# Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill

## Bill Number 130-1

## Regulatory Impact Statements


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Prepared by Policy and Strategy, Inland Revenue

May 2016

## Regulatory Impact Statement

## Aircraft overhaul expenses: deductibility and timing

## Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address timing issues about deductions for aircraft overhaul expenses. As the issues relate to timing of deductions, the options are not intended to alter the total tax payable by commercial aircraft operators over the period of time an aircraft is owned by a taxpayer.

The options are considered in the light of the Civil Aviation Authority's rules for managing safety risks in the aviation sector. The rules require aircraft components to be regularly overhauled if the aircraft owner wishes to retain the aircraft's certificate of airworthiness. The length of the overhaul period is normally determined by time in service and is usually termed the overhaul cycle. It is illegal to operate an aircraft without a current certificate of airworthiness.

For the purpose of our analysis, we assumed that the review relates to significant aircraft operations such as commercial passenger and freight services, tourism operators, and commercial agricultural uses. Our analysis of the options is based on submissions on the consultation letter, and the economic and fiscal objectives of a coherent tax system.

The estimate of the potential fiscal effect for the timing options is uncertain as it is based on a sample of cost data drawn from larger aircraft operators and also an estimate of accrued provisions for future aircraft overhaul expenses drawn from a sample of small and medium sized aircraft operators. Because of data limitations it is not possible to identify the age profile of all aircraft held by aircraft operators.

None of the policy options had environmental or cultural impacts, and nor were there any other significant constraints, caveats and uncertainties concerning the regulatory impact analysis.

None of the policy options considered would restrict market competition, reduce the incentives for businesses to innovate and invest, unduly impair private property rights or override fundamental common law principles.

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21/08/2015

## EXECUTIVE SUMMARY

This RIS provides an analysis of options to address timing issues relating to deductions for aircraft overhaul expenses. As the issues relate to timing of deductions, the options are not intended to alter the total tax payable by commercial aircraft operators over the period of time an aircraft is owned by a taxpayer.

The options are considered in the light of the Civil Aviation Authority's rules concerned with the management of safety risks for operating an aircraft. These rules require aircraft components to be regularly overhauled if the aircraft owner wishes to retain the aircraft's certificate of airworthiness. The length of the overhaul period is normally determined by time in service and is usually termed the overhaul cycle. It is illegal to operate an aircraft without a current certificate of airworthiness.

The policy proposals in this RIS are intended to:

- be straight-forward to administer and to implement; and
- maintain the integrity and coherence of the tax system, including minimising impacts on tax payments.

The options discussed in this RIS were released for consultation in a targeted letter. This consultation letter sought comment on a range of options. The options all related to timing of deductions for aircraft overhaul expenses and whether the timing was consistent with the policy objective of imposing tax on the best approximation of economic income of taxpayers.

Three submitters commented on the options set out in the consultation letter. All submitters agreed that the selected policy option should:

- give a reasonable approximation of economic income arising from aircraft operations;
- be consistent with accounting principles;
- provide suitable transitional rules that minimised potential adverse impacts on cashflows; and
- address the relationship between the policy proposals and other specific rules in the Income Tax Act.

Submitters considered that the cost of aircraft engine overhauls was a major expense for aircraft operators and that economically the cost of an engine overhaul relates to income earned over the years from one overhaul to the next overhaul. However, submitters considered that the cost of other types of aircraft overhaul was not material relative to the value of the aircraft.

Some submitters noted that in the longer term, compliance costs would not be impacted significantly. However, submitters considered it was also important to ensure that transitional measures did not adversely impact on compliance costs.

Following consideration of submissions received, our preferred option is to use the spreading method for aircraft engine overhauls, with full transitional adjustments (transitional alternative 1 – see paragraph 55 on page 17). For compliance cost reasons, an exception is proposed for taxpayers required to prepare general purpose financial reports using International Financial Reporting Standards (IFRS) and also for single-aircraft operators.

The main impacts on the timing of deductions for engine overhauls under the spreading method are:

- A faster rate of deduction for the original cost of the overhaul component of an aircraft engine. This cost is spread across the overhaul cycle following acquisition (instead of over the estimated useful life of the aircraft taxpayers – a taxpayer favourable result); and
- Aircraft overhaul expenses are spread across the next overhaul cycle instead of being deducted under the "as incurred basis" or under the provisioning practice, in advance of the deduction being incurred (a taxpayer adverse result).

We also recommend that:

- If a non-engine overhaul is a significant cost relative to the value of the aircraft the spreading method should also apply, otherwise non-engine overhauls would be deductible as repairs and maintenance.
- For simplicity and compliance cost reasons, IFRS taxpayers be permitted to use for income tax purposes, the IFRS accounting method for on-balance aircraft and to agree with the Commissioner a methodology for making appropriate tax adjustments to the IFRS accounting treatment for off-balance sheet aircraft.
- For simplicity and compliance cost reasons, single-aircraft operators be permitted to elect to time deductions for aircraft overhaul expenses under the "as incurred basis".

## STATUS QUO AND PROBLEM DEFINITION

### Background: current regulatory environment

1. Under Civil Aviation Authority (CAA) rules for managing safety risks, an aircraft is not permitted to be in service unless it has a current airworthiness certificate. It is illegal to operate an aircraft without it having a current certificate of airworthiness.

2. To retain airworthiness status for an aircraft, a commercial aircraft operator must undertake a range of scheduled maintenance activities from time to time based on time in service. Scheduled maintenance activities are set out in either :

    - the manufacturer's maintenance programme; or
    - CAA approved variations from the manufacturer's maintenance programme for the aircraft, and its various sub-components, including aircraft engines, propellers, rotors, appliances, emergency equipment, and parts.

3. The scheduled maintenance programme consists of replacement of parts after stated periods of time in service (airworthiness limitations), hard-time maintenance when the aircraft or aircraft component is withdrawn from services (overhauls), and on-aircraft inspection. The overhaul of aircraft and aircraft sub-components are an essential part of the maintenance programme but an overhaul may also be required on an unscheduled basis, such as an aircraft engine overhaul that is required after a bird strike.

4. An overhaul of a sub-component is a major work carried out on specific instruments, mechanisms, equipment, part, or accessory (including airframe, aircraft engine, and propellers):

   - that are used in operating or controlling an aircraft ; and
   - which are identifiable by part number or serial number.

5. An overhaul is defined by the CAA as a major maintenance work in relation to an aircraft or aircraft component, which involves the "… *dismantling and complete testing to specification and renewal of operational life*." This definition indicates that:

   - each major aircraft sub-component could be regarded as a separately identifiable asset rather than as a sub-component of a single wider asset, the aircraft; and
   - overhaul expenses relate to the period following the overhaul (overhaul cycle).

6. An overhaul involving the airframe and aircraft engines will normally result in either:

   - the aircraft being removed from service while the overhaul is performed in the engineering workshop (workshop visit); or
   - larger aircraft operators may replace a specific major sub-component of the aircraft (aircraft component) so the aircraft can be returned to service at an earlier stage. For example some larger operators carry spare engines for this purpose.

7. Out-of-cycle maintenance occurs when a part requires repair or replacement at earlier times than scheduled, and is generally treated as ordinary repairs and maintenance. Out-of-cycle maintenance may also involve an overhaul, such as an overhaul of an engine after a bird strike.

### Status quo: timing rules

8. Under current tax law, aircraft overhaul expenses are normally treated as an allowable deduction, unless there is some major modification carried out that improves the performance of the aircraft component. A major modification of this nature would usually be a capital expense and depreciated.

9. An overhaul of some subcomponents, in particular the engine, is normally a material cost for any aircraft operator. Consequently, the timing of deductions for overhaul expenses impacts on the amount and timing of payments of income tax.

10. Currently, the main timing practices used in the aviation sector to allocate deductions for aircraft overhaul expenses either time deductions:

    - on the basis of future estimated overhaul expenses relating to each relevant sub-component. This practice is referred to as the "provisioning accounting practice" and is based on a now-withdrawn technical ruling of the Commissioner of Inland Revenue. Under this technical ruling, aircraft operators claimed overhaul deductions for future estimated expenses for each component rather than for historic cost of the last overhaul. The provisioning accounting practice had been followed by approximately 60% of aircraft operators; or

- to the year in which the overhaul expense is incurred. This is referred to as the "as incurred" basis. This practice is adopted by approximately 40% of aircraft operators and treats overhaul expenses as repairs and maintenance of a single operational asset.

## The problem

11. In general the tax system seeks to impose tax on the best approximation of economic income. However, the two main timing practices used by aircraft operators are not consistent with this objective (provisioning accounting practice and the "as incurred" basis).

12. Because an overhaul of an aircraft component is essential for allowing an aircraft to continue in service after the overhaul, economically, the costs of the overhaul relate to the period following the overhaul (overhaul cycle). The spreading forward of those deductions to match the income generated from the use of the aircraft would then give the best approximation of economic income.

13. The key problems for these two main timing practices are as follows:

    - The provisioning accounting practice does not spread an incurred expense. Instead it values aircraft overhaul expenses on the basis of estimated future overhaul costs that have not been incurred. This results in deductions being timed in advance of the expense being incurred and so does not match the cost of an aircraft overhaul with the income generated from using the overhauled aircraft component.
    - The as incurred basis does not appropriately match the cost of an aircraft overhaul with the income generated from using the overhauled aircraft component.

14. In addition, the technical ruling allowing the provisioning accounting practice to be used for income tax purposes has been withdrawn because Inland Revenue now considers the technical ruling is inconsistent with:

    - the legal tests for deductibility of expenses.
    - the general policy setting that deductions should not be allowed for provisions for future expenses.

15. Following the withdrawal of the technical ruling, Inland Revenue's current view of the law is that the as incurred basis would be the only timing method available for allocating deductions for aircraft overhaul expenses.

16. Each of these two timing practices gives rise to tax compliance costs for taxpayers and administration costs for Inland Revenue, and distortions as follows:

    - Under the as incurred basis for timing deductions, aircraft overhaul expenses gives rise to peaks and troughs in taxable income that are more closely aligned to net cash flows of the business than with the economic income of the business. This results in income tax being underpaid in some years (usually the year of overhaul), and overpaid in other years (the years between the overhauls).
    - Under the provisioning accounting practice income tax is underpaid in most years because overhaul expenses are based on estimates of future expenses. This underpayment of tax occurs because the estimate of future expenses is revised

annually by reference to current costs, which typically increase over the period between overhauls. This type of accounting results in a form of inflation-proofing in valuing overhaul expenses. The income tax system does not generally recognise the effect of inflation as a deductible expense.

- For small and medium sized enterprises (SMEs) using the as incurred basis, compliance costs include recording and tracking tax losses.
- For IFRS taxpayers using the as incurred basis, compliance costs include making ongoing adjustments between the timing treatment under IFRS and the as incurred basis.
- For companies using the provisioning accounting practice, the accruing provision must be recorded, updated each year, and ultimately adjusted against actual aircraft overhaul expenses incurred.
- As there is no common approach to timing deductions for aircraft overhaul expenses, all other things being equal, this can lead to aircraft operators not being treated equally in the same circumstances. This is a horizontal equity concern.
- The difference in timing rules also makes it more difficult for Inland Revenue to develop consistent and uniform risk assessment tools for the aviation sector. That may lead to a higher than necessary level of audit review in the sector.
- When contrasted against other existing timing rules for deductions relating to the cost of assets, the provisioning accounting practice provides an advantage to the aviation sector that is not permitted in other sectors of the economy.

17. These inconsistencies can give rise to both economic distortions and fiscal impacts. An example of an economic distortion that could arise for small and medium size enterprises occurs when special purpose financial reports are prepared for income tax purposes rather than being general purpose financial reports. The inappropriate timing treatment of overhaul expenses contained in such a special purpose report that is also used to make financing and investment decisions may result in those decisions being based on inappropriate information.

18. A fiscal impact arising from both timing practices is that income tax is underpaid in some years and overpaid in other years within each overhaul cycle. In addition, taxpayers are more likely to be exposed to penalties in which overpayment of tax occurs because there is an increased risk of underestimating the amount of provisional tax payable.

19. The timing problem is significant for the aviation sector because aircraft overhaul expenses, particularly for engines, is a major cost for any aircraft operator irrespective of the size of the business.

## OBJECTIVES OF THE REVIEW

20. The review is aimed at considering:

- the policy and legislative implications of Inland Revenue's view that the provisioning accounting practice does not give rise to an allowable deduction for the accruing provision;

- the administrative and compliance costs of potential alternative treatments of dealing with these overhauls for taxation purposes; and
- a range of timing rules for deductions of aircraft overhaul expenses in relation to the overall efficiency and coherency of the tax system; and
- views of significant stakeholders in the aviation sector.

21. Options for timing deductions of aircraft overhaul expenses will be evaluated against the following objectives:

    a. maintaining the efficiency and coherency of the tax system;

    b. consistency with the economic effect of the transaction;

    c. minimising tax and compliance costs for taxpayers;

    d. minimising administration costs for Inland Revenue;

    e. minimising the risk of non-compliance with CAA rules; and

    f. maintaining fiscal neutrality over the time the aircraft is owned.

22. This review is not intended to alter the general tax treatment for:

    - depreciable assets as a single operational unit but recognises some special characteristics of the aviation sector in relation to the overhaul of major sub-components of an aircraft; or
    - regular maintenance of aircraft; or
    - the capital revenue boundary in relation to an overhauled aircraft sub-component.

23. We also note that trade-offs will inevitably be made across the various objectives. For example, a solution that mandates one particular timing practice inevitably will result, during transition, in a minor increase in compliance cost for some taxpayers to ensure the overall objective of improving the efficiency of the tax system is achieved.

24. The question addressed in this RIS is whether the current timing rules for deductible aircraft overhaul expenses align with the policy objectives for imposing tax on the best approximation of economic income and, if not, how these timing rules can be improved.

## REGULATORY IMPACT ANALYSIS

25. Five options (including the status quo) are considered in this RIS for addressing the problem. They are:

- Option 1: As incurred method. The general deductibility and timing rules of the Income Tax Act 2007 are applied to determine deductibility and timing of aircraft overhaul expenses.
- Option 2: Spreading method. The deductible costs for an overhaul of an aircraft (for example, an engine) are spread forward over the period from the time of the overhaul to the next overhaul, on a usage basis (time in service). Within this option, we considered three possible transitional approaches.
- Option 3: IFRS method. The accounting treatment of overhaul costs under generally accepted financial accounting practice (IFRS) would be acceptable for income tax purposes. For owned assets, this method is similar to the spreading method but for assets treated as operating leases for IFRS purposes, this method is similar to the provisioning accounting method.
- Option 4: Provisioning accounting method. Legislation would authorise the provisioning tax accounting practice to allow deductions for provisions for future expenses.
- Option 5: Equalisation method. This method is based on the provisioning accounting practice. An aircraft operator makes tax deductible cash deposits into an aircraft overhaul account administered by the Commissioner of Inland Revenue. Withdrawals from the account would be offset against the cost of the actual overhaul.

26. All options other than option 1 (the status quo) would require amendments to the Income Tax Act 2007. This is discussed later in this RIS under the section "Implementation".

27. As an integrity measure, options 1, 2, and 3 also propose a claw-back of past provisions to ensure that a taxpayer would not have two deductions for the same expense. Under this accounting practice, the accumulated provision for future expenses is always reversed (netted off) against the actual expense when it is incurred. Options 1, 2, and 3 propose stopping provisioning, and therefore, it would be necessary to ensure that past deductible provisions were reversed against the actual overhaul expenses to give the same effect and ensure a second deduction is not allowed for that future overhaul expense.

28. Option 5 would require the Commissioner of Inland Revenue to establish a system to receive and pay out deposits.

29. If the Government decides not to pursue a legislative solution, taxpayers will be obliged to apply the current deductibility and timing rules (Option 1).

### Analysis of options against the objectives of the review

#### *Option 1: as incurred method*

a. *The efficiency and coherency of the tax system*: Option 1 is consistent with the general deductibility and timing rules of the Income Tax Act 2007 (the Act) and is well known and understood by taxpayers. However, the general deductibility and timing rules do not always result in an appropriate timing effect. In particular, for SMEs, option 1

gives rise to large variations in taxable income that are more closely aligned to the cash flows of the business rather than being aligned with the economic income of an aviation business.

b. *The economic effect of the transaction*: Option 1 is inconsistent with the economic effect of an aircraft engine overhaul, as an overhaul enables an aircraft to return to service. Deductions should be matched to the income generated after the aircraft returns to service following the overhaul.

c. *Minimising tax and compliance costs for taxpayers*: Option 1 is well understood by taxpayers and would not give rise to material impacts on compliance costs. However, as it gives rise to large variations in taxable income, tax is underpaid in some years and overpaid in other years. This also increases the exposure of aircraft operators to penalties and interest.

d. *Minimising administration costs for Inland Revenue*: Option 1 is well understood by Inland Revenue and would not give rise to any material effects on administration costs.

e. *Minimising the risk of non-compliance with CAA rules*: The economic returns in some aviation sectors are insufficient to provide for aircraft replacement, and the aircraft fleet in those sectors are aging. Compliance with CAA rules is a risk identified by a number of economic commentators and CAA itself. It is recognised that preparation of financial reports is a significant cost for smaller enterprises and that as many smaller-sized aircraft operators already use the current deductibility and timing rules little change in compliance cost would be expected if these taxpayers were permitted to elect to use option 1.

f. *Fiscal neutrality over the time the aircraft is owned.* All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

### *Option 2: spreading method*

a. *The efficiency and coherency of the tax system*; Option 2 is consistent with the policy objective that tax is imposed on the best approximation of economic income.

b. *The economic effect of the transaction*: Option 2 is consistent with the economics of an aircraft engine overhaul.

c. *Minimising tax and compliance costs for taxpayers*: Some increase in compliance costs would be anticipated for taxpayers currently using option 1. In general, no material effect on compliance costs is expected because the information is either already required under CAA rules and the cost information is readily available and is already used by many taxpayers. The timing of payments of income tax will change due to an incurred cost being spread over the period between overhauls.

d. *Minimising administration costs for Inland Revenue*: Option 2 is expected to result in better information for Inland Revenue, enabling better targeting of audit activity, and a resulting reduction in administration costs.

e. *Minimising the risk of non-compliance with CAA rules*: The compliance costs for option 2 would be expected to be significant for small operators, particularly in the

agricultural sector. Consequently an election to use option 1 is proposed to overcome this problem and thereby minimise the risk of non-compliance with the CAA rules.

f. *Fiscal neutrality over the time the aircraft is owned.* All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

### *Option 3: IFRS*

a. *The efficiency and coherency of the tax system*: Option 3 is consistent with the policy objective that tax is imposed on the best approximation of economic income.

b. *The economic effect of the transaction*: Option 3 is consistent with the economics of an aircraft engine overhaul.

