any uncertainty is undesirable. Moreover, additional multilateral treaties may need to be given effect under section BH 1 in the future.

Accordingly, the bill contains proposals to put the matter beyond doubt. This includes a retrospective amendment to section BH 1, to clarify that it applies in the case of multilateral treaties. A definition relating to the MCMAA convention (under the term “**MCMAA convention**”) will also be inserted into section 3 of the Tax Administration Act 1994, which includes a specific reference to the 21 October 2013 Order in Council giving it legal effect in New Zealand.

¹⁷ Details relating to the MCMAA Convention are available on Inland Revenue’s tax policy website at <http://taxpolicy.ird.govt.nz/tax-treaties/convention-mutual-administrative-assistance-tax-matters>.

The definition of “foreign account information sharing agreement”, in section YA 1 of the Income Tax Act 2007, will also be amended to specifically include the “MCMAA convention”. The purpose of this amendment is to ensure that AEOI exchanges made under the MCMAA convention will be subject to the AEOI legislation to be inserted in Part 11B of the Tax Administration Act 1994.

The MCA agreement

Article 6 of the MCMAA convention authorises exchange of information on an automatic basis (as opposed to other forms of exchange, such as on request), and provides that any automatic exchanges must be subject to detailed terms as agreed between “competent authorities”.

Competent authorities are specific persons or authorities nominated by each treaty partner to administer the treaty. The competent authority under New Zealand’s tax treaties is the Commissioner of Inland Revenue or an authorised representative.

To give effect to the Article 6 requirement for competent authorities to agree the detailed terms of automatic exchanges, for AEOI the OECD developed an administrative instrument referred to as the *Multilateral Competent Authority Agreement (MCA agreement)*.

New Zealand signed the MCA agreement in 2015.¹⁸

In addition to other important details, such as the manner of exchanges and rules and procedures around maintaining confidentiality of exchanged data, the MCA agreement specifies the actual information to be exchanged between the parties. As this is relevant to the operation of proposed Part 11B, a definition relating to the MCA agreement will be inserted into section 3 of the Tax Administration Act 1994.

The MCA agreement also has a notification mechanism, which enables each party to confirm the actual jurisdictions that it will exchange with (see explanation of “reportable jurisdictions” below), and the timing of exchanges with each of those jurisdictions.

Although New Zealand has signed the MCA agreement, it will not provide its notifications on reportable jurisdictions until the legislation is enacted and New Zealand’s list of reportable jurisdictions is confirmed.

Incorporating the Common Reporting Standard and OECD Commentary into New Zealand law

The due diligence procedures and reporting requirements set out in the Common Reporting Standard must be interpreted and applied consistently with the OECD Commentary.

¹⁸ Details relating to the MCA agreement are available on Inland Revenue’s tax policy website at <http://taxpolicy.ird.govt.nz/topical-issues/implementing-aeoi>.

Rewriting the details of all of the rules into domestic law would risk inadvertent differences and gaps between the Common Reporting Standard and the implementing legislation. Moreover, the Common Reporting Standard and OECD Commentary will almost certainly be subject to future change, as deficiencies and improvements are identified, and in response to changes in taxpayer behaviour.

To address such issues, a number of implementing jurisdictions have adopted the approach of incorporating the Standard into law by direct reference to the Common Reporting Standard and its Commentary. The legislation proposed in this bill follows this approach. It will help ensure that the Common Reporting Standard is correctly incorporated into law, and will reduce the risk of deficiencies being identified during peer review.

The legislation generally only introduces special rules when the Common Reporting Standard or Commentary either provides flexibility or requires implementing jurisdictions to make decisions (including decisions on dates that are to apply for due diligence and reporting purposes).

To facilitate the incorporation of the Common Reporting Standard by reference, three key definitions are proposed to be inserted into section 3 of the Tax Administration Act 1994:

- The term “**CRS publication**”, referring to the official OECD publication that includes the full AEOI standard (the standard for Automatic Exchange of Financial Account Information in Tax Matters).¹⁹
- The term “**CRS standard**”, referring to the Common Reporting Standard, which comprises Part IIB of the CRS publication.
- The term “**CRS applied standard**”, referring to the CRS standard as modified by section 185O of the Tax Administration Act 1994.

Importantly, the definition of “CRS standard” includes the words “as amended from time to time”. These words give the definition ambulatory effect, meaning that future changes to the Common Reporting Standard will generally flow through into New Zealand legislation automatically.

As noted, the Common Reporting Standard must be interpreted and applied consistently with the official OECD Commentary, which comprises Part IIIB of the CRS publication. New section 185O(3) of the Tax Administration Act 1994 will incorporate that requirement into New Zealand law. Section 185O(3) also includes the ambulatory language “as amended from time to time”.

¹⁹ This publication is available on the OECD website, at <http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters-9789264216525-en.htm>.

Other definitions

The approach of incorporating the AEOI legislation into existing Part 11B of the Tax Administration Act 1994 necessarily involves merging the AEOI instrument into the concept of a **foreign account information-sharing agreement**, on which Part 11B is based. To achieve this, the definition of “foreign account information-sharing agreement” (in section YA 1 of the Income Tax Act 2007) will be amended to include the MCMAA convention (which, as noted above, will be the tax treaty predominantly used for AEOI exchanges).

The Common Reporting Standard itself contains a large number of specific definitions. Generally, incorporating the Common Reporting Standard into New Zealand law will ensure that these definitions will apply in the application of the Common Reporting Standard in New Zealand.

However, in the case of a conflict between a Common Reporting Standard definition and a defined term in the Inland Revenue Acts, a rule will be inserted as new section 185O(4) of the Tax Administration Act 1994 to ensure that when applying the Common Reporting Standard the Common Reporting Standard definition will take precedence.

The Common Reporting Standard Commentary specifies that two terms (“**passive income**” and “**maintain**”) are to take the domestic law meaning, but they must also include certain things. To ensure that the full meaning of these terms, as set out in the OECD Commentary, will apply in New Zealand, specific definitions of these terms are proposed to be included in section 3 of the Tax Administration Act 1994.

A new term “**FATCA agreement**” is also proposed in section 3, as a means of differentiating between FATCA and AEOI in Part 11B.

Framework for Common Reporting Standard obligations

Because the legislation proposed in this bill incorporates the Common Reporting Standard due diligence and reporting obligations by reference, it generally does not need to detail the specific obligations. Rather, the proposed legislative amendments are primarily concerned with establishing the framework under which the obligations will apply in New Zealand.

The application of obligations to financial institutions is facilitated by section 185N of the Tax Administration Act 1994. As noted above, section 185O sets out the specific proposed modifications to be made to the CRS standard, for application in New Zealand.