c. *Minimising tax and compliance costs for taxpayers*: No material effect on compliance costs is expected for IFRS taxpayers, although their compliance costs would reduce. However, a significant increase in compliance costs would arise for non-IFRS taxpayers as recent reforms have removed the need for these taxpayers to prepare general purpose financial reports. The timing of payments of income tax will change due to an incurred cost being spread over the period between overhauls.

d. *Minimising administration costs for Inland Revenue*; Option 3 is expected to result in better information for Inland Revenue, enabling better targeting of audit activity, and a resulting reduction in administration costs.

e. *Minimising the risk of non-compliance with CAA rules*; the compliance costs for option 3 would be expected to be significant for small operators, particularly in the agricultural sector. Like option 2, an election to use option 1 is proposed to overcome this problem.

f. *Fiscal neutrality over the time the aircraft is owned.* All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

### *Option 4: Provisioning accounting method*

a. *The efficiency and coherency of the tax system*: Option 4 is inconsistent with the coherency of the tax system In particular; the estimates of future expenses under the provisioning accounting practice are revised annually and so include an inflationary element. Current tax policy settings do not allow deductions for inflation adjusted amounts, nor do they allow a deduction for provisions for future expenses that have not been incurred. Allowing option 4 would create an incentive for other sectors to seek similar treatment.

b. *The economic effect of the transaction*: The valuation of the expense (estimated future expenses) is inconsistent with the economic effect of the transaction which would normally seek to match the value of the expense with the income generated from the aircraft after it is returned to service.

c. *Minimising tax and compliance costs for taxpayers*: This method would increase compliance costs for taxpayers currently using option 1. In general, no material effect on compliance costs is expected because the information is either already required under CAA rules and the cost information is readily available and is already used by

many taxpayers. The timing of payments of income tax will change due to an incurred cost being spread over the period between overhauls.

d. *minimising administration costs for Inland Revenue*: Option 4is expected to result in better information for Inland Revenue, enabling better targeting of audit activity, and a resulting reduction in administration costs

e. *Minimising the risk of non-compliance with CAA rules*; the compliance cost for option 3 would be expected to be significant for small operators, particularly in the agricultural sector. An election to use option 1 is proposed to overcome this problem.

f. *Fiscal neutrality over the time the aircraft is owned*: All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

### *Option 5: Equalisation method*

30. The same observations regarding option 4 apply equally to option 5. Other observations on the objectives of the review that are specific to option 5 are set out below.

a. *The efficiency and coherency of the tax system*: This option increases the complexity in the tax system. Cash deposits made represent an increase in a sinking fund to provide financing for the next overhaul. .

b. *The economic effect of the transaction*: Depositing cash up to the level of the provision made is inconsistent with the economics of the overhaul process.

c. *Minimising tax and compliance costs for taxpayers*: option 5 would increase compliance costs for taxpayers currently using Option 1. Tax payments for taxpayers using the provisioning accounting practice would be unaffected if cash deposits were made. However, it was recognised that there had been little uptake within other equalisation schemes introduced to allow deductions for cash deposits backed by provisions recorded in general purpose financial reports.

d. *Minimising administration costs for Inland Revenue*. This option would increase administration costs for Inland Revenue as a system would need to be established for option 5.

e. *Minimising the risk of non-compliance with CAA rules*: The compliance cost for option 3 would be expected to be significant for small operators, particularly in the agricultural sector. An election to use option 1 is proposed to overcome this problem.

f. *Fiscal neutrality over the time the aircraft is owned*: All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

### Impacts of each feasible option:

The analysis of each option against the objectives of the review and the economic, fiscal, compliance and administrative impacts are summarised in table 1: *Summary of analysis: objectives and impacts.* Some further specific observations on economic and compliance impacts follow table 1.

## *Table 1 Summary of analysis: objectives and impacts*

| Description | Meets objectives | IMPACTS | | | | | Net impact |
|---|---|---|---|---|---|---|---|
| | | **Economic impact** | **Fiscal impact over five years** | **Compliance impacts** | **Administration impacts** | **Risks** | |
| *Option 1: As incurred method* | *(a) and (c)) partly,*<br>*(b) no*<br>*(d),(e), and (f) yes* | *Understates income in year of overhaul. Overstates income in other years.*<br>*Inconsistent with economics of overhauls for aircraft engines.* | *$11 million positive.* | *Tax accounting practice is inconsistent with business management and investment decision needs.* | *Impact on provisional tax flows potentially affects risk assessment models* | *Potential exposure to penalties.* | *Does not address the problem.*<br>*Not recommended.* |
| *Option 2: Spreading method* | *(a), (b), (d), (e) and (f) yes*<br>*(c)mostly* | *Consistent with economics of overhauls.*<br>*Removes potential for distortions in business and financing decisions inherent in existing practices.* | *$30 million positive.* | *Negligible impact for most taxpayers as it is consistent with general accounting principles.*<br>*Minor cost in transition in calculating transitional adjustments.* | *Post-implementation review of compliance by Inland Revenue* | *Potential for non-compliance by smaller sized SMEs* | *Addresses the problem.*<br>*Consistent with policy objectives and with information needs for business management.*<br>*Specific concerns about compliance costs for single aircraft operators.*<br>*Recommended method.* |
| *Option 3: IFRS method* | *(a), (b) and (d) yes*<br>*(c) partly*<br>*(e) yes*<br>*(f) yes* | *Consistent with economics of overhauls.*<br>*Removes potential distortions in business and financing decisions inherent in existing practices.* | *$30 million positive.* | *Compliance costs increase significantly for taxpayers not required to prepare general purpose finance reports (most taxpayers in the aviation sector).* | *Post-implementation review of compliance by Inland Revenue*<br>*Minor compliance costs in calculating transitional adjustments* | *Potential for non-compliance by smaller sized SMEs* | *Addresses the problem.*<br>*Consistent with policy objectives and with information needs for business management.*<br>*Specific concerns about compliance costs for non-IFRS taxpayers.*<br>*Not recommended.* |
| *Option 4: Provisioning accounting method* | *(a,) (b)and (c) no*<br>*(d), (e) and (f) yes* | *Consistent with economics of overhauls.*<br>*Consistently overstates value of overhaul expenses in years between overhauls.* | *$60 million negative.* | *High compliance costs for aircraft operators not required to prepare general purpose financial reports. .* | *Post-implementation review of compliance by Inland Revenue*<br>*Minor compliance costs in calculating transitional adjustments* | *Potential for non-compliance by smaller sized SMEs* | *Partly addresses the problem but overstates the value of overhaul expenses.*<br>*Not recommended.* |
| *Option 5; Equalisation method* | *(a), (b), (c) and (d) no*<br>*(e) and (f) yes* | *Consistent with economics of overhauls.*<br>*Consistently overstates value of overhaul expenses in years between overhauls.*<br>*Cash deposited earns lower rate of return that when invested in the business,* | *$60 million negative.* | *High compliance costs for aircraft operators not required to prepare general purpose financial reports.* | *Post-implementation review of compliance by Inland Revenue*<br>*Minor compliance costs in calculating transitional adjustments* | *Equalisation measures may not be adopted.*<br>*Potential for non-compliance by smaller sized SMEs.* | *Partly addresses the problem but overstates the value of overhaul expenses.*<br>*Not recommended.* |

### *Economic impacts*

31. Options 2 and 3 were the only options were consistent with policy objective that timing of deductions should appropriately reflect the economics of transactions and with the objectives of a coherent tax system of using common valuation bases (i.e. the historic cost basis) across timing rules. It was also clear that option 1 was not preferred by most submitters.

32. Other potential economic impacts considered were:

- The potential impact on cash flows in transition for taxpayers using the provisioning method. Potential impacts on cash flows in transition are addressed by matching the reversal of the provision to the future expenses for which the provision was made.
- Whether complying with the spreading method might impose a disproportionate compliance burden on single-aircraft operators. This potential impact is addressed by permitting single-aircraft operators to elect to apply option 1 instead of using option 2.

### *Fiscal impacts*

33. The estimated fiscal impact for each option is based on the same data set and relate to aircraft engine overhauls only. The estimated fiscal impacts are for a period of five years following the proposed year of implementation (2017-18 income year). All of the fiscal impacts relate to timing of deductions and would reverse out over the period of ownership of the aircraft.

### *Compliance impacts*

*Small and medium size enterprises*

34. Permitting smaller sized taxpayers to elect out of the recommended option (option 2) and instead use the current deductibility and timing rules for aircraft overhaul expenses (option 1) is supported on compliance cost grounds. Many smaller-sized taxpayers already use the current deductibility and timing rules and little change in compliance costs would be expected if this concession were adopted. Submitters suggested this threshold could be set at single-aircraft taxpayers.

*IFRS taxpayers*

35. IFRS taxpayers are those required to comply with international financial reporting standards. IFRS taxpayers required to treat aircraft overhaul expense in two different ways depending on whether the aircraft is on-balance sheet or off-balance sheet:

- For on-balance sheet aircraft, aircraft overhaul expenses are spread evenly across the overhaul cycle. The original cost of the overhaul component is spread across the first overhaul cycle.
- For off-balance sheet aircraft, aircraft overhaul expenses are spread using the provisioning accounting method. Off-balance sheet aircraft are leased aircraft that are treated as operating leases under IFRS.

36. For on-balance sheet aircraft, it is considered that compliance costs would be reduced if their treatment of aircraft overhaul expenses under IFRS could be used for income tax purposes.

37. However, leases of off-balance sheet aircraft are generally finance leases for income tax purposes. Aircraft leased under a finance lease are treated as owned for income tax purposes, irrespective of the treatment under IFRS. There are significant differences in the treatment of lease expenses for off-balance sheet aircraft between IFRS and the tax finance lease rules. This is illustrated Table 2.

***Table 2: compare IFRS to finance lease rules***

| | **IFRS** | **Tax finance lease rules** |
|---|---|---|
| *Lease payment* | *Expensed* | *Interest component – a deduction* |
| *Asset* | *Off-balance sheet* | *Cost of entire asset capitalised and depreciated, capital portion of lease payment treated as loan repayment.* |
| *Aircraft overhaul expenses* | *Provisioning accounting practice* | *As incurred (as stated in annual reports)* |

38. Given the differences in accounting treatment for off-balance sheet aircraft between IFRS and tax law, it is considered that Inland Revenue should continue to consult on developing an agreed method for making appropriate tax adjustments relating to off-balance sheet aircraft of IFRS taxpayers.

*Non-engine overhauls*

39. Consultation indicated that most taxpayers consider overhaul costs of a non-material nature should be treated as repairs and maintenance. For compliance cost reasons, it is considered that non-engine overhauls that are non-material relative to the value of the aircraft should be treated as repairs and maintenance in line with the principles set out in the Commissioner's Interpretation Statement 12/03: *Income tax – deductibility of repairs and maintenance Expenditure – general principles*.

### Social, cultural or environmental impacts

40. None of the options have social, cultural or environmental impacts.

## CONSULTATION

41. Policy proposals were provided in a consultation letter to the Aviation Industry Association of NZ (Inc.), Air New Zealand, Jetstar (New Zealand), the Ministries of Business Innovation and Employment, Primary Industries, Tourism and Transport, Tourism New Zealand, and the New Zealand Institute of Chartered Accountants (now Chartered Accountants Australia and New Zealand). The consultation was limited to interested parties on the basis that the proposals related to complex technical aspects relating to tax accounting for aircraft operators.

42. Written submissions were received and considered, and a series of follow-up meetings held with those submitters who sought to continue the dialogue on a range of complex technical issues.

43. Submitters indicated that a single approach to the deductibility and timing of aircraft overhaul expenses was preferred. An approach that resulted in financial reports reflecting the economic income of an aircraft operation was considered to be a high priority as this information was relevant to management and financing decisions, as well as for calculating income tax payable.

44. The Aviation Industry Association and Chartered Accountants Australia and New Zealand both indicated their first preference was to codify the provisioning accounting practice. However, both bodies also recognised that adopting this alternative would give rise to a distortion in the tax system by allowing deductions for estimated future expenses that had no relationship with current periods of time. This distortion could give rise to pressures from other sectors seeking deductibility of provisions for future expenses.

45. Submitters considered that the accounting methodology for the spreading method:

- is not a new accounting practice; and
- would be consistent with the objective of providing the best approximation of economic income for the assessment of income tax.

46. The IFRS method was preferred by IFRS users but not by other submitters. IFRS taxpayers consider that allowing IFRS to be acceptable for income tax purposes would reduce compliance costs. The cost of complying with IFRS is significant as it applies to all balance sheet and income statement items, and not just assets. Non-IFRS submitters considered that its cost would outweigh the benefits of improved financial reporting.

47. The equalisation method was considered possible but would create an administration overload for taxpayers and for Inland Revenue.

48. Submitters also suggested that whether all aircraft overhaul costs should be subject to a timing rule should be considered in the light of Inland Revenue's interpretation statement concerning the deductibility of repairs and maintenance (*IS12/03: Income tax – deductibility of repairs and maintenance expenditure – general principles*). In that interpretation statement, the materiality of an overhaul expense relative to the aircraft as a whole is an important aspect in determining whether an expense is treated as repairs and maintenance; or treated as a capital expense (and a deduction for that expense spread under a timing rule).

## CONCLUSIONS AND RECOMMENDATIONS

49. We recommend option 2 under which:

- Non-IFRS taxpayers would spread aircraft engine overhaul deductions over the period following the overhaul up to the next overhaul by reference to the use of the aircraft.
- IFRS taxpayers may use the IFRS treatment for owned aircraft for income tax purposes.
- IFRS taxpayers may make appropriate tax adjustments to their reported IFRS income for aircraft treated as operating leases for financial reporting purposes.

- For administration cost reasons, the IFRS treatment would apply only in relation to IFRS taxpayers resident in New Zealand or for non-resident IFRS taxpayers, for aircraft registered with the Civil Aviation Authority.
- Single-aircraft operators could elect to apply Option 1.
- Transitional adjustments would be made to align the tax values of existing aircraft engines with the recommended method.
- A transitional adjustment would be made to apply the recovery of past provisions for aircraft overhaul expenses against the next aircraft engine overhauls.

50. The proposals would be consistent with:

- the objectives of both general purpose financial reporting (IFRS) and special purpose financial reporting to provide useful management and financing information.; and
- The usual matching of deductions for assets used over a period of time with the income generated from the use of the asset.
- Aircraft operators be defined to exclude non-commercial, non-powered aircraft, drones, and microlights.

While there may be some increased compliance costs (compared to the status quo) in the transitional period in calculating the one-off deduction for aircraft engines, this is adequately compensated by the deduction in the short term. There are not expected to be significant additional compliance costs otherwise.

## IMPLEMENTATION

51. The proposal is intended to work in harmony with the Civil Aviation requirements for aircraft operators. Aircraft operators must retain logbooks keeping up to date information on the time in service and service of the aircraft, propellers, engines and other airworthiness directives.

52. We considered three approaches for transitioning to the recommended spreading method, including whether to allow a deduction for a catch-up adjustment (see Table 3 following).

53. Transitional adjustments include:

- A catch-up adjustment relating to the undepreciated value of the aircraft overhaul component at transition.
- Reversing past provisions for future aircraft overhaul expenses that have previously been allowed as deductions under the administrative ruling given in a now-withdrawn technical ruling.
- Depreciation on the component would stop, resulting in reduced depreciation deductions in the future. However, this is because the undepreciated value of the component would have been adjusted in transition.

54. The catch up adjustment relates to depreciation of the original cost of acquiring an aircraft engine overhaul component. For example, if that cost was $1 million, under current law the cost would be spread over 15 years under the depreciation rules. Under the proposed spreading method, that cost would be spread over the first overhaul cycle. The catch-up adjustment ensures that any remaining undepreciated value of an existing aircraft overhaul

component is aligned to the spreading method treatment and is taxpayer friendly. Assuming this undepreciated value was $600,000 at transition, this value would be:

- an allowable deduction in transition, if the component has completed its first overhaul prior to transition; or
- if the component had not been overhauled since acquisition, spread across the period from transition up to the first overhaul.

***Table 3: Transitional approaches***

| | **Fiscal impact over 5 years** | **Transitional impact** | **Effect on taxpayer** |
|---|---|---|---|
| *Approach 1:* | *$30 million positive* | *Catch-up deduction allowed for all aircraft.*<br>Depreciation stops on overhaul component for all aircraft because depreciation values taken into account in catch-up deduction.<br>Past provisions for future aircraft overhaul expenses are reversed.<br>Future deductions for overhaul expenses spread across overhaul cycle (for all aircraft). | *Taxpayer friendly result*<br>*Taxpayer neutral result*<br>*Taxpayer adverse result* |
| *Approach 2:* | *$116 million positive* | *No catch-up deduction allowed for all aircraft.*<br>Depreciation stops on overhaul component for all aircraft, and undepreciated value taken into account on disposal of the aircraft.<br>Past provisions for future aircraft overhaul expenses are reversed (for all aircraft). | *Taxpayer adverse result*<br>*Taxpayer adverse result* |
| *Approach 3:* | *$9 million positive* | *Spreading rules apply only to aircraft acquired after implementation.*<br>No catch-up deduction allowed for all aircraft.<br>The cost of the aircraft engine component would be spread across the first overhaul cycle<br>Existing aircraft apply the "as incurred basis" and existing depreciation rules. | *Taxpayer adverse result*<br>*Taxpayer friendly result*<br>*Taxpayer adverse result* |

### *Analysis of transitional approaches*

*Approach 1*

55. This approach is consistent with the economics of the overhaul process, and would be consistent with the objective that the tax system should not distort investment decisions (objective (a): efficiency and coherency of the tax system).

56. There would be one-off compliance costs in transition for calculating the one-off transitional adjustments. It is considered that these costs are more than outweighed by the benefit of the catch-up adjustment as the fiscal estimate includes a fiscal cost in transition of approximately $33 million which is recovered within 2 years. Submitters consider this approach is appropriate if the recommended spreading method is adopted.

*Approaches 2 and 3*

57. Both of these approaches are inconsistent with the economics of the overhaul process for existing aircraft. The deferral of the depreciation deductions until disposal of the aircraft may incentivise taxpayers to either replace existing aircraft earlier than anticipated or to enter into sale and leaseback arrangements to obtain the benefit of the accelerated deductions for the overhaul components.

58. There would be negligible impact on compliance costs in transition as there are no significant transitional adjustments.

*Preferred transitional approach - conclusion*

59. We prefer approach 1 because it is consistent with the economics of the overhaul process, is consistent with the objectives that the tax system does not distort investment decisions (objective (a): efficiency and coherence of the tax system), and takes into account the concern in submissions that transitional options should not adversely impact on cash flows.

60. All three approaches give timing related fiscal related impacts which all reverse out over the period of ownership of the asset.

### *Further implementation details*

61. The recommended option and transitional approach would be included in the first available tax bill scheduled for introduction in 2016.

62. Owing to the complex technical nature of the issues, draft legislation would be provided to key stakeholders for comment. This consultation would be completed later in 2015.

63. The recommended option and transitional approach is proposed to apply from the beginning of the 2017-18 income year. This date is selected to allow taxpayers sufficient time to understand the technical requirements of the recommended option and transitional approach.

64. When introduced into Parliament, commentary will be released explaining the amendments, and further explanation of their effect will be contained in a Technical Information Bulletin item to be released shortly after the bill receives Royal assent. Normal submission processes occur when the bill is referred to the Finance and Expenditure Committee.

65. The recommended option and transitional approach would have no systems implications for Inland Revenue but may result in some additional administration costs, such as costs associated with publications to communicate the changes and to monitor and evaluate compliance with the changes. However, these costs are expected to be minor and would be met within existing baselines.

## MONITORING, EVALUATION AND REVIEW

66. In general, Inland Revenue's monitoring, evaluation, and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design and implement tax policy since 1995.

67. The final stage in the GTPP contemplates the implementation and review stage, which can involve post-implementation review of the legislation and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme and proposals would go through the GTPP.

68. Inland Revenue's normal assurance activity will evaluate and review that the preferred option achieves its intended policy objectives, as set out in paragraph 21 of this RIS.

**REGULATORY IMPACT STATEMENT**

## Cross government sharing of tax information

### Agency disclosure statement

This regulatory impact statement has been prepared by Inland Revenue. It provides an analysis of the options to address the difference in scope between the tax secrecy exception in section 81A of the Tax Administration Act 1994, which enables the sharing of personal information only, and what can be shared under an Approved Information Sharing Agreement (AISA) under the Privacy Act 1993, being both personal and non-personal information.

To support the benefits intended under the AISA framework, the Minister of Revenue has asked officials to report on extending the current tax secrecy provision to enable sharing of non-personal information under an AISA. The Minister of Revenue has asked that this amendment be included in the next tax omnibus bill to be introduced in mid-April 2016. The options in the attached statement, and the time to consider these options, have been constrained as a result.

Officials have consulted with the Office of the Privacy Commissioner, the Treasury, New Zealand Police and the Ministry of Justice. There were no concerns raised in the feedback and all four agencies support the proposed amendment.

None of the policy options restrict market competition, impair property rights, reduce incentives for small businesses to operate, or override fundamental common law principles.

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23 February 2016

## STATUS QUO AND PROBLEM DEFINITION

1. Inland Revenue's tax secrecy laws cover 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. Tax secrecy is a longstanding and important concept. It is consistent with international norms (and with the basic premise of the Privacy Act), has a perceived positive impact on compliance and has a clear role as a balance to Inland Revenue's broad information-collection powers.

2. However, the operation of Government requires that the tax secrecy requirements be balanced against wider objectives and the need to share information with other agencies. Over time a number of exceptions to the strict tax secrecy rule have been introduced, the majority of which involve cross-government information sharing. These exceptions reflect the balancing of the principles of tax secrecy against the need to support economic efficiency and growth, and wider government outcomes.

3. Section 81A of the Tax Administration Act 1994 allows the sharing of personal information under an Approved Information Sharing Agreement (AISA). An AISA is a legal mechanism, provided for by the Privacy Act 1993, which authorises the sharing of information between or within agencies (or between a government agency and a non-government agency) for the purpose of delivering public services. AISAs can be used to share personal information, or both personal and non-personal information such as company or partnership information. AISAs cannot be used to share solely non-personal information. If there is a need to share solely non-personal information then this would need to be addressed through some other legislative mechanism.

4. AISAs are not the only legislative avenue available for cross-Government sharing of tax secret information. Subsection 81(4) of the Tax Administration Act also allows for sharing in certain specified cases, and the list currently includes a number of specific provisions for sharing with other agencies. However, the AISA process is preferable because it facilitates the meeting of privacy expectations and is capable of providing increased certainty, transparency and accountability for agencies and the public.

5. A further advantage of pursuing options under an AISA is that, while the AISA framework is stable and well understood, the wider tax secrecy provisions including the section 81(4) exceptions are presently subject to a policy review of the Tax Administration Act. Public consultation was conducted over 2015 and, where possible, it would be appropriate to avoid pre-empting the outcome of this review with further amendments to the wider secrecy provisions.

6. The tax secrecy exception under section 81A of the Tax Administration Act provides only for the sharing of personal information under an AISA, precluding the sharing of both personal and non-personal information. The difference in scope between the exception to tax secrecy legislation and what AISAs can share unduly limits the ability of Inland Revenue to use AISAs. If the status quo remained it would limit the future ability of Inland Revenue to fully contribute to the Government's Better Public Services reforms of a more collaborative, cross-agency approach to supporting citizens and gaining efficiencies.

7. An example of this is the AISA between Inland Revenue and the New Zealand Police for the sharing of information to help fight serious crime. Although the New Zealand Police

can request personal information under the current agreement, non-personal information about companies or other entities that are used in committing serious crimes cannot be shared. Information held by Inland Revenue, which would be useful to Police, is often a mixture of personal and non-personal information and it is difficult to separate the information out without affecting its usefulness. New Zealand Police would like to access both personal and non-personal information under the current serious crime AISA.

8. This regulatory impact statement outlines options to address the limit on cross-Government sharing of tax secret information relating to personal and non-personal information.

## OBJECTIVES

9. The objectives against which the options have been assessed are:

- *Fairness and equity:* to support fairness in the public sector, options should, to the extent possible, seek to treat similar taxpayers in similar circumstances in a similar way.

- *Efficiency of compliance and administration*: the impacts on taxpayers of compliance with the rules and the administrative impacts on the government should be minimised as far as possible.

- *Sustainability of the public sector:* Rules for cross-government sharing of tax information should promote the integrity of and compliance with the law.

10. These objectives are weighted equally.

### Constraints

11. To contribute to the Government's Better Public Services reforms of a more collaborative, cross-agency approach to supporting citizens and gaining efficiencies, there is a move to remove the barriers to sharing information among government agencies. The current cross-agency initiatives have pressing timelines. The Minister of Revenue has directed officials to prepare changes to tax secrecy legislation that enable sharing of both personal and non-personal information under an AISA. The direction was for these changes to be included for inclusion in the next omnibus tax bill, which is scheduled for introduction in April 2016. The next opportunity would be to include the changes in the next tax omnibus bill which is scheduled to be introduced in November 2016. This would further delay the application date of the changes, which would be undesirable because the legislative issue identified represents a major restriction on progress. This timeframe has limited the options officials could consider and the analysis of those options.

## REGULATORY IMPACT ANALYSIS

12. The three options considered for addressing the problem are:

- Option 1: Retain the status quo of sharing only personal information under an AISA.
- Option 2: Amend the secrecy exception under section 81A of the Tax Administration Act to enable the sharing of information relating to both individuals and non-individuals under an AISA; and
- Option 3: Amend the secrecy exception under section 81(4), which allows disclosure of tax secret information in certain cases, to include cross-Government sharing of information relating to non-individuals for certain purposes.

13. The table below summarises our assessment of the options against the objectives of fairness and equity, efficiency of compliance and administration, and the sustainability of the public sector.

| Options | Fairness and equity | Efficiency of compliance and administration | Sustainability of the public sector |
|---|---|---|---|
| 1. Retain the status quo of sharing only personal information under an AISA | **Not met**<br><br>The Tax Administration Act does not enable full use to be made of the AISA regime to share information as it only applies to personal information.<br><br>Government departments administer the laws under their control based on the information available to them. When information is not able to be shared between departments there is a chance that people or entities can take advantage of departments not having a common understanding. | **Not met**<br><br>Compliance by an individual may be adversely affected if they perceive that others are able to avoid complying with their public obligations, due to a lack of information sharing. | **Not met**<br><br>Can undermine the integrity of the public sector if those not entitled to receive an entitlement or those not complying go unpunished. |

| Options | Fairness and equity | Efficiency of compliance and administration | Sustainability of the public sector |
|---|---|---|---|
| 2. Amend the tax secrecy exception for sharing under an AISA to enable the sharing of non-personal information. *(Preferred option)* | **Met**<br><br>This option is fairer and more equitable than the status quo. Individuals and non-individuals are treated equally as information about both can be shared.<br><br>Enables greater access to information regarding non individuals and will enable enforcement of obligations to be better targeted. | **Met**<br><br>There is potential for both a small increase in Inland Revenue administration costs (in providing additional information to other agencies) and benefits to Inland Revenue as a result of receiving more information from other agencies.<br><br>There will also be reduced compliance costs for the entity through not providing the same information twice.<br><br>Compliance impacts could be mixed for this option. Those who perceive non-compliance by others being punished could increase their own compliance. However, those who see tax information being shared with others may not provide tax information to Inland Revenue, thereby undermining tax compliance. | **Met**<br><br>Overall, supports the integrity of the public sector, including enforcement of the law. However, entities may be more hesitant to provide Inland Revenue information. But on the other hand, more sharing could improve the general public's perception of government being joined-up. |
| 3. Amend the secrecy exception for disclosure of tax secret information in certain cases, to include cross-Government sharing of information relating to non-individuals. | **Met**<br><br>This option would allow sharing to avoid people or entities taking advantage of departments lacking a common understanding, However, the AISA framework provides greater transparency, certainty and accountability both for agencies using the process and for the public. | **Partially met**<br><br>Same as option 2. However, this option would involve an extra administrative cost of developing a new exception to tax secrecy laws, despite the prior existence of the AISA framework. | **Partially met**<br><br>Same as option 2. However, this option would lack the advantages attached to the AISA framework in terms of consistency and certainty across agencies. |

12. There are no revenue, economic, social, environmental or cultural impacts from the two options.

## CONCLUSION

13. Officials recommend option 2, to amend section 81A of the Tax Administration Act to enable the sharing of information about non-individuals under an AISA. Under this option, greater access to information will enable a fairer and more equitable enforcement of obligations and support the integrity of the public sector.

## CONSULTATION

14. Officials have consulted with the Office of the Privacy Commissioner, the Treasury, and New Zealand Police on this issue. The consultation took the form of discussions with agency representatives on the proposals and each agency has been provided with the Cabinet paper for comment. There were no concerns raised in feedback. All three agencies support option 2.

15. The Office of the Privacy Commissioner is satisfied that option 2 is consistent with the scope of the AISA framework for government information sharing, as provided in the Privacy Act, and that option 2 would properly align the tax secrecy provisions with the AISA mechanism.

## IMPLEMENTATION

16. The recommended option will require an amendment to the Tax Administration Act 1994. It is proposed that option 2 be included in a bill to be introduced into Parliament in mid-April this year. Inland Revenue will include an explanation of this change in the commentary on the bill. There will be an opportunity for public comment on the proposed amendment during the select committee stage of the bill. If enacted, a publicly available Tax Information Bulletin will include an explanation of the amendment. Following enactment, AISA agreements can be entered into or amended by way of an Order in Council to provide for the sharing of personal and non-personal information.

17. Inland Revenue and the relevant other agency will administer the AISA agreements.

## MONITORING EVALUATION AND REVIEW

18. Inland Revenue will monitor the outcomes of the change pursuant to the Generic Tax Policy Process (GTTP) to confirm that they match the policy objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

19. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation, and the identification of remedial issues. Post-implementation review is expected to occur around 12-months after implementation. Opportunities for external consultation are built into this stage. Any necessary changes identified as a result of the review would be recommended for addition to the Government's tax policy work programme.

# Regulatory Impact Statement

## Exempting councils from the land tainting tax rules

## Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to address problems with the "land tainting rules" in the Income Tax Act 2007. The land tainting rules were introduced to combat tax avoidance, but overreach by taxing land that is used in business where there is no tax avoidance concern. As a result, these rules distort decision making – for example, a decision to keep or sell land may be driven by tax, rather than what makes the most economic sense. Further, the rules increase compliance costs as businesses obtain legal advice to mitigate the impact of the rules, and monitor purchase dates and the length of land ownership in order to determine whether a disposal is taxable under the rules. An example, discussed in this RIS, of where this is occurring is in the context of Auckland Council.

The preferred option removes the overreach of the rules and the associated economic distortions and compliance costs for council groups by exempting them from the associated persons provisions in the tainting rules. However, this option would not resolve the issue for other taxpayers affected by the rules.

A key gap in the analysis is that Inland Revenue does not hold sufficient data to provide an estimate of the fiscal impact of the options. An assumption made was that council groups would restructure if an amendment is not made. Without this assumption, options 1 and 2 would have fiscal impacts.

Inland Revenue has consulted the Treasury, the Department of Internal Affairs, Auckland Council, and Auckland Council's tax advisors. These parties are supportive of the conclusion reached in this RIS.

Other affected taxpayers were not consulted because of time constraints – Auckland Council seeks assurance as soon as possible that a legislative amendment will be made in order to provide certainty of tax treatment, so that development activities proposed to be undertaken by Development Auckland do not distort the decision making of the Auckland Council group. This time constraint has meant that one of the options – extending the business premises exclusion in the land tainting rules - was not able to be fully considered.

None of the policy options would impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles.

Mike Nutsford
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4 February 2016

## STATUS QUO AND PROBLEM DEFINITION

### Current tax rules

1. Generally, the proceeds from the disposal of land held on capital account are not taxable. However, in certain circumstances, the proceeds are taxable under the land disposal provisions contained in sections CB 6 to CB 23B of the Income Tax Act 2007. The sections that most commonly apply to land owners who are not land dealers, developers or builders, provide that the proceeds from the disposal of land are generally taxable if:

- the land was acquired for the purpose or with the intention of disposal (section CB 6); or
- the land was acquired for the purposes of a business relating to land (section CB 7).

2. Part of the land disposal provisions are the "land tainting rules" which are contained in sections CB 9 to CB 11 of the Income Tax Act. For the purposes of this RIS, the relevant parts of the legislation are sections CB 9(2), CB 10(2) and CB 11(2) of the Income Tax Act 2007. These provisions include in the tax base land owned by an associated person of a land dealer, developer or builder, if it is acquired or improved at the time the dealer, developer or builder was in business and is disposed of within 10 years of acquisition or improvement.

3. The Income Tax Act provides rules that govern where a person is associated with another person[1]. Generally speaking, a person is associated with another where there is a sufficiently close relationship between the two parties. The most relevant test for the purposes of this RIS is the company association rule, which provides that two companies are associated where a group of persons hold voting interests in each company of 50% or more.

### *Policy intention behind the land tainting rules*

4. Before the land tainting rules were introduced there were evidentiary problems with proving a person's purpose or intention, which meant that a developer was able to avoid tax by claiming that properties were held as investments[2] or by holding properties in the name of an associated person[3].

5. To combat this tax avoidance, in 1973, the Government introduced the land tainting rules.[4] These rules supplement the purpose/intention test[5] by providing an objective "bright line" rule under which developers and persons associated with them are taxed on land disposals made within 10 years of purchase or improvement. As purpose or intention are not part of the tainting rules, the associated evidentiary problems and tax avoidance no longer occur.

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1 "Person" is used in a broad sense encompassing companies, persons acting in capacity as a trustee etc., as well as natural persons.

2 Dealers would buy and sell regularly under the "purpose" of acquiring better investments and thereby avoid tax.

3 The associated person would not be assessed on the sale as the taxing provisions required them to acquire the land for the purpose of selling it or to have acquired the land for a business of dealing in property. As both of these factors are established by a pattern of activity (among other things), it was very difficult to apply these provisions to a one-off venture.

4 Sections CB 9 and CB 11 were introduced in 1973. Section CB 10 was introduced in 1983 to ensure that land developers and subdividers were also caught by the land tainting rules.

5 "Intention" was not introduced into the rules until 1973. Before 1973 there was a "purpose of sale" rule.

6. Although it was recognised that such a blanket rule could result in capital account land being subject to tax in certain circumstances, it was a deliberate decision by Parliament that all gains on land sold by property developers and associated persons within 10 years of acquisition should generally be taxed.

### *Exclusions from the rules*

7. In order to reduce the circumstances in which the tainting rules would tax capital account land, residential land and business premises are excluded from the rules. For the purposes of this RIS, the business premises exclusion contained in section CB 19 is the most relevant. Put simply, this provision excludes from the tainting rules premises that are occupied mainly to carry on a substantial business.

## The problem

8. The tainting rules are overreaching by taxing capital account land used in businesses of persons associated to a property developer in situations where there is no tax avoidance concern.

### *Capital account land used in business*

9. The business premises exclusion is narrower than is required to ensure the tainting rules achieve their objective of combating tax avoidance. For example, it has been held that:

- The provision only applies to land with buildings on them, not to a business solely involving land.
- The land must be physically occupied by the taxpayer.
- The taxpayer is required to be carrying out their business operations from the property because of the definition of "occupation" and that "carry on" implies a repetition of acts or a habitual course of conduct, which is to occur "from" the premises.
- Substantial business must be carried on from the land – for example, it has been held that a storage facility does not fall within the exemption.

10. It is fact specific as to what falls within the ambit of this provision. For the most part, a person associated with a developer would not be taxed on land they dispose of that has been used as their business premises. However, there could be circumstances in which capital account land used in the business does not fall within the exemption and, therefore, is subject to tax. It is recognised that capital account land should be subject to tax to a certain extent as it would not be possible to create a workable rule to determine whether the land is held on capital account in every scenario unless purpose and intention are introduced into the rules.[6] Even so, it is considered that the business premises exclusion results in capital account land being subject to tax more than is necessary to prevent tax avoidance.

11. Therefore, capital account land that is used in business could be taxable in circumstances when there is no tax avoidance concern. For example, an ice-cream

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[6] This would result in some of the original problems that the tainting rules were designed to prevent – that is, people avoiding tax because of the evidentiary problems with proving purpose or intention.

manufacturer (who is associated with a property developer) purchases a storage facility to store materials used in his business. He sells the storage facility 9 years later because a downturn in business means it is no longer required. Even though it is clear that no tax avoidance is occurring, this transaction would be subject to tax under the tainting rules because it has been held that the business premises exemption does not apply to storage facilities.

***Application of the tainting rules to Auckland Council***

12. A further example of the rules taxing capital account land genuinely used in business occurs in the context of Auckland Council (AC) subsidiaries[7]. AC, through its subsidiary Development Auckland (DA),[8] will be undertaking land development activities that seek to increase housing supply by creating infrastructure that allows for intensification of development in the Auckland region. It could also be involved in social housing developments in the Auckland region, although this would only form part of its development role.

13. Council subsidiaries are subject to tax, whereas councils themselves are exempt as local authorities. Therefore, as DA will be undertaking land developments, it is likely to be considered to be carrying on a business of dealing in land, developing land or erecting buildings. The result of this is that any gain on the disposal of land by other council-controlled organisations ("CCOs") and port, energy and electricity companies controlled by AC could be taxable if the land has not been held for more than 10 years or if the disposal is made within 10 years of completing improvements to the land. Put simply, land held by other entities in the group that would not ordinarily be taxable upon disposal may be taxable simply by virtue of these entities' association to the development entity.