It is proposed that these obligations will be supplemented by specific record-keeping requirements in respect of Common Reporting Standard compliance to be inserted into section 22 of the Tax Administration Act 1994. This will include a specific requirement for financial institutions to keep a record of any failure to obtain a self-certification.

The application of obligations to persons other than financial institutions (such as account holders, controlling persons or intermediaries) is facilitated by the proposed insertion of section 185P of the Tax Administration Act 1994.

Some complexity arises from the fact that the Common Reporting Standard treats certain legal arrangements (particularly trusts) as entities. As this concept does not fit well with the categorisation of such arrangements under New Zealand law, a supplementary rule is proposed in section 185Q to ensure that any obligations expressed in the Common Reporting Standard as applying to an entity are to apply to the relevant person in the New Zealand context. (For example, for trusts, the obligations will apply to the trustees.)

Modifications to the Common Reporting Standard

Modifications made to the Common Reporting Standard by section 185O include rules that require the Common Reporting Standard to be applied consistently with the OECD Commentary.

Section 185O(2) provides that a number of other specific modifications will be detailed in new schedule 2 to the Tax Administration Act 1994.

Section 185O also provides that a Common Reporting Standard definition is to prevail in the case of any conflict with a domestic law definition, and generally permits financial institutions to make elections contemplated in the Common Reporting Standard and OECD Commentary.

Dates

Much of proposed schedule 2 is concerned with inserting the commencement dates and due diligence timeframes that are to apply in New Zealand. These include the date on which Common Reporting Standard obligations are to commence, dates for determining whether a financial account is to be considered a new account or a pre-existing account, and the deadlines for financial institutions to complete due diligence and reporting.

In the Common Reporting Standard and OECD Commentary, these dates have generally been left open for each implementing jurisdiction to insert (subject to these meeting international expectations).

In addition, because New Zealand has adopted a reporting period other than the default calendar year reporting period contemplated by the Common Reporting Standard, a rule is included such that all references to reporting period and calendar year are to be read in the context of the New Zealand reporting period (unless the context requires otherwise).

Schedule 2

Schedule 2 makes the following specific modifications to the Common Reporting Standard:

- Item 1 clarifies that references in the Common Reporting Standard to reporting period and calendar year should be read as applying to a reporting period ending 31 March.
- Items 2 and 3 mandate the use of the “wider approach” for due diligence. This is an important compliance minimisation option offered to implementing jurisdictions in the Common Reporting Standard. It is explained in detail further below, under the section “Wider approach”.
- Item 4 withdraws a choice available in the Common Reporting Standard (to allow a transitional period for the introduction of a requirement to report gross proceeds from the sale or redemption of financial assets). The reasons for this are articulated below under “Excluded choices”.
- Items 5 to 10 set out various due diligence timeframes that apply for different types of pre-existing accounts.
- Item 11 allows for the adoption of an option relating to certain employer-sponsored group insurance contracts or annuity contracts.
- Item 12 provides that dollar amounts referred to in the Common Reporting Standard (which, by default are in United States currency), can be treated as being in New Zealand dollars.
- Items 13 and 22 to 24 are mechanical provisions that ensure New Zealand’s published lists of its Participating Jurisdictions, Reportable Jurisdictions, Non-Reporting Financial Institutions and Excluded Accounts are included within the meaning of the relevant definitions of those terms.
- Item 14 sets out the date at which a credit card issuer is required to implement various defined policies and procedures in order to come within the definition of “Qualified Credit Card Issuer” in the Common Reporting Standard.
- Items 15 and 16 set out various dates from which collective investment vehicles are required to no longer issue physical shares in bearer form and by which they must have policies in place to ensure that such shares are redeemed or immobilised in order to come within the term “Exempt Collective Investment Vehicle” defined in the Common Reporting Standard.
- Items 17 and 18 define “pre-existing accounts” and “new accounts”. The definition of “pre-existing accounts” incorporates the option in the Common Reporting Standard to apply the due diligence procedures for pre-existing accounts to new accounts opened by pre-existing customers in circumstances permitted in the Standard.
- Items 19 and 20 set out dates that are relevant to determine whether a pre-existing account is a “Lower Value Account” or a “High Value Account”.

- Item 21 sets out a deadline date by which a financial institution is required to implement defined policies and procedures in order for a type of depository account to be an excluded account.
- Item 25 clarifies which of two possible definitions of the term “Related Entity” the Common Reporting Standard will apply.

Obligations of financial institutions

The Common Reporting Standard provides that a financial institution that is resident (as that concept applies for Common Reporting Standard purposes) in a jurisdiction will be subject to Common Reporting Standard obligations in that jurisdiction.

However, a branch of a New Zealand-resident financial institution located outside of New Zealand is excluded from the rules. Conversely, a branch of a non-resident financial institution located in New Zealand is subject to the New Zealand rules.

These fundamental rules are set out in section 185N(1) and (2).

The Common Reporting Standard also includes a complex series of definitions that set out the actual criteria for identifying financial institutions.

For Common Reporting Standard purposes, the term “**financial institution**” is broadly defined. It extends beyond traditional financial institutions (such as banks) to a wide range of entities that would not normally be considered as financial institutions (for example, it will include some professionally managed trusts).

However, the Common Reporting Standard CRS also specifies a number of categories of financial institution that pose a low risk of being used to facilitate offshore tax evasion, and which therefore are excluded from the due diligence and reporting obligations. These are defined as “**non-reporting financial institutions**”.

Proposed section 185N(3) provides that a financial institution must comply with the due diligence and reporting obligations set out in the Common Reporting Standard applied standard.

Proposed section 185N(4) imposes an annual reporting deadline for financial institutions of 30 June.

Consistent with the timeframes contemplated in the Common Reporting Standard and OECD Commentary for completing due diligence of pre-existing accounts, proposed section 185N(5) sets a deadline of 30 June 2018 for due diligence and reporting on pre-existing individual accounts that are high value accounts, and 30 June 2019 for due diligence and reporting for all other pre-existing accounts. Otherwise, proposed section 185N(5) includes a general rule for the timing of reports in respect of an account identified as reportable during a particular reporting period.

Proposed section 185N also includes other supplementary rules.

Obligations of persons other than financial institutions

Proposed section 185P also extends Common Reporting Standard obligations to persons other than financial institutions.

This reflects the fact that financial institutions will often be required to collect documentation and information directly or indirectly from account holders (and sometimes the controlling persons of the account) in order to comply with their Common Reporting Standard obligations. This includes circumstances when the institution has a customer relationship with an intermediary that holds an account for the benefit of an account holder and, potentially, other controlling persons.

This requires an efficient transfer of information from those account holders and other persons directly or indirectly to the institution.

Financial institutions should generally face few problems in obtaining documentation and information from customers on account opening. However, they may face challenges in obtaining documentation and information from customers in other circumstances. For example, a customer may not respond to a written request for information. There may also sometimes be difficulties obtaining documentation and information from persons connected with particular types of accounts, such as trust accounts.