*Overreach in the context of Auckland Council*

14. The tainting rules are overreaching by taxing capital account land that is genuinely used in the business of AC's subsidiaries. The tainting rules were introduced to prevent avoidance, however it is clear that the land held by the subsidiaries is not held in order to avoid tax for DA, because:

- The subsidiaries of AC are holding land necessary for their operations to ensure that they are individually accountable for its use and able to more easily make commercial decisions in relation to the land;
- They have held land prior to any entity in the group being considered a developer;
- If the AC group were intending to avoid tax, it would not develop land in a taxable entity such as DA, nor would it hold land in its taxable subsidiaries. Instead, AC would undertake the development itself and lease all necessary land to its subsidiaries. This would have no tax effect, as AC is exempt;

[7] The term "subsidiary" is used in this RIS to denote CCOs as well as port, energy and electricity companies controlled by councils. These entities do not fall within the CCO definition for tax purposes. The tax definition of "council-controlled organisation" is wider than the ordinary meaning of subsidiary, as it includes entities controlled by councils through means other than an ownership interest.

[8] Development Auckland was established on 1 September 2015.

- The subsidiaries of AC are operated independently of each other, with distinct businesses and objectives. They are so independent that each subsidiary has its own separate board and makes decisions without reference to AC or the other subsidiaries. Therefore, any land held by a subsidiary is likely to be unrelated to the development activities of DA.

15. Some of the land held by the council group may fall under the business premises exemption in CB 19. However, we have been made aware of numerous examples of land that may not fall within the exemption, resulting in a potential tax liability of multi-million dollar value.

16. In order for DA to proceed with its development activities with any certainty about the tax implications for the AC group, AC's subsidiaries would need to seek a binding ruling on each individual premises that is on the borderline of the exemption. This would have significant compliance costs and delay essential developments. Even then, capital account land that does not fall within the exemption could still be tainted.

17. AC has suggested that assurance that an amendment will be made to resolve this issue should be provided as soon as possible so that DA can undertake its development activities with certainty of tax treatment.

**Consequences arising from the rules**

18. The tainting rules distort the decision making of businesses and result in excessive compliance costs. The extent of these consequences is described below in the context of Auckland Council.

***Distortions to decision making***

19. In the past, the AC group has specifically restricted the operations of its subsidiaries to prevent them from being considered land developers due to the tainting implications.

20. Following the formation of DA (which will be considered a developer) and without any legislative change to address the issue, the AC group may structure land holdings in a way that minimises the impact of the tainting rules even where (ignoring tax) doing so does not make economic sense. For example, if AC owns all group land and leases it back to the relevant subsidiaries it will not be taxable on any disposals. The property would still be tainted, but there would be no tax effect, as AC is exempt from tax. This type of structuring would not lead to good governance as AC subsidiaries would need approval from the council board in order to make commercial decisions in relation to land leased to them.

21. Even if this were not to occur, the tainting rules would affect business decisions in other ways – for example, a decision to keep or sell property could be dictated by tax rather than by what makes the most economic sense. Furthermore, the AC group may refrain from undertaking certain activities because of the tax effect.

22. Although taxes generally impose economic costs because they induce individuals to make decisions that they would not have made in absence of the tax, a principle of the Government's broad-base, low rate tax policy framework is that tax should not, as far as possible, affect people's decisions.

*Excessive compliance costs*

23. In addition to affecting commercial decisions, the tainting rules as they currently operate increase compliance costs for AC. AC is likely to continue to obtain expensive legal advice in order to mitigate the tax effects of the rules unless an amendment is made. Furthermore, there is the added compliance cost of having to consider the impact that the transactions and activities undertaken by one subsidiary have on the tax position of the others. This is particularly burdensome given the autonomy and independence of the council subsidiaries.

*Wider implications*

24. We consider that these impacts apply to any situation where the land tainting rules tax capital account land genuinely used in business by a person associated with a builder or developer. This mainly occurs in council groups and large corporate structures where many different businesses (as long as one of them involves property development) are owned by the same parent. DIA have informed us of other council groups who are negatively impacted by the tainting rules; we have no measure of the scale of the problem in relation to the private sector, although we have received anecdotal evidence suggesting it is a problem.

## OBJECTIVES

25. The objectives against which the options are to be assessed are to:

(a) Remove tax impediments to Auckland Council's development and housing objectives;

(b) Improve the coherence of the tax system overall;

(c) Improve the equity of the tax system;

(d) Improve the economic efficiency of the tax system and minimise deadweight costs as far as practicable; and

(e) Reduce compliance costs.

26. All objectives are weighted equally. There may be trade-offs amongst the various objectives. For example, a specific exemption for councils would best meet objective (a), but would be inconsistent with objective (c) as it provides preferential treatment to councils over other entities.

27. AC seeks assurance as soon as possible that a legislative change will be included in the next available tax bill (currently scheduled for introduction in March 2016), so that DA can proceed with its developing activities without distorting the decision making of the AC group. This feature presented a timing constraint on the extent of the analysis that could be undertaken.

## REGULATORY IMPACT ANALYSIS

28. Three options for change and the status quo have been considered for addressing the problem and achieving the stated objectives. The options are:

- Option 1: AC exemption – Exempt AC subsidiaries from the associated persons provisions in the land tainting rules.

- Option 2: Council exemption – Exempt council subsidiaries generally from the associated persons provisions in the land tainting rules.

- Option 3: Extension of the business premises exclusion – Extend the business premises exclusion in the land tainting rules to ensure that more capital account land used in business falls within it, while also upholding the integrity of the tainting rules.

- Option 4: No changes are made to the land tainting rules. This is the status quo option against which all other options are compared below.

**Option one**

29. Under this option, there would be an exemption for AC subsidiaries from sections CB 9(2), CB 10(2) and CB 11(2) of the Income Tax Act. The effect of this is that the land held by other AC subsidiaries would not be tainted by the development activities of DA.

30. The subsidiaries will still be subject to tax under the land disposal provisions in sections CB 6 to CB 13 – for example, if they:

- are considered to be developers, dealers or builders themselves (sections CB 9(1), CB 10(1) or CB 11(1).

- undertake certain development or division work (section CB 12 or CB 13).

- acquire the land with the purpose or intent of selling it (section CB 6).

- acquire the land for the purpose of a business relating to land (section CB 7).

31. It is only the associated person aspect of the tainting rules that the subsidiaries would be exempt from – that is, the development activities of one subsidiary would not taint land owned by another subsidiary.

32. Additional property purchased by DA would still be "tainted" by its own development activities – for example, if DA purchased land that was not for development purposes, it would still be subject to tax upon sale, provided the necessary requirements in any of sections CB 9 to CB 11 were met.

***Assessment against objectives – option one***

- **Removal of tax impediments to Auckland Council's development and housing objectives:** The tainting rules would not impede DA's development objectives under this option, as the subsidiaries of AC would be exempt from the rules. This option meets this objective.

- **Coherence:** Coherence would be improved under this option. The unintended consequences of the tainting rules would no longer arise for the subsidiaries of AC (that is, they would no longer be taxed on the disposal of capital account land). This option partially meets this objective as it resolves the overreach of the tainting rules for a specific group, but does not resolve the issue for other groups.

- **Equity:** It may be seen as unfair for the subsidiaries of AC to be exempt from the tainting rules when other taxpayers are not. This could encourage other entities to lobby for similar treatment. However, this option partially meets the equity objective as it improves the fairness of the tainting rules for Auckland Council when compared to the status quo.

- **Economic efficiency:** The distortions to decision making associated with the impact of the tainting rules would no longer affect AC. Due to this option's limited scope, it only partially meets this objective.

- **Compliance costs:** Compliance costs would be reduced as AC would no longer incur compliance costs obtaining legal advice to mitigate the impact of the rules, or from monitoring the length of land ownership. Due to this option's limited scope, it only partially meets this objective.

**Option two (officials' preferred option)**

33. Under this option, there would be an exemption for all council subsidiaries from sections CB 9(2), CB 10(2) and CB 11(2) of the Income Tax Act. This means that the subsidiaries of a council would not be tainted by the land development activities of one of the other subsidiaries. Council subsidiaries would still be taxable under the other land taxing provisions as outlined in paragraph 30.

34. We are aware of subsidiaries of other councils that are undertaking land developments. This option would prevent land tainting issues from arising for these entities, as all council subsidiaries would be exempt from the associated person provisions in the land tainting rules.

***Assessment against objectives – option two***

35. The analysis of this option against the objectives is much the same as for option one, although this option slightly better meets objectives (b), (c), (d) and (e) because of its wider application – that is, it applies to all council subsidiaries, not just AC subsidiaries.

**Option three**

36. Under this option, the business premises exemption would be better targeted to ensure it captures more capital account land used in business but at the same time prevents tax avoidance.

37. This option proposes that the business premises exemption should be amended to provide that the land tainting rules do not apply to a disposal of land where the land disposed of had a direct connection with the taxpayer's business, and the taxpayer's business is/was not related to a business of dealing in land, developing land, or erecting buildings.

38. Careful thought is required on the wording of this exemption as it could be susceptible to abuse. For example, if the exemption were drafted so as to exclude all land used in business from the tainting rules, people may acquire land and take the minimum steps necessary to show the land is used in their business, and then dispose of the land in order to avoid tax for a developer associated with them. The rule would need to provide that the land is to have a sufficient degree of connection with the business so tax avoiders would be discouraged by the amount of work required to establish such a connection. At the same time,

the rule should not be so strict as to exclude land genuinely used as part of a business – for example, the storage facility in the ice-cream manufacturer example above.

39. Owing to time constraints (outlined in paragraph 27), the exact parameters of this exemption have not been able to be determined and so the extent of any unintended consequences has not been quantified.

***Assessment against objectives – option three***

- **Removal of tax impediments to Auckland Council's development and housing objectives:** The tainting rules would not, for the most part, impede DA's development objectives under this option, although this would depend on the final draft of the exemption. It could be that some capital account land used in business would still be taxable if a council subsidiary is unable to show that it is sufficiently connected to its business. Because of the inherent uncertainty of such an exemption and the potential for unintended consequences, significant consultation would be required and therefore this option would not be able to be advanced in time for the March tax bill. Further, the lack of certainty this option would provide would not enable DA to undertake developments without distorting the decision making of the AC group, even if assurance was given that a legislative change would be made. As a result, this option partially meets this objective.

- **Coherence:** This option promotes coherency in the tax system by ensuring the tainting rules are better targeted at their original problem for the majority of taxpayers, not just council subsidiaries. On the other hand, the loosening of the rule creates the risk that some tax avoidance activities may escape the tax net. Further, it would not promote certainty, as the words of the section would be open to interpretation. This option partially meets the coherence objective due to the risk of unintended consequences.

- **Equity:** This option is equitable, as taxpayers are treated equally. It also improves the fairness of the rules over and above the status quo. This option meets this objective.

- **Economic efficiency:** The distortions to decision making associated with the overreach of the tainting rules would no longer affect the majority of taxpayers. This option meets this objective.

- **Compliance costs:** This option would reduce compliance costs for the same reasons as option one (larger reduction than the other options due to the wider scope). Some compliance costs may arise for taxpayers whose activities are borderline as they may wish to obtain legal advice on whether their activities fall within the scope of the exemption.

**Option four**

40. The status quo does not meet objectives (a), (b) (d) and (e), but partially meets (c) because:

- The rules would impede DA's development activities.

- The tainting rules would continue to overreach by taxing capital account land where there is no tax avoidance concern.

- The rules would operate unfairly, although they would apply consistently across the board.
- The rules would continue to distort decision making.
- The rules would result in excessive compliance costs (as outlined in paragraph 23).

### Summary of analysis of options

| Options | Does it meet the objectives (A, B, C, D and E) | Impacts | | |
|---|---|---|---|---|
| | | Fiscal | Administration | Risks |
| Option one – AC exemption | Meets A, partially meets B, C, D and E. | None – there will be no revenue impact if, should the status quo persist, councils restructure so that all group land is held in the tax exempt council entity and leased to the relevant subsidiaries.<br><br>However, there will be a revenue impact if, should the status quo persist, councils do not restructure (although we expect that AC will restructure if an amendment is not made).<br><br>This option would also prevent AC subsidiaries from claiming losses on tainted land. | Minimal – costs associated with publications to communicate the changes. | Precedent risk – other groups may lobby for similar treatment. |
| Option two – Council exemption (officials' preferred option) | Meets A, partially meets B, C, D and E (a higher partially meets than option one). | None – same as option one. | Minimal – same as option one. | Precedent risk – same as option one. |
| Option three – extension of the business premises exclusion | Partially meets A and B, meets C, D and E | Unquantifiable reduction in revenue as more land will fall within the business premises exemption and therefore will not be subject to tax on disposal. | Moderate – same as option one but there may also be administrative costs associated with confirming how the law impacts various groups. | Unintended consequences – the loosening of the rule creates the risk that some tax avoiders may escape the tax net. |
| Option four – status quo | Does not meet A, B, D or E, partially meets C | None | Possible administrative costs associated with confirming how the law impacts on the arrangements | This option will likely distort economic development decisions of the AC group (and others) and lead to excessive compliance costs. |

| | | | entered into by the AC group. | |
|---|---|---|---|---|

*Key: Objective A, Removal of tax impediments to Auckland's development and housing objectives; Objective B, Coherence; Objective C, Equity; Objective D, Efficiency; Objective E, Compliance costs.*

41. The economic and compliance impacts of the options have been outlined in the assessment of the options against the objectives section of this RIS. No cultural, social or environmental impacts are expected to arise directly from the options.

## CONSULTATION

42. Inland Revenue officials have consulted with Auckland Council (and their tax advisors) and the Treasury on the problem definition and the objectives, as well as on the legal analysis and options. Consultation was in the form of face-to-face meetings, telephone calls and emails over the second half of 2015. All support option two.

43. One of the major concerns raised by the Treasury in consultation was that allowing a council-specific exemption may encourage others to lobby for similar treatment. Inland Revenue, Treasury and Auckland Council's tax advisors consider that the unique circumstances of council groups (see paragraph 14) and the urgency of the situation warrants a specific fix for councils.

44. The Department of Internal Affairs was also consulted and informed us that the tainting rules were impacting at least 2 other council groups.

45. Wider consultation was not conducted due to time constraints (described in paragraph 27).

## CONCLUSIONS AND RECOMMENDATIONS

46. Inland Revenue prefers option two for the following reasons:

- It would result in no revenue impact because it is expected that, if the status quo remained, council groups would restructure so that the council owns the land (rather than its subsidiaries). The council would not be taxable on any land disposals because of its tax exempt status.
- It would prevent the tainting rules from operating contrary to their policy intent in relation to councils as capital account land held by council subsidiaries would no longer be tainted by the activities of other council subsidiaries.
- The distortions to decision making and excessive compliance costs brought about by the tainting rules would cease, enabling DA and other council subsidiaries to undertake developments unencumbered by the rules.
- It provides a certain and timely solution to an urgent situation.

47. Option 2 is preferable over option 1 as it would resolve the problem for all council groups, not just AC. Options 1 and 2 would not resolve the problem for other groups.

48. Although option 3 could resolve the issue for all affected parties, it is not preferred because of the potential revenue implications, the timeframe that would be required for consultation and the uncertainty and potential unintended consequences that may arise. However, it is recommended that a review of the business premises exemption is considered for inclusion on the tax policy work programme for consideration at a later date.

## IMPLEMENTATION

49. Changes to the land tainting rules will require amendments to the Income Tax Act 2007. It is proposed that these amendments will be included in the tax amendment bill scheduled for introduction in March 2016 (expected to receive Royal assent by the end of 2016). This amendment will need to have retrospective application to 1 September 2015, the date DA was formed. While the legislation would not need to be retrospectively applied until when DA begins developments, it is considered appropriate to apply the legislation from the date DA was formed as it can be unclear as to when exactly a development begins. Inland Revenue will work with any council groups who have already filed their 2016 income tax by enactment date to ensure that only the correct amount of tax is paid.

50. When introduced to Parliament, commentary will be released explaining the amendments, and further explanation of their effect will be contained in a *Tax Information Bulletin*, which will be released shortly after the bill receives Royal assent. Inland Revenue also plans to write to council groups informing them of the proposed changes, following their approval by Cabinet.

51. Inland Revenue will administer the proposed changes. The proposals would have no systems implications for Inland Revenue but may result in some additional administrative costs, such as costs associated with publications to communicate the changes. These costs are expected to be insignificant and would be met within existing baselines.

## MONITORING, EVALUATION AND REVIEW

52. Inland Revenue will monitor the effectiveness of the proposed changes in the first 12 months of operation. This work will be carried out by a small group within Inland Revenue that is responsible for local authorities' taxation. Policy officials will deal with any calls for Inland Revenue to expand the proposed treatment to other taxpayers that may be similarly affected.

53. In general, Inland Revenue monitoring, evaluation and review of tax changes takes place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

# Regulatory Impact Statement

## GST Current Issues

## Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to address four GST-related items. The issues arise in situations where the technical requirements of the Goods and Services Tax Act 1985 result in high compliance costs for businesses, do not match commercial practice, or do not reach the right policy outcome.

Four items are considered in this RIS. They are:

- The deductibility of GST incurred in raising capital to fund a taxable business activity
- Compliance costs experienced in determining the proportion of GST that can be deducted
- The ability to recover GST embedded in secondhand goods composed of gold
- The treatment of services closely connected with land

A key gap in the analysis of the issues is the information around the size and scale of the items. Information from public sources, provided by submitters, or held by Inland Revenue, has been used to estimate these impacts as far as possible, but in many cases it is incomplete or anecdotal. This has also made it difficult to quantify the impacts.

Submissions received during public consultation on these items and analysis generally agreed with officials' views on the size and scale of the underlying issue. Submitters included professional firms and industry associations, who may be expected to have a good overview of a number of businesses that may be affected by the proposed regulation.

Where there is not sufficient information to quantify the impacts, this bas been noted in the RIS.

Inland Revenue has consulted the Treasury in relation to all four items. The Ministry of Business, Innovation and Employment was consulted in relation to the capital raising proposal. Both agencies were supportive of officials' preferred solutions.

The items were also publicly consulted on through an officials' issues paper, *GST Current Issues*, released on 17 September 2015. Submitters supported officials preferred solution to the first three items. Submitters did not support officials' preferred solution for the fourth item relating to the treatment of services closely connected with land. The feedback received has been taken into account in developing options and in the analysis contained in this RIS.

None of the policy options would impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles.

Marie Pallot
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Inland Revenue

11 February 2016

## INTRODUCTION

1. This Regulatory Impact Statement considers four GST-related items. Although each item is separate, they all occur within the policy framework of GST and the legislative requirements, found in the Goods and Services Tax Act 1985 (the "GST Act"), that give effect to this policy.

2. These items were the subject of public consultation (in the officials' issues paper *GST Current Issues* which was released on 17 September 2015). 14 submissions were received. Most submitters were industry associations or professional firms.

3. The items were:

- To enable businesses to recover GST on costs incurred to raise capital to fund their taxable business activities;
- To address high compliance costs experienced by large, partially exempt, businesses (such as retirement villages) in calculating the GST they can recover;
- To enable businesses acquiring secondhand goods composed of gold, silver or platinum to claim deductions for embedded GST; and
- To amend the tests for when services closely connected with land are treated as consumed in New Zealand, and therefore subject to GST, with the international approach.

4. Analysis of each item follows the following format:

  - Status quo and problem definition
  - Key objectives for the item
  - Regulatory impact analysis – assessment against the stated objectives
  - Consultation – how feedback from consultation shaped the analysis of the item
  - Conclusion – officials preferred option

### GST policy and law

5. Goods and Services Tax (GST) is a tax on consumption. GST is imposed according to the destination principle – that is, that goods and services should be taxed in the jurisdiction in which they are consumed. This results in most supplies of goods and services in New Zealand, as well as imports, being charged with GST. Conversely, exports are not charged with GST.

Consistently with New Zealand's general tax policy settings, GST is imposed at a single rate (15%), across a broad base of goods and services. This broad-based single-rate approach is intended to distort suppliers', and purchasers' preferences as little as possible.

*Tax on consumption*

6. Although GST is a tax on consumption, it is imposed on all supplies and not just supplies to consumers. To ensure that GST does not accumulate at each step of a supply chain, businesses are able to recover the GST incurred on goods or services they purchase (via "input tax deductions"), where they use those goods and services to make taxable supplies. Input tax deductions are set off against the amount of GST that the business is required to pay on their own supplies of goods and services. If input tax deductions exceed the tax to pay,

they are refunded to the business. This "credit-invoice" mechanism ensures that GST is not a cost to business, and is only imposed once on consumption.

7. An exception to this approach exists for some supplies (exempt supplies) which are not taxed when supplied by the business and are instead taxed by preventing the business making the exempt supply from claiming input tax deductions. This option typically will not tax the full value of consumption and is therefore the second-best option from a theoretical point of view. In practice it is used where difficulties valuing the consumption or other practical considerations mean that taxing the consumption is not feasible and input tax deduction denial is the best practical option.

8. Input tax deductions are also allowed for secondhand goods acquired by a business, from a person who does not charge GST on that supply (for example, because they are a consumer). Although the supplier does not charge GST, they will have incurred GST when they purchased the good, which they could not recover. The input tax deduction recognises the consumption of the goods has already been taxed, and that GST is implicitly embedded in the purchase price.

9. In the absence of this rule, secondhand goods could be subject to taxation multiple times – by being taxed when they are first supplied, and taxed again if they are later repurchased and resold by a GST-registered business. The secondhand goods input tax deduction ensures that only additional value added is taxed.

*Consumption in New Zealand*

10. Another key criterion for goods and services to be taxable is that they be consumed in New Zealand. A number of legislative rules apply to determine whether goods or services are consumed in New Zealand or outside New Zealand. In practice the residency and location of the recipient are used to determine whether services are consumed in New Zealand or not, as well as the nature of the service.

11. Services that are physically performed in New Zealand are generally subject to GST, as they are typically consumed in New Zealand. Under the new place of supply rules proposed in the *Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Bill,* GST will also apply to "remote" services (where the supplier and purchaser are not required to be in the same place for the services to be performed) that are performed outside New Zealand, if they are supplied to a New Zealand-resident consumer.

12. In contrast, supplies of services to non-residents outside New Zealand will typically not be taxed. To give effect to this policy of not taxing exported services, the services may be "zero-rated". The supplier is able to claim input tax deductions for the GST they incur in making the supply, but they will not be required to return GST. This ensures that, for registered businesses, the supply is not taxed, nor is there GST implicitly embedded in the price.

## OBJECTIVES

13. The overarching goal is to ensure that GST continues to meet its policy objectives of being a broad-based tax on consumption in New Zealand.

14. The objectives against which the options for each item are to be assessed are:

- **Neutrality:** Taxation should seek to be neutral and equitable between forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation.
- **Efficiency:** Compliance costs for businesses and administrative costs for the tax authorities should be minimised as far as possible.
- **Certainty and simplicity:** The tax rules should be clear and simple to understand so that taxpayers can anticipate the tax consequences in advance of a transaction, including knowing when, where, and how the tax is to be accounted.
- **Effectiveness and fairness**: Taxation should produce the right amount of tax at the right time. The potential for tax evasion and avoidance should be minimised while keeping counteracting measures proportionate to risks involved.

### Constraints

15. A key constraint and consideration in meeting these objectives is revenue and, in particular, the policy to tax supplies of goods or services as enshrined in the GST Act. This means that certain minimum compliance and administration costs will be incurred in meeting the obligations imposed under the Act and that most supplies will already be subject to a 15% tax based on their value (with an associated impact on efficiency and neutrality).

## REGULATORY IMPACT ANALYSIS

16. The four items analysed in this RIS are:

A) The deductibility of GST on costs incurred to raise capital to further a taxable business activity (**"Capital raising costs"** – page 5 - 10);

B) The compliance costs incurred in applying the legislated approach to determining the amount of input tax deduction that can be claimed in respect of goods and services used to make both taxable and exempt supplies (**"Apportionment rules"** – page 10 - 17);

C) The ability to claim input tax deductions for secondhand goods composed of gold, silver or platinum (**"Secondhand goods and gold"** – page 18 - 25); and

D) The treatment of supplies of services that are connected with land ("**Services connected with land"** – page 25 - 32).

### Item A: Capital raising costs

#### *Status quo and problem definition*

17. Supplies of financial services are generally exempt supplies. Exempting financial services recognises the inherent difficulty in determining the value of the service, as the financial service provider may be compensated by a margin or spread (for example, on the interest charged for lending) rather than an explicit fee. As it is therefore difficult to determine the value of the financial service consumed, the supply is effectively taxed by denying input tax deductions.

18. There are some exceptions to this approach. Since 1 January 2005, supplies of financial services to GST-registered businesses that predominantly make taxable supplies can be zero-rated, allowing financial service providers to claim deductions for the GST incurred in making these supplies. This was intended to reduce the potential for tax cascades caused by the exempt treatment of financial services, where tax must either be absorbed or passed on by the business receiving the supplies.

19. Another exception is for financial services supplied to non-residents outside New Zealand. The services are zero-rated, as any consumption occurs offshore.

20. Similar concerns arise when businesses that primarily provide taxable goods and services incur costs in raising capital. As the provision of debt or equity securities is treated as an exempt supply of financial services, the GST costs incurred in making these supplies cannot be recovered. Examples of these costs may include NZX listing fees, legal fees and costs associated with preparing a product disclosure statement.

21. As GST is applied on a transactional basis, the ability to claim input tax deductions in respect of goods or services is based on the supplies those goods or services are used to make. As the goods or services are used to make exempt supplies of financial services, deductions are denied.

22. This produces the correct result where the financial services are being consumed by the recipient (for example, the services are consumer lending). However, where the financial services are provided to raise capital, there is a strong argument that these supplies are actually part of the business' supply chain, and are not consumed by the providers of the capital. Denying deductions for these costs is said to lead to tax cascades, as a taxable business must either absorb the GST cost or pass the cost onto its customers, with GST being charged on this amount again in later stages of the supply chain. This is contrary to GST's role as a tax on consumption, rather than on business.

23. This analysis does not apply to businesses that principally make supplies of financial services. As these businesses act as intermediaries between borrowers and lenders, it is more difficult to determine the extent borrowing relates to the general business activities and the extent it relates to specific supplies. Special rules exist to enable businesses to elect to zero-rate their business-to-business supplies of financial services. Financial service providers may also enter into an agreement with the Commissioner of Inland Revenue on a fair and reasonable method of apportioning their costs between their taxable and exempt supplies.

24. This analysis is constrained by the available information on capital raising activities. Information on new, publicly listed, equity and debt is published by the NZX. The information published in the annual metrics between 2011 and 2014 indicates approximately $7 billion of new, primary, and secondary and dual equity issued per annum, and $400-500 million of debt.

25. Information on private capital raising is less readily available, both as to the amount of capital raised, and the number of participants in the industry. Industry publications suggest that, in 2014, $200 million of new equity was raised within the venture capital industry. Information on private debt is not available.

***Objectives***

26. The key objective is effectiveness and fairness. GST is intended to be a tax applied once on consumption only once so that cascades do not occur. This is not the result when capital raising costs are not deductible, and are incurred by the business or passed on. Passing on the cost of this GST may result in a tax cascade, where the unrecoverable GST is embedded in the price paid for the supply, and the supply itself is taxed. Neutrality is also an important objective for this item.

***Regulatory impact analysis***

27. One policy option and the status quo were considered for addressing the policy problem and meeting the objectives.

- Option 1: Allow a deduction for capital raising costs to the extent that a registered business makes taxable supplies as a proportion of their total supplies.
- Option 2: Retain the status quo under which businesses cannot deduct GST costs incurred in raising capital

*Option 1: Allowing a deduction for capital raising costs*

28. This option would involve allowing a deduction for GST costs incurred when a registered business raises capital. Amending legislation mechanism would provide for registered businesses that are raising capital in order to fund their taxable activity to calculate an amount that can be deducted.

29. In particular, it would allow a GST-registered business, that does not principally make financial supplies, to claim an input tax deduction for GST costs incurred in the:

- issue or allotment of a debt or equity security;
- renewal or variation of such a security;
- payment of interest, dividends, or an amount of principal in respect of such a security; and
- provision of a guarantee of another person's obligations under such a security (for example, to guarantee repayment of the principal advanced under a debt security).

30. The GST incurred in relation to these costs would be deductible to the extent that the taxpayer makes taxable supplies, as determined using a method that produces a fair and reasonable result. This method would be consistent with the approach used to determine GST recovery in respect of other goods and services used to make both taxable and exempt supplies. The fairness and reasonableness of the result would need to be determined with regard to the overall business activity to ensure that, as money is fungible, the costs are not allocated in a way to maximise deductions.

31. Currently, there is potentially a tax preference for businesses to source funding in ways that would enable GST to be recovered. Examples include sourcing funds from offshore or, for businesses that have elected to zero-rate their business-to-business supplies of financial services, from a New Zealand business. Providing the ability to deduct capital raising costs that relate to a business' taxable activity would help address this bias.

32. This option would reduce compliance costs, as registered businesses that only make taxable supplies will not need to identify and apportion the costs that relate both to raising capital and to their other, taxable, business activities.

33. This option also reduces the potential for tax cascades where GST costs are either absorbed by the business or passed on through the supply chain. This improves the effectiveness of GST as a tax on consumption, rather than on registered businesses.

*Option 2: Retain the status quo*

34. The status quo potentially creates a disincentive to seeking funding from within New Zealand as businesses issuing securities to domestic investors would be unable to deduct their GST costs, whereas those who are exporting financial services can zero-rate these supplies.

35. This option is associated with greater compliance costs for registered businesses that are raising capital, as the costs associated with raising capital need to be determined and treated differently to other inputs acquired by the business to make taxable supplies. This may result in less certainty as the business is required to determine whether the good or service it has acquired is used for raising capital.

> The identification of additional practical options to address the objectives was limited, due to the cause of the problem. The problem arises due to a mismatch between the legal and economic frameworks underpinning the GST Act. The question is therefore whether the current legal framework (Option 2) ought to be altered to match the economic framework (Option 1).

***Summary of the analysis of the options***

36. Option 1 is expected to increase economic efficiency, as it will remove a tax preference for raising capital in ways that maximise GST recovery (for example, from offshore). However, it is not known whether GST recovery is a significant factor in this decision.

37. Compliance costs may be reduced under Option 1. Some costs may relate to both capital raising and other costs, and may arguably be required to be apportioned. Where a business is otherwise wholly taxable, these costs would instead be fully deductible and apportionment would not be required.

38. Administration costs are not expected to vary significantly between the options, beyond the costs of updating products and communicating changes. Businesses would be expected to apply the rules under either option, and Inland Revenue would monitor compliance.

39. As noted in the problem definition above, there is some uncertainty around the total cost of GST that is not deductible under the status quo, but would be deductible under Option 1. Officials have estimated the total cost of allowing deductions at $10 million per annum, although submitters have indicated that they consider the true cost to be lower, around $3-4 million per annum.

40. Neither option is expected to have social, cultural or environmental impacts.

41. Table 1 summarises the analysis of the options against the stated objectives.

## Table 1: Analysis of options for Item A (Capital raising costs)

| | Neutrality* | Efficiency | | Certainty and simplicity | Effectiveness and fairness* | Fiscal impact |
|---|---|---|---|---|---|---|
| | | Compliance costs | Administration costs | | | |
| **Option 1: allowing a deduction for capital raising costs** | **Increased** - GST recovery is less influenced by the source of capital. *Meets objective* | **Decreased -** the need to apportion deductions is reduced or the calculation of the deductions simplified. *Meets objective* | **No change** - IRD monitors taxpayers' compliance with the rules (as with other tax rules). *Meets objective* | **Increased** – fully taxable businesses would not need to apportion costs. Tax obligations are therefore more transparent. *Meets objective* | **Increased** - ensures that final consumption is taxed once. *Meets objective* | **Decreased –** estimated $10 million per annum fiscal cost. |
| **Option 2: status quo** | **No change** - incentive to obtain funding in ways that enable GST recovery, such as from overseas. *Partially meets objective* | **No change** - some costs relating to both capital raising and other activities of the business may need to be apportioned. *Meets objective* | **No change** - IRD monitors taxpayers' compliance with the rules (as with other tax rules). *Meets objective* | **No change** – businesses would need to determine which costs relate to capital raising, and which costs relate to other activities. *Meets objective* | **No change** - denial of deductions leads to GST being imposed multiple times in supply chain. Tax cascade overtaxes the consumption. *Does not meet objective* | **No change.** |

** = Key objective*

### *Consultation*

42. Feedback from consultation supported Option 1.

43. Submitters made points about the technical features of Option 1, including the services involved in capital raising and the method that should be used to determine the proportion of input tax that may be deducted, where the funds may relate to both taxable and exempt activities. This feedback has been taken into account in refining these features.

44. Submitters also suggested various application dates, including a retrospective change to enable businesses to claim past deductions. We do not support this suggestion. Policy changes generally apply prospectively, and making an exception in this case could give rise to fairness concerns if the same treatment was not extended in other situations.

45. We note that one submitter submitted on the application of the suggested rules to financial service providers, and supported their exclusion.

### *Conclusions and recommendations*

46. Option 1 is officials' preferred option on the basis that it best meets the objective. Option 1 better achieves the key objectives of neutrality and effectiveness and fairness. Both options satisfy the other objectives.

## Item B: Apportionment rules

### *Status quo and problem definition*

47. A business that makes both taxable and exempt supplies, must apply certain rules to determine the amount of input tax it may deduct. A business that acquires goods or services must estimate the extent to which it expects to use the goods or services to make taxable supplies, as a percentage of total use. The method of determining the use of the goods and services is not prescribed, and the legislation provides for businesses to use a method that produces a fair and reasonable result. This estimated percentage use is the proportion of input tax which the business may deduct in respect of those goods or services.

48. Once a year – and subject to exceptions, including for low-value goods and services – at the end of an "adjustment period" each GST-registered business is required to review the actual use of goods or services it has acquired, and compare it to the estimated use in making taxable supplies. If there is a difference between the estimated use and actual use, the business may be required to make an adjustment – either claiming an additional deduction, or repaying some of a claimed deduction – so that the proportion of input tax deducted accurately matches the actual use of the goods and services in making taxable supplies.

49. Review of the actual use may be required for a number of adjustment periods, subject to rules which reduce compliance costs by only requiring adjustment where the difference between the use and actual use exceeds a certain percentage point amount or the difference in available deduction exceeds $1,000, and by setting out the maximum number of periods for which adjustments need to be made. (For land, there is no maximum number of adjustment periods).

50. While most businesses are required to apply these apportionment and adjustment rules, there are a limited number of exceptions. One exception applies to allow the Commissioner of Inland Revenue and a person who principally supplies financial services to agree an alternative method of calculating deductions. The alternative method must have regard to the tenor of the apportionment and adjustment rules. This recognises the complexity of applying these rules to this industry, and provides a lower compliance-cost alternative.

*Problem definition*

51. In most cases the apportionment rules are expected to be relatively straightforward to apply, as most businesses can expect to perform a one-off apportionment upon acquisition, with limited further adjustment. However, some business may experience a greater cost in performing these calculations. The key features that are said to give rise to a higher cost include:

- A business activity that includes making both taxable and exempt supplies;
- Use of the same goods and services to make both taxable and exempt supplies;
- A changing proportion of taxable use of the goods or services, or one-off use (in an adjustment period) that does not reflect the long term use;
- A high volume of purchased goods or services; and
- A use of the goods or services which is unknown at the time the goods or services are acquired, or is difficult to determine.

52. Problems also arise due to the need to apportion and adjust the input tax deductions claimed in respect of goods and services, on a supply-by-supply basis. Retirement villages provide an example of these difficulties. The GST treatment of retirement villages, including the treatment of accommodation and the application of the apportionment rules, is discussed in Inland Revenue's standard practice statement *IS 15/02 - Goods and Services Tax - GST and retirement villages*.[1]

53. The GST treatment of accommodation depends on the nature of the supply of accommodation. A supply of accommodation in a residential dwelling is exempt, and commercial accommodation is taxable. Many retirement village operators will supply both kinds of accommodation. In some cases, the factor that determines whether a supply is exempt or taxable will be whether, and what kind of, additional goods and services are supplied alongside the accommodation. This may depend on the package of goods and services residents choose, or are required to acquire, alongside the accommodation.

54. This means that it cannot always be possible to accurately determine in advance whether a unit will be used to make taxable or exempt supplies. The actual use will have to be monitored, and adjustments to deductions claimed for goods and services used to construct that unit may be required. This use may also change over time – for example, if residents choose to acquire additional goods and services; or if an existing resident moves to a different unit to receive more intensive care and a new resident acquires the old unit, along with a different package of goods and services. This change in use may also require adjustment of

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[1] The interpretation statement may be accessed on the "Technical tax area: interpretation guidelines and interpretation statements" page of the Inland Revenue website at: http://www.ird.govt.nz/technical-tax/interpretations/interpretations/2015/

claimed deductions, in respect of specific goods and services, even if the relative taxable/exempt make-up of the entire activity does not change.

55. These difficulties in applying the legislation are understood to also be exacerbated by practical difficulties – in particular, where there is a large volume of goods or services purchased, that must be apportioned and adjusted, and where it is difficult to determine the actual use of the goods and services. An example of the latter is where the goods and services provided are used to construct buildings in which residents will receive accommodation, but it is not clear to what extent the supplies relate to the particular buildings because the invoices do not or cannot provide sufficient detail.