To assist compliance, an amendment proposes to impose an obligation on such customers and other entities or persons, to obtain and provide any documentation and information that the institution requests from them directly or indirectly in the course of undertaking their Common Reporting Standard due diligence obligations.

Such customers/persons will also have an obligation to provide updates on any material change in circumstances that they are aware of that may affect their status as a reportable person.

These obligations are set out in proposed section 185P.

Record-keeping obligations

The Common Reporting Standard specifically requires implementing jurisdictions to have rules in place requiring that financial institutions keep records of the steps undertaken, and any evidence relied upon, for the performance of their Common Reporting Standard obligations.

This requirement will be met by the proposed introduction of specific rules in section 22 of the Tax Administration Act 1994. This will include a requirement for a financial institution to keep a record of any failure to obtain a required self-certification. These record keeping requirements will assist Inland Revenue in verifying compliance with the Common Reporting Standard and addressing any non-compliance (including considering the application of any relevant penalties).

Optionality

Although the success of the AEOI global initiative depends on jurisdictions implementing similar rules, the Common Reporting Standard provides implementing jurisdictions with a number of options. These options have been developed with a view to minimising compliance costs for financial institutions, in areas that are not considered likely to compromise the effectiveness of the Standard.

The circumstances of each financial institution can differ markedly, meaning that financial institutions may have different preferences as to whether these options should be adopted. Accordingly, the legislation proposed has been framed to generally permit each financial institution to make its own decision on whether to adopt any particular option offered in the Common Reporting Standard.

Some of the specific choices available to financial institutions are set out in section 185N. Otherwise, section 185O(5) generally provides that a financial institution may make an election that is expressed as being available to them.

Excluded choices

In a small number of cases, a particular choice will be mandated for all financial institutions.

Two “excluded” choices are set out in section 185N(11), which provides that the optionality provided in the Common Reporting Standard to adopt alternative reporting periods, and in the OECD Commentary in respect of the alternative use of average balances rather than period end balances, will not be available to financial institutions.

- The **reporting period** to be used in New Zealand will be the 12-month period ending 31 March.²⁰ This is consistent with the New Zealand tax year and the reporting period adopted by New Zealand for FATCA purposes. The period ending 31 March must be adopted by all financial institutions.
- The OECD Commentary provides that jurisdictions that already require financial institutions to report average account balances can permit their financial institutions to maintain this approach for AEOI, rather than reporting period end-balances. This does not apply in New Zealand. However, for clarity, the legislation expressly provides that this option is not available to New Zealand financial institutions.

As noted, an additional excluded choice is set out at item 4 of schedule 2. This relates to an option available in the Common Reporting Standard to allow a transitional period for the introduction of a requirement to report gross proceeds from the sale or redemption of financial assets. On this point there is a mismatch between the Common Reporting Standard and the exchange commitments set out in the MCA agreement, where this is not allowed as an option. Therefore this is specifically set out as an excluded choice.

²⁰ The first period will be a transitional period from 1 July 2017 to 31 March 2018.

The “wider approach”

The “wider approach” to due diligence

An important option offered in the Common Reporting Standard is the “wider approach” to due diligence. This option addresses the practical issue that the Common Reporting Standard only requires the identification by financial institutions of persons that are tax-resident in reportable jurisdictions (that is, jurisdictions that New Zealand will exchange AEOI information with). Over time, additional jurisdictions will join the initiative and become reportable jurisdictions. Without specific rules, each new jurisdiction joining would trigger a new round of due diligence reviews of accounts by financial institutions.

To avoid this problem, and to minimise compliance costs, the Common Reporting Standard includes an option for implementing jurisdictions to adopt a “wider approach” to due diligence. Under this approach, a jurisdiction’s financial institutions would be permitted to collect and retain Common Reporting Standard information for all non-residents identified rather than just that pertaining to residents of reportable jurisdictions.

The legislation proposed adopts the wider approach to due diligence. To ensure consistency, and prevent any financial institution from being put at a competitive disadvantage, this approach will be mandatory for all financial institutions.

This modification to the CRS standard is made at item 2 of the new schedule 2.

The “wider approach” to reporting

Adopting the wider approach to due diligence will require financial institutions to sort and filter the collected data to determine the accounts that need to be reported to Inland Revenue (so that they can identify the reportable accounts that are held and/or controlled by reportable persons, which they are required to report).

The Common Reporting Standard therefore provides a further option, to allow financial institutions to report all of the information to the tax authority (Inland Revenue in this context). Under this option, financial institutions may choose that the reporting requirements under the Common Reporting Standard in relation to financial accounts held or controlled by a resident of a reportable jurisdiction apply to all financial accounts maintained by that institution and held or controlled by a resident of a foreign tax jurisdiction. The proposed approach is, therefore, for financial institutions to effectively be permitted to pass the responsibility for sorting and filtering the data on to the tax authority (Inland Revenue), thereby potentially saving costs. Inland Revenue would then be responsible for determining the information to be exchanged with reportable jurisdictions.

The legislation proposed in this bill allows this as an option for financial institutions. This option will be set out in sections 185N(7) and (8).

Determinations and regulatory powers

The Common Reporting Standard defined terms “participating jurisdiction” and “reportable jurisdiction” are key concepts in the application of the Common Reporting Standard. The Common Reporting Standard requires New Zealand to publish lists of its participating jurisdictions and reportable jurisdictions.

The Common Reporting Standard also includes important carve-outs from AEOI obligations, for “non-reporting financial institutions” and “excluded accounts” that pose a low risk of being used for tax evasion purposes. Some generic categories of these are set out in the Common Reporting Standard, but New Zealand will also be required to publish lists of specific institutions and accounts that it approves as meeting other general low-risk criteria.

These lists will be published by a mix of Commissioner’s Determinations and by regulation.

Participating jurisdictions

New Zealand must publish a list of its participating jurisdictions. A participating jurisdiction is generally one that has implemented AEOI and indicated that it will provide AEOI information to other jurisdictions. More specifically, New Zealand’s participating jurisdictions will be those with which an agreement is in place for that jurisdiction to provide AEOI information to New Zealand.

New Zealand’s list of participating jurisdictions will be important for New Zealand’s financial institutions, because the Common Reporting Standard due diligence procedures require financial institutions to “look through” passive NFEs to determine the natural persons that are its ultimate controlling persons.

This look-through rule extends to cover certain investment entities that are not from participating jurisdictions. This means that New Zealand’s list of participating jurisdictions will impact on the circumstances when New Zealand financial institutions will need to “look through” their account holders to identify the ultimate controlling persons.