56. The scale of the difficulties experienced by businesses in the retirement village sector is expected to increase as the number of businesses, or the size of businesses, participating in this sector increases. Figures published in the Retirement Village Association's 2015 Annual Report indicate that there are over three hundred registered retirement villages, with over twenty three thousand units, in New Zealand.

57. Submitters have also indicated that this difficulty may be experienced outside the retirement village industry, by other providers of mixed commercial and residential accommodation. The size of this group is not known.

***Objectives***

58. The key objectives are efficiency and effectiveness and fairness. However, there may be a trade-off in designing a rule to reduce compliance costs incurred in calculating deductions, while also ensuring that the correct amount of tax is collected at the correct time. Improvements in accuracy of the rule will increase compliance costs for taxpayers.

59. It is more important that the effectiveness and fairness of GST is maintained. Effectiveness and fairness is therefore a more important objective than efficiency.

***Regulatory impact analysis***

60. The approach preferred by the industry during preliminary consultation was to extend the Commissioner's ability to agree an alternative method of apportioning, and making subsequent adjustment to, input tax deductions. This gave rise to two alternative options: enabling large, partially exempt, businesses to agree an alternative method with the Commissioner (which is assessed as Option 1); and, following consultation, extending this to also enable industry associations to apply to the Commissioner to agree a method that could be applied across the industry (which is assessed as Option 2).

61. In either approach, an applicant would be expected to apply to the Commissioner to agree an alternative method. The purpose of an agreed method would be to reduce compliance costs by providing an easier way to reach a similar input tax deduction entitlement as would be reached under the apportionment and adjustment rules. To this end, methods would be required to be fair and reasonable, and to have regard to the outcomes that would be reached under the existing apportionment and adjustment rules.

62. An agreed method would be expected to be specially tailored to address the specific difficulties encountered by a business or sector in applying these rules. Therefore, it is not proposed to specify the format or content of a method, however, it is expected that an agreed method would set out:

- all relevant business activities of the applicant;
- the methodology proposed (for example, calculation based on turnover, floor space, time spent, number of transactions or cost allocations);
- categories of costs that can be directly attributed to either taxable or non-taxable supplies, and categories of costs that relate to both taxable and non-taxable supplies;
- the methodology proposed for significant one-off acquisitions such as land;
- the method by which disposals of assets will be dealt with (for example, what input tax adjustments will be made);
- any adjustments that will be made in relation to goods and services that have already been acquired, including those that are subject to the current apportionment rules, transitional rules or old apportionment rules;
- details of any proposed variations to the minimum number of adjustment periods for which adjustments will be made;
- details of any proposed variations to the period in which adjustments will be returned; and
- an explanation of why the proposed methodology is fair and reasonable, and how it reflects the outcomes that would be reached under the apportionment rules.

63. Both Inland Revenue and the applicant are expected to incur costs in agreeing, and maintaining a method. However, it is expected that generally there would be an ongoing compliance cost saving to the customer and a minimal administrative cost for the Commissioner.

*Option 1: agreed methods*

64. Option 1 would limit eligibility to agree a method to large businesses, which have or expect to have a turnover in a 12-month period exceeding $24 million. In the absence of some kind of threshold, while the Commissioner would not be required to agree a method with every applicant, costs would still be experienced from processing applications and assessing their merits. A turnover threshold would provide an objective test that could easily be applied as a filter, and would limit applications to those expected to be more likely to produce an overall benefit.

65. Businesses would be expected to experience greater certainty under an agreed methodology. It is expected that, for businesses experiencing the compliance difficulties outlined, an agreed alternative method would enable the tax consequences of their transactions to be more readily apparent than under the apportionment rules.

66. It is not expected that an agreed apportionment method would significantly affect the substantive amount of tax paid by a business, and therefore methods should not affect competition between businesses nor the effectiveness and fairness of the tax system, and should not have a fiscal impact. Where a method produced a timing advantage or disadvantage in relation to an input tax deduction (for example, by allowing a flat percentage to be deducted immediately, rather than increasing the amount over a number of years), it is expected that this would be accounted for in the agreement with the Commissioner. For example, a smaller percentage deduction may be allowed to take into account a timing advantage.

67. The use of the turnover threshold under this option to govern applications could potentially create some fairness issues between taxpayers, to the extent that taxpayers who would experience significant compliance cost savings fell beneath the threshold.

*Option 2: agreed methods (including industry methods)*

68. This option would expand eligibility to agree a method to a wider group of businesses. Industry associations as well as businesses under Option 1 would be able to agree a methodology. Businesses within that industry could then apply to use the agreement with any necessary adjustments as agreed with the Commissioner.

69. Enabling industry associations to also agree a method would be comparatively more efficient, as a single agreement would apply to a number of businesses. The benefit experienced by the entire group could mean that agreeing a method was efficient, taking into account compliance and administration costs, even if the cost of negotiating the method, for an individual member, would not be efficient.

70. This would also help ensure that businesses competing within a sector are on the same footing, and the threshold does not create a benefit of larger size through reduced compliance costs – as all could potentially apply the method.

*Option 3: Status quo*

71. It would also be possible to maintain the status quo, in which case the situation described in the problem definition would prevail.

***Summary of the analysis of the options***

72. Option 1 may affect competition between the group of businesses that exceed the threshold and those that do not. Those exceeding the threshold would have an advantage, at the margins, as they would be able to agree an alternative method to reduce the costs of complying with their tax obligations. Option 2 is not expected to produce this same distortion, as where difficulties are experienced by competitors within the same industry, this may be addressed by an industry agreement. Neither option is expected to have an economic impact.

73. Option 1 and Option 2 are expected to reduce compliance costs compared to the status quo. The exact savings are not known.

74. Administration costs under Option 1 and Option 2 are expected to be relatively constant. Some administration costs will be incurred in agreeing a method. The amount of this cost cannot be quantified, as it will depend on the specific circumstances raised, which any alternative method needs to address. Minimal costs are expected to be incurred in monitoring the suitability of an existing method.

75. As the correct treatment of deductions will be easier to determine under a method, it is expected that there will be some administration cost savings in ensuring the compliance of businesses subject to a method. The exact savings cannot be quantified, as it would depend on the specific facts in each instance.

76. None of the options are expected to have social, cultural or environmental impacts.

77. Table 2 summarises the analysis of the options against the stated objectives.

## Table 2: Analysis of options for Item B (Apportionment rules)

| | Neutrality | Efficiency* | | Certainty and simplicity | Effectiveness and fairness* | Fiscal impact |
|---|---|---|---|---|---|---|
| | | Compliance costs* | Administration costs | | | |
| **Option 1: agreed methods** | **No change** - alternative methods are not expected to disturb the substantive amount of tax payable.<br><br>*Meets objective* | **Decreased -** costs incurred in agreeing methods.<br><br>Minimal cost of maintaining a method.<br><br>Lower cost incurred in applying a method to calculate deductions.<br><br>*Meets objective* | **No change -** costs incurred in agreeing methods.<br><br>Minimal cost of maintaining a method.<br><br>Expected lower costs of ensuring compliance.<br><br>*Meets objective* | **Increased -** calculation of tax liability expected to be easier as the agreed method can be tailored to the specific difficulties.<br><br>*Meets objective* | **No change** - methods required to have regard to the outcomes under the apportionment and adjustment rules, to ensure quantity and timing of tax is fair and reasonable.<br><br>*Meets objective* | **No change** - agreed methods are not expected to alter the amount of deduction that can be claimed. |
| **Option 2: agreed methods (including industry methods)** | **No change** - alternative methods are not expected to disturb the substantive amount of tax payable.<br><br>*Meets objective* | **Decreased -** costs incurred in agreeing methods.<br><br>Minimal cost of maintaining a method.<br><br>Lower cost incurred in applying a method to calculate deductions.<br><br>*Meets objective* | **No change -** costs incurred in agreeing methods.<br><br>Minimal cost of maintaining a method.<br><br>Expected lower costs of ensuring compliance.<br><br>*Meets objective* | **Increased -** calculation of tax liability expected to be easier as the agreed method can be tailored to the specific difficulties, across a broader group.<br><br>*Meets objective* | **No change** - methods required to have regard to the outcomes under the apportionment and adjustment rules, to ensure quantity and timing of tax is fair and reasonable.<br><br>*Meets objective* | **No change** - agreed methods are not expected to alter the amount of deduction that can be claimed. |
| **Option 3: Status quo** | **No change** - existing apportionment rules determine amount of deductions.<br><br>*Meets objective* | **No change** - high compliance costs experienced in applying rules.<br><br>*Does not meet objective* | **No change -** IRD will continue to monitor taxpayers' compliance with the rules.<br><br>*Meets objective* | **No change** - calculation of liability may be difficult and complex.<br><br>*Does not meet objective* | **No change** - existing apportionment and adjustment rules ensure correct tax paid at the correct time.<br><br>*Meets objective* | **No change -** existing rules would continue to apply to determine the deduction that can be claimed. |
| ** = Key objective* | | | | | | |

### *Consultation*

78. Seven submitters supported Option 1, although submissions raised concerns that the suggested $24 million turnover threshold was too high and that it would exclude a number of businesses who experienced high costs in applying the apportionment rules. However, a more appropriate threshold, that would still manage the risk of incurring administration costs from a high volume of applications, was not suggested.

79. Submitters suggested extending the application of the rules to industry associations to extend the ability to agree a method to these groups too. This suggestion is assessed as Option 2 in our analysis.

80. Three submitters suggested that apportionment methods should apply retrospectively to legitimise past approaches. This was considered to increase certainty and be more efficient – submitters were concerned that they may be required to discuss the same issues more than once, for example as part of an audit and in agreeing a method. We do not agree with this suggestion. Allowing a method to be retrospective would increase uncertainty around a business' obligations in the interim, as it would not be clear whether a business needed to comply with the apportionment rules or if it could instead use a different method (which may be later approved by the Commissioner). Inland Revenue's internal processes should help minimise duplication of effort and avoid submitters' efficiency concerns.

### *Conclusion and recommendation*

81. All options meet the objective of neutrality. Agreements with the Commissioner, under Option 1 or Option 2 would not be expected to significantly alter the incidence of tax, from the status quo, but rather be limited to an easier way of reaching a similar figure, so should not affect competition between businesses. Consequently, all options should also result in businesses paying the correct amount of tax at the right time (as agreed methods would be required to take into account the timing of deductions), and there should also be no fiscal impact from any option.

82. Option 1 and Option 2 both satisfy the key objective of efficiency, as the methods agreed between the Commissioner and businesses would reduce compliance costs. Option 2 best satisfies this criterion, as the benefit is extended to a wider group via industry methods. The status quo does not satisfy this objective, as high compliance costs will continue to be incurred in applying the existing rules. All options (including the status quo) are expected to meet this requirement in respect of administration costs. Although entering into an alternative agreement would involve some minor ongoing administration costs, they would produce benefits from making compliance easier to monitor.

83. Both Option 1 and Option 2 would increase certainty for businesses that enter into an agreed method, and the treatment of supplies under an agreed method is expected to be simpler to understand than under the status quo. However, Option 2 applies this to a wider group so therefore better meets this objective. Businesses (in particular, retirement villages) consulted have indicated that they do not find the status quo simple or certain to apply.

84. On balance, Option 2 best meets the objectives, including the key objective of efficiency. Option 2 is therefore officials preferred option.

## Item C: Secondhand goods and gold

### *Status quo and problem definition*

85. While input tax deductions are allowed for most secondhand good with few exceptions, one exception is for goods composed of gold, silver, or platinum (collectively referred to as "gold"). The exception applies to the extent that the goods are composed of gold.

86. This exception potentially results in multiple layers of GST accruing on this gold content of secondhand goods. A business acquiring these goods will not be able to claim an input tax deduction; however it may be required to return GST when it supplies the good itself.

87. Alternatively, where secondhand gold is supplied to a refiner who is using it to produce new fine (very high purity) gold, multiple layers of GST should not be incurred (as the fine gold will not be subsequently taxed) but this is the result if the GST is unrecoverable. This outcome is contrary to the policy that fine gold not have embedded GST, and therefore results in taxation contrary to the purpose of the Act.

88. Compliance with the strict rules denying GST deductions results in a number of effects:

- Compliance costs must be incurred in valuing the gold content to determine the extent of permissible deductions;
- Gold goods potentially bear a higher GST burden than other goods, as they are taxed every time they are supplied between a GST-registered business and a consumer, rather than only being taxed on their final consumption;
- Certain methods of transacting, that avoid double taxation, are tax-favoured. For example, there may be an incentive for a secondhand dealer to instead supply an item as an agent for the owner, as only their agent fees will be subject to GST, rather than the full sale price of the item. Alternatively, there is an incentive to sell jewellery privately, thereby avoiding the imposition of additional GST on the gold; and
- Consequently, government revenue is higher, to the extent of the denied deductions. Input tax deductions would offset tax that would otherwise be paid, or paid out as a refund.

89. In practice, these rules are said to be poorly understood, and compliance is said to be low. Most businesses are understood to be claiming input tax deductions for this secondhand gold already. This is said by businesses to distort competition for compliant businesses as businesses that claim deductions can offer a higher purchase price for this secondhand gold because the cost to the business is reduced to the extent a claimed deduction is received.

90. Non-compliant businesses (anecdotally expected to be primarily smaller, less tax-sophisticated, businesses) may be exposed to reassessment by the Commissioner, and to claims for unpaid tax, penalties and interest.

91. Stakeholders have indicated that there are approximately two to three hundred businesses that deal in secondhand gold goods. Many of these businesses are said to have claimed deductions for these goods, based on a lack of understanding of the current obligations. Anecdotally, this lack of understanding is also said to extend to some advisors.

*Root cause*

92. This situation arises due to a technical exception to the definition of "secondhand goods" in the Goods and Services Tax Act 1985. In particular, deductions are denied for two kinds of secondhand goods that include a gold component:

- Secondhand goods which consist of fine gold, silver or platinum; and
- Secondhand goods which are, or to the extent they are, manufactured from gold silver or platinum.

93. This first exception recognises that the GST policy settings are intended to result in no GST being payable in respect of supplies of fine gold, silver or platinum, and therefore no credit should be available in respect of these goods.

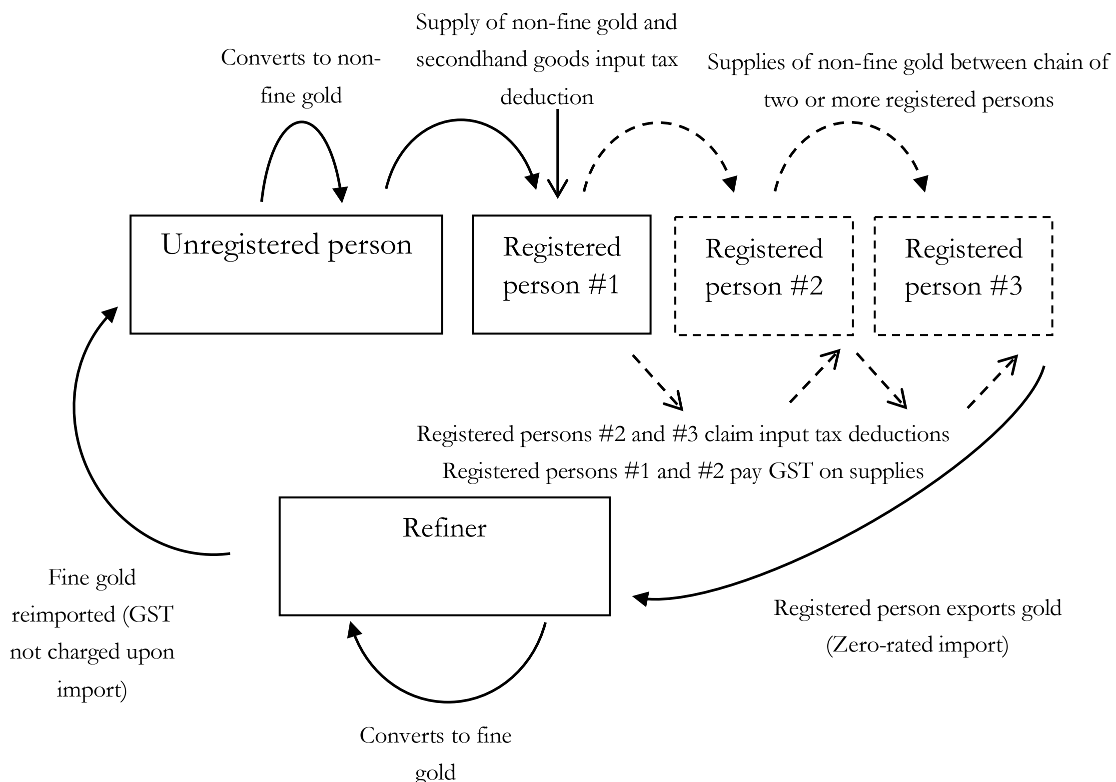
94. As a supply of these metals is not taxed (being exempt, with the first supply of new fine metal being zero-rated) this first exception does not give rise to double taxation concerns – there should be no embedded GST to be recovered.

95. The second exception results from historic concerns about a kind of fraud. As gold may be transmuted between fine and non-fine forms, by combining it with other metal(s), there was a concern this difference in treatment between fine gold and other gold could be abused and used to produce input tax deductions (under the rules for secondhand goods) without any tax having been paid.

96. The specific concern was that untaxed fine gold would be converted to non-fine gold by an unregistered person, and supplied to a registered person who claimed a deduction. The gold would be subsequently supplied between other parties, and eventually exported (as a zero-rated supply) to be refined into a fine form again. (At least two parties were required, as there was, at the time, a prohibition against zero-rating an export, if a secondhand goods input tax deduction had been claimed). Any GST charged as part of this arrangement would be deducted by another party. This is shown diagrammatically on the following page.

97. We note that the conversion between forms <u>must</u> take place by an unregistered person, for this concern to arise, as a registered person carrying on this activity would be required to charge GST when they supplied the gold, in which case GST paid and input tax deductions claimed would net off.

**Example: fraud involving gold**




98. This taxation without crediting embedded tax potentially produces two results in respect of the gold content of these goods. Where these goods are on-sold, or are subsequently used to make taxable supplies, the lack of input tax for the value attributable to this gold content potentially results in its double taxation. Alternatively, where these goods are fine gold, which is not taxed itself, the denial of deductions means that it may be effectively taxed, contrary to the policy intention.

***Objectives***

99. The key objectives are effectiveness and fairness, neutrality, and certainty and simplicity. That is, to ensure that the rules meet the underlying objective that GST applies evenly to the consumption of different goods and services, and that GST distorts competition as little as possible, while providing certainty in a complex area of law.

***Regulatory impact analysis***

100. Given that the underlying issue is caused by an exception to the framework that is designed to provide for goods to be taxed evenly, both options analysed (aside from the status quo) adopt this as a starting point, with the main difference being the timing of a change, that is, whether or not it should be retrospective.