The proposed amendments in this bill provide for the Commissioner of Inland Revenue to make a Determination about whether a particular jurisdiction is a participating jurisdiction. This Determination-making power will be inserted into the Tax Administration Act 1994 as proposed new section 91AAU. The provision will allow the Commissioner to impose limitations on, amend, suspend or withdraw a Determination.

It will take time to confirm whether all jurisdictions that have committed to implementing AEOI have correctly carried through with their commitments. As a transitional measure, the OECD has permitted jurisdictions to tentatively treat all committed jurisdictions as participating jurisdictions. New Zealand intends adopting this approach.

However, the transitional measure is only to apply for a limited time, and jurisdictions are required to publish final lists by 30 June 2017. Given that New Zealand's start date is 1 July 2017, the intended approach is to publish a transitional list that would apply for the first period (1 July 2017 to 31 March 2018) and then a final list by 30 June 2017 that would apply from the beginning of the second period (that is, from 1 April 2018).

Reportable jurisdictions

In addition to publishing its list of participating jurisdictions, New Zealand must also publish a list of its reportable jurisdictions.

A participating jurisdiction is one that provides AEOI information. However, not all participating jurisdictions will be reportable jurisdictions. For example, some participating jurisdictions may be smaller economies that do not have a tax system, and which therefore would have no need to receive information.

In general, international expectations are that AEOI information will be provided to all participating jurisdictions that have indicated in the MCA agreement that they wish to receive such information. However, the OECD acknowledges that this raises potential concerns about confidentiality and data security.

AEOI exchanges will comprise sensitive personal and financial information. Under the express terms of the legal instruments under which the information will be exchanged, this information may only be disclosed to specified persons and may only be used for specified (tax) purposes.

Many jurisdictions have been exchanging such sensitive information for many years, have robust laws, processes and systems in place for ensuring exchanged data is kept secure and is only used for legitimate purposes, and have a track record of maintaining confidentiality. However, some jurisdictions that are implementing the AEOI Standard have had little, or no, prior experience in exchange of information for tax purposes.

Implementing jurisdictions may make decisions not to provide information to particular jurisdictions if they hold genuine concerns about confidentiality and/or data security. However, such decisions cannot be used to frustrate the purposes of the Common Reporting Standard.

This is a difficult balancing act. To assist, the Global Forum is conducting specific reviews of implementing jurisdictions' confidentiality and data safeguards, and will be making its conclusions available to competent authorities of participating jurisdictions.

The amendments proposed in this bill include specific procedures for ensuring that the New Zealand Government retains oversight and control of New Zealand's determination of its reportable jurisdictions.

A regulation-making power will be inserted into the Tax Administration Act as proposed new section 226D. The decision to provide AEOI information to any jurisdiction will require confirmation by Order in Council.

To ensure that, in the case of any serious breach, exchange of information with a particular jurisdiction can be swiftly suspended, the Commissioner of Inland Revenue will be authorised to make a Determination to temporarily suspend that jurisdiction as a reportable jurisdiction. This Determination-making power will be inserted into the Tax Administration Act 1994 as proposed new section 91AAV. Any such Determination would need to be subsequently confirmed by Order in Council.

This power will only exist as a contingency to ensure that the time taken to make an Order in Council to suspend a jurisdiction does not result in a legal obligation to provide information being switched off too late due to an exchange deadline.

Non-reporting financial institutions

As noted above, the Common Reporting Standard provides that some categories of financial institution that pose a low risk of being used for offshore tax evasion can be treated as a “non-reporting financial institution”.

A number of generic categories of non-reporting financial institution are set out in the Common Reporting Standard. There is also an additional category of low risk financial institutions that an implementing jurisdiction can itself determine. However, these must meet certain specified criteria, must be confirmed by the implementing jurisdiction in a published list, and must meet a final test of not frustrating the purposes of the Common Reporting Standard.

The amendments proposed provide for the Commissioner of Inland Revenue to make a Determination as to whether a particular financial institution, or type of financial institution, is a non-reporting financial institution. This Determination-making power will be inserted into the Tax Administration Act 1994 as proposed new section 91AAW. The provision will include the ability for the Commissioner to impose limitations on, amend, suspend or withdraw a Determination. All Determinations made under this provision must be published.

Excluded accounts

Similarly, the Common Reporting Standard provides that some categories of financial account that pose a low risk of being used for offshore tax evasion can be treated as “excluded accounts”. Excluded accounts will not be subject to due diligence or reporting.

A number of generic categories of excluded account are set out in the Common Reporting Standard. There is also an additional category of “low risk” accounts an implementing jurisdiction can itself determine. However, these must meet certain specified criteria, must be confirmed by the implementing jurisdiction in a published list, and must meet a final test of not frustrating the purposes of the Common Reporting Standard.

The legislation proposed in this bill provides for the Commissioner of Inland Revenue to make a Determination on whether a particular financial account, or type of financial account, is an excluded account. This Determination-making power will be inserted into the Tax Administration Act 1994 as proposed new section 91AAW. The provision will include the ability for the Commissioner to impose limitations on, amend, suspend or withdraw a Determination. All Determinations made under this provision must be published.

Enforcement

The Common Reporting Standard requires implementing jurisdictions to have rules and procedures in place to ensure compliance and address non-compliance. This includes having appropriate anti-avoidance rules, record-keeping requirements, compliance programmes, and effective sanctions to address identified non-compliance.

Accordingly, this bill proposes a comprehensive suite of enforcement rules and penalties.

Strong sanctions will apply to financial institutions for intentional failure to comply or for failure to comply through lack of reasonable care.

The penalties to be imposed on financial institutions will be backed with specific obligations and penalties to be imposed directly on account holders, controlling persons or intermediaries that (i) provide false information or a false self-certification, (ii) fail to comply with a request for information or a self-certification, or (iii) fail to inform of any material change in circumstances that they are aware of relating to information or a self-certification that they have provided. However, as explained below, these penalties will be subject to the application of “no fault” and “reasonable efforts” defences.

Specific record-keeping obligations are also proposed, together with an anti-avoidance provision that will apply to arrangements and practices entered into or by financial institutions, persons, or intermediaries with “a main purpose” of avoiding an obligation under Part 11B.

The bill proposes that the following penalties will apply to financial institutions:

- a general (civil) penalty of \$300, to be imposed on a financial institution for any failure to comply with its Common Reporting Standard due diligence and reporting requirements;
- a specific (civil) penalty of \$300, to be imposed on a financial institution for each new account when there is a failure to obtain a self-certification when opening such accounts when obtaining such a self-certification is required by the Common Reporting Standard;
- the above provisions will be subject to a transitional period (until 31 March 2019) in which penalties will not be imposed if the financial institution is able to demonstrate it has made reasonable efforts to comply with its Common Reporting Standard due diligence and reporting obligations; and

- a specific (civil) penalty of \$20,000 for a first offence and \$40,000 for any subsequent offence, to be imposed in circumstances when a financial institution fails to take reasonable care in complying with its Common Reporting Standard due diligence and reporting requirements.

Knowledge-based offences by financial institutions will be subject to the application of existing legislative provisions.

The bill also proposes that the penalties to be imposed on financial institutions will be backed with specific obligations and penalties to be imposed directly on account holders, controlling persons or persons that otherwise hold accounts for the benefit of others (including trusts and intermediaries):

- a specific (civil) penalty of \$1,000, if a person or entity provides a false self-certification or related information, fails to provide a self-certification or related information within a reasonable time after receiving a request, or fails to provide information about a material change of circumstances that they are aware of relating to a self-certification or related information within a reasonable period of time;
- however, this penalty is subject to a “no fault” defence (for a failure to provide information or a self-certification within the control of the information provider) and a “reasonable efforts” defence (for a failure to provide information or a self-certification relating to another person or entity and not within the control of the information provider).

Knowledge-based offences by such persons or entities will be subject to the application of existing legislative provisions.

The mix of transitional measures and available defences is included in the proposed legislation in recognition of the fact that the rules are complex, that financial institutions face short implementation timelines, and that there is a risk of inadvertent error. The intended approach is that for the first two years, reasonable efforts by financial institutions to comply will be recognised. Sanctions will generally only be imposed in cases of intentional non-compliance or lack of reasonable care.

However, the proposed legislation is also structured to recognise the fact that New Zealand’s rules will be subject to international peer review, and that any perceived leniency could be criticised. Accordingly, as an effective deterrence, strong sanctions are proposed for identified cases of serious failure or non-compliance.

FATCA

For consistency, the bill proposes amendments to the FATCA implementation legislation to first, align the FATCA anti-avoidance rule with the AEOI anti-avoidance rule (with application to any person with an obligation under Part 11B), and secondly, to provide for the imposition of the same obligations and penalties on persons other than financial institutions under FATCA as for AEOI.

Foreign trust disclosure rules

FOREIGN TRUST DISCLOSURE RULES

(Clauses 5, 8(8), 8(9), 9(4), 10 and 11)

Summary of proposed amendments

New information disclosure rules are proposed for foreign trusts with a New Zealand-resident trustee. These include requirements for the trust to register with Inland Revenue, file annual returns and pay registration and filing fees. In addition, the register of foreign trusts would be shared with certain New Zealand government agencies.

The resident trustee of the foreign trust would need to comply with the registration and filing obligations in order to qualify for the exemption from tax on foreign-sourced amounts.

The proposed changes follow the Government's April 2016 Inquiry into Foreign Trust Disclosure Rules which was set up to examine and make recommendations regarding disclosure rules and other related matters to ensure that New Zealand's reputation is maintained.

The Inquiry concluded that, given the current environment of greater transparency and sharing of information, the current information disclosure rules are inadequate. The Inquiry recommended a number of amendments to the disclosure requirements for foreign trusts. On 13 July 2016 the Government announced it would adopt the Inquiry's recommendations.

Application date

The amendments will come into force on the date of enactment.

Key features

Resident trustees required to register foreign trust

Resident trustees of a foreign trust will be required to apply for registration of the trust. As part of the registration, the resident trustee must provide certain information relating to the foreign trust to the Commissioner, including information relating to settlors and beneficiaries and the trust deed.

Foreign trusts formed after the date of enactment will need to register with Inland Revenue within 30 days. Existing foreign trusts will have to register by 30 June 2017.

Annual returns

Resident trustees of a foreign trust will be required to file annual returns, including the trust's financial statements and details of settlements and distributions, made over the year. The annual return would also include any changes made to the information that is provided as part of the initial disclosure on registration.

The resident trustee will be required to file annual returns for every year that the trust is registered. The due date for annual returns corresponds to the foreign trust's balance date, with the annual returns due three months after the trust's balance date. If the trust does not have a balance date because it does not prepare financial statements, the return is due 30 June following the end of the tax year.

Existing foreign trusts will generally need to provide their first return under the proposed new rules by 30 June 2018.

Grace period for new migrants

There would be a "grace period" for New Zealand trustees who are new migrants and who are not in the business of providing trustee services. Under this grace period the registration and filing requirements would be delayed for two years. This would mirror the existing grace period for new migrants in respect of providing initial foreign trust disclosures.

Registration and annual filing fee

The proposed amendments include a registration fee of \$270 and an annual filing fee of \$50. The bill also proposes a regulation-making power which will allow the registration and annual filing fees to be amended by Order in Council.

Information sharing with other agencies

The information collected by Inland Revenue as part of the proposed new registration and annual filing processes would be shared with the New Zealand Police and the Department of Internal Affairs.

Sanctions for non-compliance

To qualify for the exemption for tax on foreign-sourced income, resident trustees of a foreign trust will have to be compliant with the disclosure requirements for registration, and will also need to fulfil their annual filing obligation.

In addition, it is proposed that the current "safe harbour" for qualifying resident trustees of a foreign trust be removed.

Background

A foreign trust is a trust with a foreign settlor. Foreign trusts with New Zealand-resident trustees are exempt from tax on foreign-sourced income.

There is currently no formal registration process for foreign trusts. However, the Tax Administration Act 1994 requires foreign trusts with a New Zealand-resident trustee to disclose certain information to the Commissioner of Inland Revenue upon establishment. The information required to be disclosed upon establishment is the name or identifying particulars of the foreign trust, the name of a New Zealand trustee, and whether there is an Australian settlor.

The Tax Administration Act also requires New Zealand-resident trustees of foreign trusts to keep certain records in relation to the foreign trust, including the trust deed, and (if they are known) the names and addresses of settlors who make a settlement on the trust and beneficiaries who receive a distribution. These records must be provided to Inland Revenue on request. If the information provided upon initial disclosure has changed, the New Zealand-resident trustee of a foreign trust must update the information, but annual filing with Inland Revenue is not otherwise required.

There are two forms of sanctions for non-compliance under the current rules. First, an intentional breach of a requirement to supply information to Inland Revenue can result in a fine of up to \$50,000 and imprisonment for up to five years. Secondly, the foreign trust loses its tax exemption on foreign-sourced income if:

- a trustee is convicted of an offence for not providing information requested by Inland Revenue; and
- the trust does not have a “qualifying resident foreign trustee” for an income year. (A qualifying resident foreign trustee is a member of a specified professional body – for example, a member of the New Zealand Law Society or Chartered Accountants Australia and New Zealand.)

Inland Revenue shares information about foreign trusts with overseas tax authorities in countries with whom New Zealand has an agreement which includes information sharing provisions. This information is shared when requested by the overseas tax authority or proactively in instances where Inland Revenue considers that the information may be of interest to that tax authority.