101. One option is therefore to narrow the exception to the secondhand goods rules, to allow deductions to be claimed for these secondhand goods. Another option is to make the change retrospective, aligned with the time bar for the Commissioner to reassess a return.

*Option 1: allowing secondhand goods deductions*

102. The exception to the secondhand goods rules for the gold content of any goods could be narrowed. A narrower exception could allow these deductions for goods, such as jewellery, that would pose a lower risk of fraud.

103. Narrowing the exception would help ensure neutrality within business sectors that deal in these goods:

- All businesses would be able to claim deductions in respect of these goods, ensuring that competition takes place upon an even playing field;
- Allowing deductions would remove the tax preference to transact in certain ways, for example, for businesses to add value as agents rather than to purchase and resupply goods themselves, or for consumers to sell items privately.

104. Secondhand gold goods would bear a similar tax burden to other goods. This would have a dual effect of ensuring that GST applies to tax consumption evenly, and collects the right amount of tax at the right time, and would increase neutrality between business sectors, by ensuring that the additional taxation did not distort purchasing or investment decisions.

105. As the current treatment of gold results from an exception to the ordinary rules that apply to secondhand goods, restricting the application of this exception (so that it is not commonly applied and is effectively limited to preventing this fraud) would make the legislation clearer and simpler, and businesses could be more confident that they have applied it correctly. In addition, it is consistent with what we understand to be many businesses' current practice.

106. However, there may be some remaining uncertainty surrounding businesses' past compliance. The current legislation is complex and poorly understood, so businesses may not have a high degree of certainty in their past transactions, including the amount of claimed deductions they may technically have to repay, or certainty that they have accurately determined the allowable deduction given that in some cases it may be difficult to precisely value the gold content.

107. Allowing deductions for the gold content of these goods would be expected to reduce compliance costs for compliant businesses. Under this option, these businesses should only incur the ordinary costs of maintaining the required records (which they would currently be expected to do, to claim input tax deductions for the non-gold component of secondhand goods) and would no longer incur cost in apportioning the price paid for the good between the gold content and the non-gold content.

108. Businesses that comply with the secondhand goods rules, but not the exception for gold (that is, they are already claiming these deductions), would be expected to already maintain these records, so this approach would maintain their status quo.

109. No special administration costs are expected to be incurred in administering this option. Costs would be incurred in communicating the changes, updating products and dealing with customer contacts. These costs would not be expected to be significant.

110. Allowing input tax deductions in respect of these goods would reduce the amount of GST collected, as the deductions would reduce GST paid by the business or be refunded. This would reduce GST revenue by a forecast $0.4 million per annum. Persons dealing in these goods would receive a corresponding benefit of $0.4 million per annum.

*Option 2: allowing secondhand goods deductions – retrospective (officials preferred option)*

111. A variant of the option above would be to apply a change retrospectively, aligned with the time bar for Commissioner reassessments to increase tax payable in a period. This would depart from the above analysis in the following ways:

- It would provide greater certainty to those taxpayers who have previously claimed these deductions, as they would not be required to reassess their past tax positions, and to businesses who have valued the gold content to claim input tax deductions in respect of the non-gold component.

- It would maintain greater fairness and equity between taxpayers. It is possible that non-compliant taxpayers would be reassessed by the Commissioner, and required to repay amounts claimed, use-of-money interest, and penalties. This could have a significant effect on a wide group of businesses given that many businesses are expected to have claimed these deductions. It is arguably not fair for businesses to suffer a significant impact due to a misapplying a complex piece of technical legislation, that is a counter-intuitive exception (for those who are not aware of the underlying policy reason) to the ordinary rules.

- Conversely, compliant businesses should not be disadvantaged by reason of their compliance. Enabling these businesses to recover deductions within this period ensures they are treated equivalently.

112. This option would have a higher fiscal cost, due to the payment of previously unrecovered deductions. This is estimated as an additional one-off cost of $1.6 million.

*Option 3: status quo*

113. It would be an option to maintain the current treatment. In that case, the situation outlined in the problem definition would continue.

***Summary of the analysis of the options***

114. Option 1 and Option 2 are expected to increase economic efficiency by removing a tax preference for certain kinds of transactions, and by ensuring all businesses have a similar entitlement to deductions.

115. Option 1 and Option 2 are expected to reduce compliance costs, as businesses will not be required to determine the gold content of secondhand goods, for the purpose of claiming a deduction for the non-gold portion of the goods.

116. Neither option is expected to significantly increase administration costs.

117. None of the options are expected to have social, cultural or environmental impacts.

118. Table 3 summarises the analysis of the options against the stated objectives.

**Table 3: Analysis of options for Item C (Secondhand goods and gold)**

| | Neutrality* | | Efficiency | | Certainty and simplicity* | Effectiveness and fairness* | Fiscal impact |
|---|---|---|---|---|---|---|---|
| | Within sectors | Between sectors | Compliance costs | Administration costs | | | |
| **Option 1: Allowing secondhand goods deductions** | **Increased** - value added is taxed – GST is otherwise neutral between businesses and transaction types. *Meets objective* | **Increased** - secondhand gold treated the same as most other secondhand goods. *Meets objective* | **Decreased** - compliance costs comparable to other secondhand goods. *Meets objective* | **No change** - IRD monitors taxpayers' compliance with the rules (as with other tax rules). *Meets objective* | **Increased** - no special rule for gold. Rules consistent with the rest of the Act. Some uncertainty regarding past positions. *Meets objective* | **Increased** - results in taxation of consumption of gold. *Meets objective* | **Reduced** – revenue decrease estimated at $0.4 million per annum. |
| **Option 2: Allowing secondhand goods deductions – retrospective (officials' preferred option)** | **Increased** - value added is taxed – GST is otherwise neutral between businesses and transaction types. *Meets objective* | **Increased** - secondhand gold treated the same as most other secondhand goods. *Meets objective* | **Decreased** - compliance costs comparable to other secondhand goods. *Meets objective* | **No change** - IRD monitors taxpayers' compliance with the rules (as with other tax rules). Some returns would need to be reopened. *Meets objective* | **Increased** - no special rule for gold. Rules consistent with the rest of the Act. Past positions preserved. *Meets objective* | **Increased** - results in taxation of consumption of gold. *Meets objective* | **Reduced** – revenue decrease estimated at $0.4 million per annum. One-off cost forecast at $1.6 million. |
| **Option 3: Status quo** | **No change** - GST-registered businesses disadvantaged compared to unregistered businesses. Non-compliance distorts competition. *Does not meet objective* | **No change** - secondhand gold treated less favourably than other secondhand goods. *Does not meet objective* | **No change** - compliance costs higher than other secondhand goods as purchaser must determine gold metal content. *Does not meet objective* | **No change** - IRD monitors taxpayers' compliance with the rules (as with other tax rules). *Meets objective* | **No change** - rules more complex and less consistent, require greater understanding. Some uncertainty regarding past positions. *Does not meet objective* | **No change** - results in taxation upon supply of gold, rather that upon consumption. *Does not meet objective* | **No change**. |

### *Consultation*

119. Four submissions were received on this item, supporting the proposal to make a retrospective amendment (Option 2). Two submitters suggested ensuring that a business that had been reassessed during the retrospective period be able to recover the reassessed amount (even if the particular goods to which the claimed deductions related were purchased outside the four year period). Officials supported this as being consistent with maintaining business' status quo while ensuring equity between taxpayers. This has been incorporated into Option 2.

### *Conclusion and recommendation*

120. Option 1 and Option 2 both satisfy the key objective that tax be neutral (both within a sector and between sectors) and efficient.

121. It is difficult to determine the relative administration costs of the options – under Option 2, Inland Revenue may incur some costs in reopening a number of returns to pay claimed refunds. However, the cost of the other options will depend on the amount of resources the Commissioner decides to spend on compliance activities.

122. Both options provide similar certainty and simplicity of rules for businesses going forward. Option 2 provides more certainty in respect of past periods, as businesses have certainty about their past affairs. Option 2 is fairer than Option 1, as it ensures that compliant businesses are not disadvantaged by reason of their compliance, while both options ensure that the correct amount of tax (in a policy sense) is collected.

123. On balance, Option 2 best meets the objectives, including being the option that best meets all three key objectives. We therefore recommend this option.

## Item D: Services connected with land

### *Status quo and problem definition*

124. Exceptions to the normal rules that tax services based on the location and residence of the recipient exist for services that are closely connected with land. The International VAT/GST Guidelines published by the OECD (the "Guidelines") recognise that certain supplies, closely connected with real property, may be taxed where that property is located. These services are likely to fall into one of three categories:

- the transfer, sale, lease or the right to use, occupy, enjoy or exploit immovable property,
- supplies of services that are physically provided to the immovable property itself, such as constructing, altering and maintaining the immovable property, or
- other supplies of services and intangibles that do not fall within the first two categories but where there is a very close, clear and obvious link or association with the immovable property.

125. For services to have a sufficiently close connection with land, the Guidelines suggest that the connection with the land must be at the heart of the supply of services and constitute its predominant characteristic,[2] and the associated land must be clearly identifiable.[3]

126. New Zealand to some extent follows this approach of taxing services with a close relationship to the land. The GST Act contains two relevant provisions, which create special treatment for services connected to land:

- Supplies of services to non-residents, located outside New Zealand, (which are generally not taxable) may be taxed where the services are provided "directly in connection" with land in New Zealand (section 11A(1)(k)(i)(A)); and
- Supplies of services "directly in connection" with land outside New Zealand are not taxed (section 11A(1)(e)).

127. The meaning of the "directly in connection with" test, which is used to determine whether certain services with a close connection with land are taxable in New Zealand, has been considered in cases such as *Malololailai Interval Holidays New Zealand Ltd v CIR*[4] and *Wilson & Horton v CIR*[5]. The courts have found that a service will not be supplied directly in connection with land when the service merely brings about or facilitates a transaction with a direct effect on land, or when the service could be described as being "one step removed" from such a transaction.

128. A consequence of this interpretation is that a number of services that have a close connection to land may not fall within the scope of these provisions. It is clear that services that have a direct physical effect on land, such as landscaping or construction services, will satisfy the "directly connected with" test under this interpretation. However, it is less clear how the test applies to professional or intellectual services that do not have a direct physical effect on land.

129. Inland Revenue has issued a Public Ruling that legal services provided in respect of land in New Zealand do not meet the test of being supplied "directly in connection with" land, and therefore are zero-rated under section 11A(1)(k) when supplied to offshore non-residents.[6] For example, legal services that facilitate the change of ownership of land, such as the drafting of a sale and purchase agreement, are zero-rated as the service is "one step removed" from the direct transaction between the vendor and the purchaser.

130. Other professional or intellectual services could also fall outside the scope of the specific rule under this interpretation. For example, services provided by an architect could be considered to be "one step removed" from a direct transaction, being the construction of a building. Similarly, services provided by real estate agents in facilitating a change in ownership of land could be "one step removed" from having a direct effect on land.

131. Such a result seems to be inconsistent with the policy intent of the provision. The test was intended to treat services that have a strong connection with land as effectively being consumed where the land is located. It was intended to encompass all services that are closely

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[2] *International VAT/GST Guidelines* (OECD, November 2015), at [3.176]

[3] At [3.175]

[4] (1997) 18 NZTC 13,137

[5] (1994) 16 NZTC 11,221

[6] BR Pub 15/03 "Goods and Services Tax – legal services provided to non-residents relating to transactions involving land in New Zealand", Tax Information Bulletin Vol. 27, No. 3 (April 2015)

related to land, rather than to create a distinction between services that have a physical effect on land and those that bring about or facilitate such a transaction.

132. Another consequence of the interpretation is that New Zealand's specific rule is out of step with international practice, which may lead to double taxation or non-taxation of cross-border services that are connected with land.

133. Equivalent provisions in Australia, Canada and the European Union apply to a broader range of services that are connected with land, as their tests consider whether there is a direct relationship between the purpose or objective of a service and land. In these jurisdictions, legal, architectural and real estate agent services are treated as having a sufficient connection with land where this test is satisfied in relation to a particular property. (However, the Australian Taxation Office considers that, following the interpretation in *Malololailai,* the services of a real estate agent will not be considered to be directly connected to real property if the agent merely markets the property to willing purchasers.)

134. Double taxation or non-taxation may arise when New Zealand's specific rule does not capture similar services to those in other jurisdictions. For example, a service provided by a New Zealand lawyer to a New Zealand resident in relation to land outside New Zealand could be taxed in both jurisdictions. Conversely, a service provided by a New Zealand lawyer in relation to the purchase of land in New Zealand may not be taxed in either jurisdiction, if the recipient is a non-resident who is outside New Zealand. In contrast, a resident acquiring the same service, in respect of the same land in New Zealand, would incur GST.

135. The application of the specific rule for services that are received by non-residents is limited by the broad definition of "resident" that applies for GST purposes. Under the GST Act, a "resident" includes a person who carries on a taxable activity or any other activity in New Zealand, while having a fixed or permanent place in New Zealand relating to that activity. This means that services will generally already be taxed in New Zealand when they are supplied to a person who carries on an activity of developing, dividing or dealing in land, or residential or commercial rental of a property in New Zealand. The potentially narrow scope of the specific rule could lead to additional complexity for service providers, as they will need to consider whether their customer is a resident under the expanded definition in order to determine whether each supply should be zero rated.

136. The exact number of businesses providing services that fall outside the scope of the current definition is not known, as we do not have detailed knowledge of the affected industries. However, a number of law firms would be affected, and a number of other professional firms, such as real estate agents or architects may also be affected.

***Objectives***

137. The key objective is effectiveness and fairness. GST should apply evenly to consumption in New Zealand, and residents and non-residents should be taxed alike. The determining factor for whether GST is charged should be where the goods or services are consumed, rather than who consumes them. GST is not effective and fair when it results in different outcomes for residents and non-residents who are consuming the same services in relation to land in New Zealand.

***Regulatory impact analysis***

138. One policy option and the status quo were considered for addressing the policy problem and meeting the objectives.

- Option 1: Broaden the scope of the specific rule to apply to services where there is a direct relationship between the purpose or objective of the service and land,

- Option 2: Retain the current GST treatment where the specific rule applies to services which have a direct effect on land, and not to services that could be considered to be "one step removed" from a direct transaction.

139. Note that it is assumed, for the purpose of this analysis, that the policy changes contained in the *Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Bill* would be implemented. The Bill would treat cross-border services and intangibles, supplied by non-residents outside New Zealand and received by New Zealand residents, as supplied in New Zealand. Non-residents providing these cross border services and intangibles may therefore be required to register and return GST. The Bill also contains a "tax credit" rule that ensures services provided to non-residents will not be subject to double taxation under both New Zealand's GST and a foreign equivalent.

140. The identification of additional practical options to address the objectives was limited, due to the cause of the problem. The problem arises due to a mismatch between the legal interpretation of the GST Act and the economic framework underpinning the GST Act. The question is therefore whether the current legal test for where services are consumed (Option 2) ought to be altered to match the economic reality (Option 1).

*Option 1: Broadening the scope of the test*

141. This option would alter the "directly in connection with land" test, so that it applies to services where there is a direct relationship between the purpose or the objective of the service and land. This would include services that have the purpose or objective of affecting or defining the nature or value of land, protecting land, or affecting the ownership or any interest in land. However, services would not satisfy the test where the part of the service that relates to land is only an incidental aspect of the supply, or if the service does not relate to a designated property.

142. This would mean that services such as those provided by real estate agents, architects and legal services in respect of land in New Zealand would not be zero-rated when supplied to offshore non-residents. Conversely, when these services are provided in respect of land outside New Zealand, they would be zero-rated regardless of the residence of the recipient.

143. Bringing New Zealand's specific rule for services that are provided in respect of land in line with equivalent rules in other jurisdictions would reduce the potential for double taxation of New Zealand residents' consumption, and non-taxation of non-residents consumption. This would help ensure that GST taxes consumption effectively and fairly. It would also ensure that residents and non-residents incur the same amount of GST, increasing fairness.

144. In certain cases this option would create a competitive advantage for businesses performing services – connected with land in New Zealand and supplied to non-residents – offshore. These services may not be taxed, including under the new rules for cross-border supplies of services and intangibles. If these services are performed in New Zealand, they

may be taxable. This creates an incentive for non-residents to acquire these services from offshore. However, it is not clear to what extent there is in fact competition between New Zealand and offshore suppliers in relation to these services.

145. The opposite applies to services connected with land outside New Zealand and supplied to residents – New Zealand businesses may have a competitive advantage for services supplied to New Zealand residents (depending on overseas rules).

146. Submitters expressed some concern that adopting a new test would reduce certainty, as businesses would need to adapt to the new test and, in contrast the status quo is relatively well understood. It is expected that guidance on the intended application of the rule would be published, to help reduce the uncertainty and to clarify the intended effect of the rule.

147. Submitters were also concerned that the change would potentially increase compliance costs, where businesses making multiple supplies to non-residents would need to distinguish between services connected with land and subject to the new rule, and those that were not. However, other businesses may benefit from the option, as a wider range of services would be subject to more consistent treatment, rather than the GST treatment of a transaction varying based on the residence or location of the recipient.

*Option 2: Retain the status quo*

148. The status quo results in a narrower range of services being included within the test. In particular, this potentially results in:

- The non-taxation of certain services in relation to land in New Zealand that are consumed in New Zealand by non-residents ;
- The taxation (and potential double taxation) of certain services that are consumed by New Zealand residents outside New Zealand in relation to land outside New Zealand.

Submitters indicated that they considered their obligations under the status quo to be relatively well known. However, submissions were primarily received from industry associations and professional firms – it is not clear if this view is more widely held, particularly as there is no published guidance from Inland Revenue on the application of this test to services, aside from legal services.

***Summary of the analysis of the options***

149. Option 1 is expected to slightly reduce economic efficiency, as offshore businesses may have an advantage in some cases when providing services to non-residents, in connection with land in New Zealand. It is not clear to what extent there is competition between these resident and non-resident service providers, or to what extent GST influences decisions.

150. Both options are expected to be relatively neutral in relation to compliance costs. Option 1 would change the legal test applied by businesses to determine the GST treatment of their supplies. While there may be some initial uncertainty, this can be reduced by published guidance on the policy intention and intended application of new rules, when they are enacted.

151. Neither option is expected to significantly affect administration costs.

152. Neither option is expected to have social, cultural or environmental impacts.

153. As noted in the problem definition, the exact scale of the impact is not known. Law firms and real estate agencies are expected to be affected by a change. The changes in Option 1 would affect services they provide to non-residents, in respect of land in New Zealand and services they provide to residents, in respect of overseas land. It is uncertain which other businesses will be affected, as it will depend on their specific contractual agreements.