Detailed analysis

Registration

Proposed section 59B requires resident trustees to apply for registration of the foreign trust.

This section also sets out the information that must be provided to Inland Revenue for registration, namely:

- a) the name and other identifying particulars of the trust;
- b) the date and detail of each settlement on the trust;

- c) the name, email address, residential address, country of tax residence, and Taxpayer Identification Number for the following persons:
 - i. each settlor
 - ii. each person with a power under the trust deed to control the dismissal of appointment of a trustee, to amend the trust deed, or to add or remove a beneficiary
 - iii. each person with a power under the trust deed to control a trustee in the administration of the trust
 - iv. each trustee
 - v. for a fixed trust, each beneficiary and nominee for an underlying beneficiary;
- d) for a discretionary trust, details of each class of beneficiary sufficient for the Commissioner to determine, when a distribution is made under the trust or when rights apparently vested under the trust are exercised, whether a person is a member of the class; and
- e) a copy of the trust deed.

A new definition of “Taxpayer Identification Number” (TIN) is proposed in section 3(1) of the Tax Administration Act. A TIN is the equivalent of a person’s IRD number in the jurisdiction in which they are tax-resident.

Some foreign trusts have a trust “protector”. This is a person who is able to exercise some control over the trustee(s) under the trust deed – for example, the protector may have the ability to appoint or remove a trustee, or to veto the appointment or removal of a trustee. The Inquiry recommended that identity details of protectors be provided to Inland Revenue. Protectors are intended to be captured by (c)(ii) and (iii) in the above list.

The Inquiry also recommended that identity information of any other natural person who has effective control of the trust (including through a chain of control or ownership) should be provided. There are existing rules in the Income Tax Act 2007 that prescribe when a person will be treated as a settlor for the purpose of the trust rules. It is expected that the existing definition of settlor, in conjunction with the nominee look-through rule in section YB 21 will include situations where a natural person has effective control of the trust through a chain of control or ownership.

As part of the registration, the resident trustee must provide a signed declaration that the settlors, trustees and persons referred to under (c)(ii) and (iii) have been informed of, and have agreed to provide the information necessary for compliance with, the requirements relating to the provision of information imposed by:

- a) the Tax Administration Act 1994;
- b) the Anti-Money Laundering and Countering Financing of Terrorism Act 2009; and
- c) the regulations made under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009.

The time limits for registration and the associated disclosure are provided in proposed section 59C. Foreign trusts formed after the date of enactment will need to register with Inland Revenue within 30 days of establishing. Existing foreign trusts will have to register by 30 June 2017.

Annual returns

Proposed new section 59D sets out the information that must be provided annually, and the time limits for providing this information and paying the associated fee.

Specifically, resident trustees must provide:

- a) any changes to the information provided as part of registration;
- b) the trust's financial statements;
- c) the date and nature of each settlement;
- d) the name, email address, residential address, country of tax residence, and Taxpayer Identification Number of each settlor making the settlement;
- e) the date and amount of each distribution made by the trustee of the trust in the year; and
- f) the name, email address, residential address, country of tax residence and Taxpayer Identification Number of each beneficiary to which the distribution is made.

The resident trustee is required to file annual returns for every year that the trust is registered.

The specific time limits for filing an annual return are set out in proposed section 59D(3). The due date for annual returns corresponds to the foreign trust's balance date, with the annual returns due three months after the trust's balance date. If the trust does not have a balance date because it does not prepare financial statements, the return is due 30 June following the end of the tax year.

Existing foreign trusts will generally need to provide their first return by 30 June 2018.

Grace period for new migrants to comply with obligations

While most foreign trusts that are currently disclosed to Inland Revenue are professionally managed, a trust will also be a foreign trust if an individual who is the trustee of a family trust with a foreign settlor migrates to New Zealand (temporarily or permanently).

For example, take the situation of a person living in the United Kingdom (UK) who is the trustee of a family trust that was settled by the person's UK-resident parents.

If that individual migrates to New Zealand (either temporarily or permanently), they would become a New Zealand-resident trustee of a foreign trust.

In this situation, the New Zealand resident trustee must comply with the foreign trust disclosure and record-keeping requirements. However, the current law provides a “grace period” for New Zealand trustees who are new migrants and who are not in the business of providing trustee services. Under this grace period the disclosure requirements are delayed for two years.

Proposed sections 59C(3) and 59D(1)(d) provide an equivalent grace period of two years, in respect of the new registration and annual filing obligations, for New Zealand trustees who are new migrants and who are not in the business of providing trustee services. This is intended to ensure that temporary migrants (such as workers on a short-term contract) are not caught by the new rules, and that new migrants have time to adjust to their obligations.

Registration and annual filing fee

Proposed section 59E of the Tax Administration Act prescribes the fees for registration and annual filing. The registration fee is proposed to be set at \$270. The annual filing fee will be set at \$50. This provision includes a regulation-making power to change the fee by regulation.

No tax exemption if trustee is non-compliant

Under the proposed amendment to section HC 26, a foreign trust with a resident trustee will lose its tax exemption unless the trustee has registered the trust and fulfilled the associated disclosure obligations at that time. However the exemption would still be available if the non-registration or disclosure was unintentional and was remedied immediately.

It is also proposed to repeal the current qualifying resident trustee safe harbour in section HC 26(3). As noted above, under current rules this safe harbour allows a trust to keep its tax exemption as long as one of its trustees is a “qualifying resident foreign trustee” (a member of a specified professional body). The definition of a “qualifying resident foreign trustee” in section 3(1) of the Tax Administration Act would consequentially be repealed.

Information sharing with other agencies

A proposed amendment to section 81(4) will allow Inland Revenue to share the register of foreign trusts with the Department of Internal Affairs and the New Zealand Police. This will give these agencies access to information about foreign trusts that they need for regulatory or law enforcement purposes.

Consequential amendment to record-keeping requirements

Currently, New Zealand resident trustees of foreign trusts are specifically required to keep records relating to the trust deed, and certain information about settlements and distributions under section 22(7)(d)(i) and (ii) of the Tax Administration Act. The trust deed and information about settlements and distributions would have to be provided to Inland Revenue under the proposed registration and annual disclosure requirements. As a consequence, it is proposed to repeal section 22(7)(d)(i) and (ii) because it is no longer necessary.

Design of START

ADMINISTRATION OF THE LATE PAYMENT PENALTY RULES

(Clauses 112 and 113)

Summary of proposed amendment

The proposed amendments will enable Inland Revenue to continue to administer the late payment penalty grace period during the period in which tax types are operated out of two Inland Revenue software platforms. As part of Inland Revenue's Business Transformation programme, Inland Revenue's current computer platform, FIRST, will be replaced with a new software system known as "START". This will occur in four stages. The amendments will enable the Commissioner of Inland Revenue to ignore defaults in payment if:

- doing so is necessary due to tax types being administered from different systems as a result of the coexistence of FIRST and START; and
- doing so would not result in the imposition of a penalty that is greater than would otherwise have been imposed (had she not ignored these defaults in payment).

Application date

The proposed amendments will come into force on the date of enactment.

Key features

Amendments to sections 139B(1)(b) and 139B(1)(c), and proposed new section 139B(1B) of the Tax Administration Act 1994, introduce a discretion into the provisions setting out whether a taxpayer is entitled to a grace period from late payment penalties. Proposed new section 139B(1B) provides that this discretion may only be exercised when the following two conditions are satisfied:

- ignoring the failure to pay tax on time is necessary as a result of resource constraints imposed on the Commissioner during the period of coexistence of two Inland Revenue software platforms; and
- this would not result in a greater penalty being imposed than the taxpayer would otherwise be liable for if the Commissioner were not to ignore this failure to pay tax on time.

An amendment to section 138E will mean that certain rights of challenge do not apply to section 139B.

Background

The current tax rules impose a late payment penalty if a taxpayer does not pay on time. If, however, the taxpayer has punctually paid all relevant taxes due in the two years before the default in question, the Commissioner must first issue a notice to the taxpayer specifying a further date for payment of the unpaid tax, before a late payment penalty can be imposed. This gives the taxpayer a grace period in which to pay the amount owing before late payment penalties are imposed.²¹

Application of the late payment penalty grace period is determined on the basis of the taxpayer's previous compliance in terms of the payment of tax across all relevant tax types (such as GST, income tax and PAYE deductions).²²

The transition from Inland Revenue's FIRST to START system will be done on a tax-type basis, in four stages, with GST being transferred in early 2017 and income tax, FBT and PAYE scheduled to be transferred in 2018. This raises an issue in relation to the late payment penalty grace period, as the current legislative framework for the application of the penalty requires the Commissioner to consider the taxpayer's compliance history across all applicable tax types. As information relating to the taxpayer's tax compliance history and payment activity will reside in two software systems, it will be difficult for the Commissioner to look across all applicable tax types to determine whether the taxpayer is entitled to a grace period without significant manual intervention.

Detailed analysis

The discretion in new section 139B(1B) will enable the Commissioner to look only at tax information about a taxpayer's compliance history held in the system from which the tax type in payment default is being administered.

As tax types are transitioned to the new START system, a "compliance history indicator" will also be brought across to show when the taxpayer is next entitled to a grace period, based on the date they last paid late. The "compliance history indicators" will hold the taxpayer's payment history from two years prior to the tax type being brought across to START to the date of transition for tax types that have been administered from FIRST up to the date of transition. For example, the indicator that is transferred to START at the same time as GST would hold the taxpayer's payment history from two years before the date on which GST is transferred to START to the date of transfer in relation to income tax, GST, FBT and PAYE. During Stage 1 of Inland Revenue's Business Transformation programme, this indicator would be used to determine whether the taxpayer is entitled to a grace period when they default on a GST payment (when the GST period in question is a period after the date on which GST was transferred to START). If the taxpayer defaults on a payment for a tax type that is still being administered through FIRST, the compliance

²¹ If the taxpayer does not make payment within that notified further period, the late payment penalty is imposed from the day after the due date, as would have been usual.

²² The late payment penalty grace period applies to all tax types except the following: child support, student loan scheme, tax credits (formerly known as rebates), certain types of provisional tax, KiwiSaver voluntary employer contributions and complying fund debt referred to Inland Revenue from the Financial Markets Authority.

history held in FIRST at that time will be used to determine whether the taxpayer is entitled to a grace period.

This means that at a given point in time, the information held in START will be information contained within the compliance history indicator and information relating to the taxpayer's payment compliance with tax types being administered out of START from the date they were transitioned to START. The information held in FIRST will be information relating to the taxpayer's payment compliance in relation to all tax types up to the date they were transitioned to START.

Examples

The following examples assume that the taxpayer's only payment defaults are those specifically stated.

1. The date is 31 August 2017. Judy is a small business owner who fails to pay her GST liability by the 28 August 2017 due date. She was two weeks late in paying her PAYE liability by the 20 June 2017 due date. As the PAYE period in which she defaulted occurred after GST and the compliance history indicator were transferred to START, this PAYE information will not be visible in START. In accordance with proposed section 139B(1B), the Commissioner will be able to ignore Judy's PAYE default in determining whether she should be entitled to a grace period in relation to the late payment of her GST liability due by 28 August 2017. This means that the Commissioner will grant Judy a grace period, giving her a further 30 days to pay her GST liability.
2. The date is 31 August 2017. Kiri is a small business owner who fails to pay her PAYE liability by the 20 August 2017 due date. She was also two weeks late in paying her GST liability by the 28 June 2017 due date. As the GST period in which she defaulted occurred after GST was transferred to START, this information will not be visible in FIRST. In accordance with proposed section 139B(1B), the Commissioner will be able to ignore Kiri's GST payment default in determining whether she should be entitled to a grace period in relation to the late payment of her PAYE liability due on 20 August 2017. This means that the Commissioner will grant Kiri a grace period, giving her a further 30 days to pay her PAYE liability.
3. The date is 30 June 2017. Amir is a small business owner who fails to pay his PAYE liability (of one period) by the 20 June 2017 due date. He was two weeks late in paying last year's income tax liability, due 7 April 2016. As PAYE will still be being administered within the FIRST system, information on Amir's income tax payment default will be able to be considered by the Commissioner in determining whether he should be entitled to a grace period in relation to his PAYE payment default. This means he will not be entitled to a grace period, and a late payment penalty will automatically be imposed.

AMENDING THE RULES FOR NEW AND INCREASED ASSESSMENTS BY THE COMMISSIONER

(Clauses 113(1) and (5), 115, 117 and 118)

Summary of proposed amendment

A proposed amendment to section 142A of the Tax Administration Act 1994 will remove the requirement to set a new due date for the payment of tax resulting from a new or amended assessment made by the Commissioner of Inland Revenue. The timing and application of use-of-money interest (UOMI) and late payment penalties will remain unchanged.

The change will allow the Commissioner to apply credits or refunds that become available in payment of the taxpayer's tax liability from the moment the Commissioner has made a new or increased assessment.

The proposed new rules will be built into Inland Revenue's new software platform (START) and will apply to a tax type as and when the administration of that tax type is transitioned to START. This will happen in four stages.

Application date

The amendment will come into force on the date of enactment.

Key features

The bill proposes an amendment to section 142A so that the requirement to set a new due date for the payment of tax resulting from a new or increased assessment by the Commissioner made less than 30 days before, on or after the original due date is removed.

Consequential amendments to sections 139B and 139BA of the Tax Administration Act 1994 are proposed to ensure that taxpayers will be given the same amount of time as they are currently given for the payment of tax before late payment penalties are imposed and collection actions other than the application of credits and refunds occur. Consequential changes to section 142B are also proposed to ensure that taxpayers will have the same amount of time for payment of any shortfall penalties. Use-of-money interest will continue to apply from the day after the original due date for payment of the tax.

The only difference to the current rules will be that the Commissioner can apply credits or refunds the taxpayer has in payment of the taxpayer's tax liability from the moment the tax has been assessed in the situations addressed by section 142A. This reduces taxpayers' interactions with the tax system and their risk of exposure to penalties and UOMI. The amendment would also avoid customisation of Inland Revenue's new software platform, which will minimise its long-term cost.

Inland Revenue is moving the administration of the tax system to a new software platform on a tax-type by tax-type basis, in stages over a period of several years (four stages). To facilitate this, an amendment is proposed to section 142A to provide the Commissioner with a discretion to set a new due date for payment of the tax for tax types that are still administered in the old software platform.

During stage 1 the administration of Goods and Services Tax (GST) is administered in START whereas the other tax types are administered in Inland Revenue's old software platform (FIRST). This means, for example, that a taxpayer whose GST assessment is amended and increased will not receive a new due date for the payment of the increased amount of GST. The taxpayer will, however, have time for payment before late payment penalties apply. A taxpayer whose income tax assessment is amended and increased after the original due date will receive a new due date for payment of any increased income tax liability under the current rules during stage 1.

Background

At present, when the Commissioner makes a new assessment, or increases an assessment less than 30 days before, on or after the original due date for payment of the tax, a new due date is set for the payment of the tax resulting from the new or increased assessment (unless an exception applies). This is to allow the taxpayer time for payment before late payment penalties apply. The new due date is 30 or more days after the date of the notice of assessment (two calendar months in practice). A late payment penalty applies for amounts unpaid from the day after the new due date. Use-of-money interest, however, is calculated from the day after the original due date for payment of the tax for the assessed tax period.

When a new due date is set for payment, credits or refunds becoming available before the new due date are generally refunded to the taxpayer. The taxpayer then needs to make a payment to Inland Revenue by the new due date shortly after receiving the refund.

To give time before the imposition of late payment penalties on an assessment or re-assessment made close to, on or after the original due date, Inland Revenue's FIRST software platform required a new due date to be set. Inland Revenue's new START software platform has the ability to use the original due date for the payment of tax but allow time for payment before the imposition of late payment penalties. The effect of this is that the tax is due from the original due date and credits or refundable amounts are used to offset the tax liability. Incorporating a new due date rule would add to the complexity of the design of START.

Taxpayers will have the ability to seek refunds operationally for amounts applied in payment of a new or increased tax liability that would previously have been refunded.

USE-OF-MONEY INTEREST AND TRANSFERS OF TAX

(Clauses 106, 119 and 120)

Summary of proposed amendment

Amendments are being made to the Tax Administration Act 1994 to prevent taxpayers from transferring tax to an earlier period that exceeds the amount in debt or in dispute in that period, and to clarify when use-of-money interest (UOMI) starts and when a transfer takes effect for GST refunds and GST overpayments.

Application date

The amendments will come into force on the date of enactment.

Key features

The proposed amendments to sections 173L and 173M will limit transfers of excess tax within the taxpayer's accounts or to another taxpayer to the total of the amount in debt and/or in dispute in the requested period. This limit will only apply to transfers to earlier periods, not to future periods. Amendments to section 173L also clarify the effective transfer date of GST refunds and overpayments.

Changes to section 120C distinguish the rules that determine when UOMI starts for GST overpayments from the rules that determine when UOMI starts for GST refunds. This will ensure that the date UOMI begins for overpaid GST is consistent with when UOMI begins for other tax types that have been overpaid.

Background

Taxpayers are able to transfer tax credits to tax periods, tax types or other taxpayers.

Currently, taxpayers are able to transfer amounts that exceed the amounts owing in previous periods. When this happens they are paid UOMI from an earlier date than if they had not moved the money.

The Tax Administration Act does not distinguish between a GST refund, which occurs when GST inputs/expenses exceed GST outputs/sales, and a GST overpayment, which occurs when a taxpayer overpays their GST liability. As both scenarios result in a refund, it can be argued that a GST overpayment constitutes a refund, and is therefore eligible for the transfer date applicable to GST refunds, which is earlier than the transfer date applicable to overpayments. The date of transfer affects when UOMI on a previous overpayment stops being charged. Therefore a taxpayer transferring an overpayment of GST to settle a debt in a previous period will pay less UOMI to Inland Revenue than was intended because the payment will be transferred at the earlier refund date.

The policy intent behind the proposed amendments is to ensure taxpayers are paid the correct amount of UOMI on overpayments or refunds of tax, and that taxpayers pay the correct amount of UOMI to Inland Revenue on underpayments of tax.

Other policy matters

COLLECTING TAX ON EMPLOYEE SHARE SCHEMES USING THE PAYE SYSTEM – TECHNICAL CLARIFICATIONS

(Clauses 57, 84, 85 and 92(7))

Summary of proposed amendments

Two technical changes are proposed to the rules for employers to report and withhold tax on benefits received under an employee share scheme. The changes are intended to ensure the new rules operate effectively.

Application date

The proposed changes will come into force on 1 April 2017 and will apply to employment income received after that date.

Key features

The term “pay period” is replaced with “PAYE payment period” to avoid confusion between an employer’s payroll system and the timing of PAYE payments set out in section RD 22(2) of the Income Tax Act 2007.

To assist employers calculating tax on extra pays in section RD 17 for a benefit under an employee share scheme, the proposed amendment to section RD 6(3) will provide certainty about the date when the benefit is treated as paid.

Background

The Taxation (Transformation: First Phase Simplification and Other Measures) Act 2016 simplified the collection of tax on employment income in the form of benefits under an employee share purchase agreement. From 1 April 2017, the general PAYE collection rules in the Income Tax Act and disclosure rules in the Tax Administration Act have been changed to:

- allow employers to choose to use the PAYE system and withhold tax on any employment income an employee receives under a share purchase agreement; and
- require employers to report the value of any benefits an employee receives under a share purchase agreement via the employer monthly schedule (EMS).

The changes should remove the obligation for most employees to include this form of employment income in a tax return.

The changes in this bill provide additional clarity on how tax is withheld under the new rules.

STUDENT LOAN DRAFTING AMENDMENT

(Clause 121)

Summary of proposed amendment

Section 27E(3)(b) of the Student Loan Scheme Act 2011 refers to “applicant” when it should refer to “entity”. The bill proposes an amendment to rectify this.

Application date

The proposed amendment will come into force on 14 May 2016.