154. Table 4 summarises the analysis of the options against the stated objectives.

## Table 4: Analysis of options for Item D (Services connected with land)

| | Neutrality | | Efficiency | | Certainty and simplicity | Effectiveness and fairness* | Fiscal impact |
|---|---|---|---|---|---|---|---|
| | Land in New Zealand | Land outside New Zealand | Compliance costs | Administration costs | | | |
| **Option 1: Broadening the scope of the test** | **Decrease -**<br>*Supplies to residents*<br>Treatment of New Zealand and overseas businesses should be equivalent.<br><br>*Supplies to non-residents*<br>Possible competitive advantage for businesses performing services outside New Zealand.<br><br>*Meets objective* | **No change -**<br>*Supplies to residents*<br>Possible competitive advantage for New Zealand businesses performing services in New Zealand.<br><br>*Supplies to non-residents*<br>Treatment of New Zealand and overseas businesses should be equivalent.<br><br>*Meets objective* | **No change -** businesses would apply a new test, which is not expected to significantly alter compliance costs from the current test.<br><br>*Meets objective* | **No change** - IRD monitors taxpayers' compliance with the rules (as with other tax rules).<br><br>Cost from updating products and communicating changes.<br><br>*Meets objective* | **Decrease** - increases uncertainty of business' obligations.<br><br>Guidance on intended effect would help mitigate this uncertainty.<br><br>*Meets objective* | **Increase** - GST applies evenly to consumption in New Zealand. GST does not apply to consumption outside New Zealand.<br><br>*Meets objective* | **Increase** – revenue increase forecast at $4 million per annum. |
| **Option 2: Status quo** | **No change -**<br>*Supplies to residents*<br>Treatment of New Zealand and overseas businesses should be equivalent.<br><br>*Supplies to non-residents*<br>Treatment of New Zealand and overseas businesses should be equivalent.<br><br>*Meets objective* | **No change -**<br>*Supplies to residents*<br>Possible competitive advantage for New Zealand businesses performing services in New Zealand.<br><br>*Supplies to non-residents*<br>Treatment of New Zealand and overseas businesses should be equivalent.<br><br>*Meets objective* | **No change -** businesses continue to apply current test.<br><br>*Meets objective* | **No change** - IRD monitors taxpayers' compliance with the rules (as with other tax rules).<br><br>*Meets objective* | **No change** – businesses would apply a longstanding test.<br><br>Currently little guidance on application to services, other than legal services.<br><br>*Meets objective* | **No change** - non-residents receive more favourable treatment of some consumption in New Zealand.<br><br>Residents' consumption outside New Zealand is taxed.<br><br>*Does not meet objective* | **No change.** |
| ** = Key objective* | | | | | | | |

*Consultation*

155. Submitters were generally opposed to Option 1, with concerns focussing on the uncertainty created by replacing an existing test, which was said to be well understood, with a new one. Officials are aware of this concern, and will seek to clearly set out the policy underlying a change, if one is made, in publicly available material, including the commentary to the relevant amendment bill, and an article in Inland Revenue's Tax Information Bulletin.

156. Submitters noted that there is currently congruence between the tests for when services provided in connection with land are subject to GST and for when services provided in connection with other goods are subject to GST. Submitters considered that aligning these two tests increases simplicity and consistency of the rules.

157. Two submitters were concerned that Option 1 would negatively impact the neutrality of the rules by creating an incentive for non-residents to source services from overseas, as these services would remain untaxed. It is not clear to what extent providers of services, closely connected to land, within New Zealand compete with persons outside New Zealand.

***Conclusion and recommendation***

158. Option 1 best satisfied the objectives of effectiveness and fairness. The status quo best satisfied the objectives of neutrality, efficiency, and certainty and simplicity. While the status quo better satisfies more objectives than Option 1, it did not satisfy the key objective, and where it did satisfy an objective better than Option 1, the margin between the options was small.

159. In contrast, Option 1 best satisfies the key objective, by ensuring that residents' and non-residents' consumption in New Zealand would be taxed more evenly, and satisfied the remaining objectives. On balance, Option 1 is therefore officials' preferred option.

## IMPLEMENTATION

160. The recommended options would need to be given effect through primary legislation amending the Goods and Services Tax Act 1985. Amendments would be suitable for inclusion in the next omnibus taxation bill.

161. We recommend amendments have effect from the following dates:

- Capital raising costs – from 1 April 2017
- Apportionment rules – from date of enactment
- Secondhand goods and gold – from date of enactment (with a four year retrospective effect)
- Services connected with land – from 1 April 2017

162. Once these amendments had been made, they would form part of the body of tax legislation applied by taxpayers and monitored and enforced by Inland Revenue. Communications products, such as inclusion in a Tax Information Bulletin article, would publicise the changes, once they are enacted.

163. This is subject to the following additional comments:

*Apportionment rules*

164. Under this proposal, individual taxpayers who meet the criteria and industry associations could apply to Inland Revenue to agree an alternative method, which would then be negotiated between the parties.

*Secondhand goods and gold*

165. Enabling businesses to recover previously unclaimed deductions would require a number of returns to be reopened. The number would depend on the number of taxpayers in this position. This would be performed under existing processes.

## MONITORING, EVALUATION AND REVIEW

166. Inland Revenue will monitor the effectiveness of the proposed changes in the first 12 months of operation, pursuant to the Generic Tax Policy Process ("GTPP"). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995

167. The final step in the GTPP is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

# Regulatory Impact Statement

## Loss grouping and imputation credits

## Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to address the current tax disadvantage created by the interaction of the loss grouping and dividend imputation rules for non-wholly owned companies that are part of a commonly-owned group. This tax disadvantage arises from the claw-back of the benefit of loss grouping when the recipient of the loss doesn't have sufficient imputation credits to impute a dividend to its shareholders resulting in additional tax being required to be paid.

The tax disadvantage is an unintended outcome of the interaction between the two sets of rules, is inconsistent with current tax settings and leads to sub-optimal decision making (i.e. it creates an incentive for 100 percent, rather than partial, corporate acquisitions in circumstances where this may not be the most economically efficient outcome).

Analysis of the status quo involved reviewing a sample of the population of all companies that undertook a loss offset or subvention payment. This sample was reviewed to check the ownership structure and, if these companies were non-wholly owned, whether they paid unimputed dividends to their shareholders.

There are two key constraints on the analysis:

- Because of data limitations it is not possible to ascertain the reasons why companies may be paying unimputed dividends or how many companies are choosing to remain in a wholly-owned group structure in order to prevent the tax disadvantage arising. Consequently, it is not possible to determine the full extent of the problem.

- A number of assumptions were made in order to determine the likely fiscal impact. The tax disadvantage does not appear to raise significant tax revenue as taxpayers can structure their affairs to prevent the taxation of unimputed dividends. Structuring options to achieve this include: staying as a wholly-owned group; not paying dividends; not grouping losses; or accessing imputation credits from another source. The options in this RIS may decrease tax revenue (owing to unimputed dividends becoming imputed) or increase tax revenue (because new imputed dividends may be paid to a person on a tax rate higher than 28 percent). The fiscal estimates were refined following targeted private sector consultation.

A range of options have been considered and measured against the criteria of economic efficiency, fairness and integrity and coherence whilst minimising compliance costs for taxpayers and disruption to current practices and administrative costs for Inland Revenue. There are no environmental, social or cultural impacts from the recommended changes.

Inland Revenue is of the view that, aside from the lack of information on current ownership structures and dividend payment behaviour, and the difficulty with fiscal estimates, described above, there are no other significant constraints, caveats and uncertainties concerning the regulatory analysis undertaken.

None of the policy options identified is expected to restrict market competition, reduce the incentives for businesses to innovate and invest, unduly impair private property rights or override fundamental common law principles.

Peter Frawley
Policy Manager, Policy and Strategy
Inland Revenue

20 November 2015

## STATUS QUO AND PROBLEM DEFINITION

1. The question addressed in this RIS is how to deal with the tax disadvantage that occurs when the loss grouping and dividend imputation rules in the Income Tax Act 2007 are applied by a non-wholly owned group of companies.

### Loss offset

2. A company that has at least 66 percent of shareholders the same as another company is referred to as being "commonly-owned". A company ("the loss company") can transfer the benefit of a loss incurred to a commonly-owned company ("the profit company") by undertaking a loss offset or receiving a subvention payment ("a loss transfer").

3. A loss offset has the effect of reducing the loss of one company and decreasing the taxable profit of another company within a commonly-owned group by an equivalent amount. A subvention payment achieves the same effect by the profit company making a deductible payment (and therefore reducing its net income) to another company in a commonly-owned group. The subvention payment is assessable to the loss company and reduces its loss. Taxpayers in a commonly-owned group can use any combination of loss offsets and subvention payments to transfer the benefit of a loss. The examples in this RIS apply a subvention payment equal to the tax value of the total loss transfer and a loss offset for the balance, this combination provides the loss company with a cash compensation for the value of the losses they have transferred.

4. When considered as a group, the loss transfer will reduce income tax payments required in the current year but will make fewer losses available to offset against future year profits. This reduction in income tax payments means the profit company will generate fewer imputation credits than if the loss had not been transferred.

5. Loss transfers between companies with "substantially the same" shareholders or under common control was originally introduced in the Land and Income Tax Act 1954 as an anti-avoidance measure when New Zealand had a progressive company tax rate. It was designed to prevent a business being broken into a number of separate companies to avoid the higher marginal tax rates.

6. In 1968 the law was amended so that the Commissioner of Inland Revenue no longer had to invoke avoidance to assess group companies (now defined to be companies with 2/3rds common ownership) at the tax rate that would apply to the aggregate taxable income of the group. The corollary of this automatic aggregation of group income was the ability of group companies to use subvention payments to group tax losses. It was originally proposed that grouping of income would occur at 50 percent commonality and subvention payments could be made at 75 percent commonality. Ultimately, the 2/3rds threshold was adopted for both income and losses. New Zealand's 66 percent commonality threshold for loss grouping is substantially lower than other OECD countries – notably Australia which only allows grouping within a consolidated group (which requires 100 percent common ownership).

### Dividend imputation

7. Imputation credits represent a credit for income tax paid by a company and can be attached to a dividend paid by the company to its shareholders. Imputation credits are also assessable to the owner of the company receiving the dividend, but are a credit against tax payable. This system allows the value of tax paid by a company to reduce the tax liability of its shareholders so that the same income stream is not taxed twice. When a company pays a dividend that has imputation credits attached equal to the company tax rate this dividend is known as a fully imputed dividend. When some imputation credits are attached, but less than the full company tax rate, this is known as a partially imputed dividend.

8. When the profit company pays a dividend to its shareholders it will often have insufficient imputation credits to fully impute the dividend because the losses transferred mean less tax has been paid by the profit company. The shareholder will therefore have to pay more income tax compared to if the dividend was fully imputed. When the commonly-owned group and its shareholders are considered as a whole, more tax will be paid than if the loss was not transferred.

### The problem

9. Example 1 illustrates how the additional tax arises. In this example a loss company has a 90 percent shareholding in a profit company (which makes it eligible to group losses). All shareholders are assumed to be on a 28 percent tax rate in order to simplify the example.

***Example 1***

- The loss is transferred from LossCo to ProfitCo via a combination of a 28 percent subvention payment and a loss offset election for the remaining $7,200 tax loss.
- ProfitCo has $10,000 of profit after the loss transfer so pays $2,800 tax. It therefore has $14,400 of cash and $2,800 of imputation credits.[1]
- ProfitCo pays 10 percent of its profits as a dividend to Minority Shareholder. This is $1,440 cash and $280 of imputation credits. This dividend is not fully imputed so Minority Shareholder has to pay extra tax of $202.
- ProfitCo pays 90 percent of its profits as a dividend to LossCo. This is $12,960 cash and $2,520 of imputation credits. This dividend is not fully imputed so LossCo has to pay extra tax of $1,814.
- LossCo pays its $10,000 interest bill and distributes its remaining $3,946[2] as a cash dividend with $1,534 of imputation credits attached.
- This can be shown in a diagram as:

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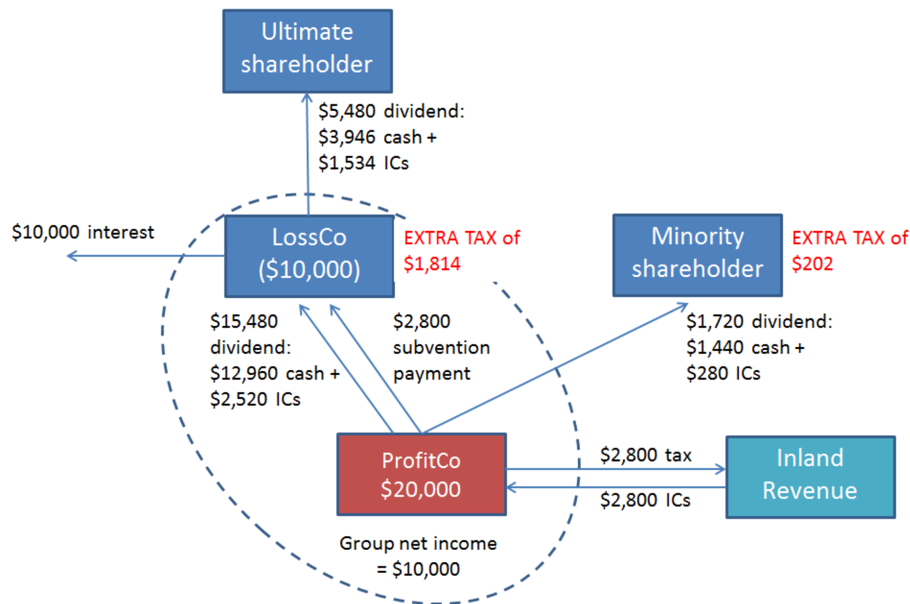
[1] $20,000 less $2,800 subvention payment and $2,800 tax payment.

[2] $2,800 subvention payment plus $12,960 cash dividend less $10,000 interest payment less $1,814 tax payment.




10. The consequences of this transaction are that $4,816[3] of tax has been paid even though only $10,000 of total income was earned. Also, LossCo ends up with $2,800[4] of imputation credits that cannot be used unless additional income is generated without additional tax being paid.

11. This problem does not arise for wholly-owned groups because of the operation of the inter-corporate dividend exemption. The inter-corporate dividend exemption allows a company to pay a dividend to its 100% corporate shareholder without the dividend being included in the recipient company's assessable income. This exemption recognises that one company wholly-owning another company is economically equivalent to a single company undertaking all of the activities of both companies and there are efficiency benefits in not requiring imputation credits to be tracked across this transaction. The same arguments do not apply to a non-wholly owned group as a company having more than one shareholder means the company and its shareholders cannot be considered as a single economic unit.

12. Because this problem does not arise for wholly-owned groups it creates a tax disadvantage for non-wholly owned groups and incentivises 100 percent ownership, even when - in the absence of tax - it would be economically efficient for a group to include a minority shareholder(s).

13. The root cause of the problem is that losses can be offset between commonly-owned groups whereas the inter-corporate dividend exemption is only available to wholly-owned groups. The tax disadvantage for non-wholly owned groups created by the interaction of these two sets of rules would disappear if these two thresholds were aligned.

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[3] $2,800 paid by ProfitCo plus $202 by Minority Shareholder plus $1,814 by LossCo.

[4] $2,520 from the dividend plus $1,814 from tax paid less $1,534 distributed to Ultimate Shareholder.

### Scale and impact of the problem

14. Although this problem influences the ownership structuring decisions of company shareholders, it does not appear to have a large impact on the amount of tax paid. This is because groups can make decisions that prevent income being subject to tax twice such as maintaining a wholly-owned group, not transferring the full amount of losses or not paying dividends.

15. Owing to data limitations there is no reliable way of estimating how many companies may be discouraged from taking on minority shareholders because of the interaction of the loss grouping and dividend imputation rules. This is because we can observe what unimputed dividends have been paid but cannot observe what dividends have not been paid and what wholly-owned groups have not taken on a minority shareholder(s).

## OBJECTIVES

16. The main objective is to remove or reduce the tax disadvantage created by the interaction of the loss grouping and dividend imputation rules.

17. The criteria against which the options will be assessed are:

- ***Economic efficiency:*** A loss company, within a non-wholly owned group that undertakes a loss transfer, should be able to pay a dividend to its shareholders without the single income stream being subject to two layers of taxation. If a profitable company receives the benefit of a loss transfer then distributes part or all of this as a dividend, the shareholder's tax liability should be equivalent to the tax liability that would have arisen if that profitable company had instead paid income tax and attached imputation credits to the dividend.

- ***Effectiveness:*** Because the changes are expected to apply to a relatively narrow subset of taxpayers, the main objective should be achieved with minimal impact on taxpayers who are not transferring losses within non-wholly owned groups.

- ***Integrity and coherence:*** The ability to transfer tax-free profits and/or imputation credits both within and outside of wholly-owned and non-wholly owned groups is subject to many areas of existing law. New opportunities should not be created for taxpayers, and particularly those who are not within the problem definition, to transfer profits between entities that are inconsistent with the existing policy intent that the distribution of profits (other than within a wholly-owned group or other specific exceptions) should be subject to tax.

- ***Efficiency of compliance and administration:*** The loss grouping and imputation rules are both applied by a wide variety of taxpayers. The complexity of these rules should be minimised to ensure they are applied correctly and with a minimum of compliance and administration costs.

18. While all criteria are not equally weighted all criteria are important. If all of the last three criteria cannot be met to some degree an option that met the economic efficiency criteria would not be preferred.

## REGULATORY IMPACT ANALYSIS

19. Three policy options and the status quo were considered for addressing the policy problem and meeting the main objective. These were:

- *Option 1*: Retain the current law. This is the status quo option against which the other options are being assessed.
- *Option 2*: Allow the transfer of imputation credits as part of a loss transfer (preferred option)
- *Option 3*: Introduce a targeted exemption for dividends following a loss transfer; and
- *Option 4*: Align the loss transfer and inter-corporate dividend thresholds.

20. There are no environmental, social or cultural impacts for any of the options considered.

### Option 1: Retain the current law (status quo)

21. This option would retain the current law and the existing tax disadvantage for non-wholly owned groups arising from the interaction of the loss grouping and imputation rules.

#### *Assessment against criteria – option 1*

22. The status quo would not meet the economic efficiency criteria. However, the status quo will not result in any additional compliance or administration costs or create further tax planning opportunities inconsistent with the policy intent so meets the effectiveness, integrity and efficiency of compliance and administration criteria. Therefore, this option is only a valid option if no other option achieves the main objective without creating excessive additional compliance or administration costs or tax planning opportunities.

### Option 2: Allow the transfer of imputation credits as part of a loss transfer (preferred option)

23. Under this option the loss company, or another member of the commonly-owned group, would transfer imputation credits to the profit company as part of the loss transfer arrangement. These imputation credits would allow the profit company to impute the dividend paid to its shareholders.

24. Example 2, which uses the same scenario from example 1, illustrates how option 2 would work.

*Example 2*

- As part of the $2,800 subvention payment and $7,200 loss offset LossCo also transfers $2,800 of imputation credits.

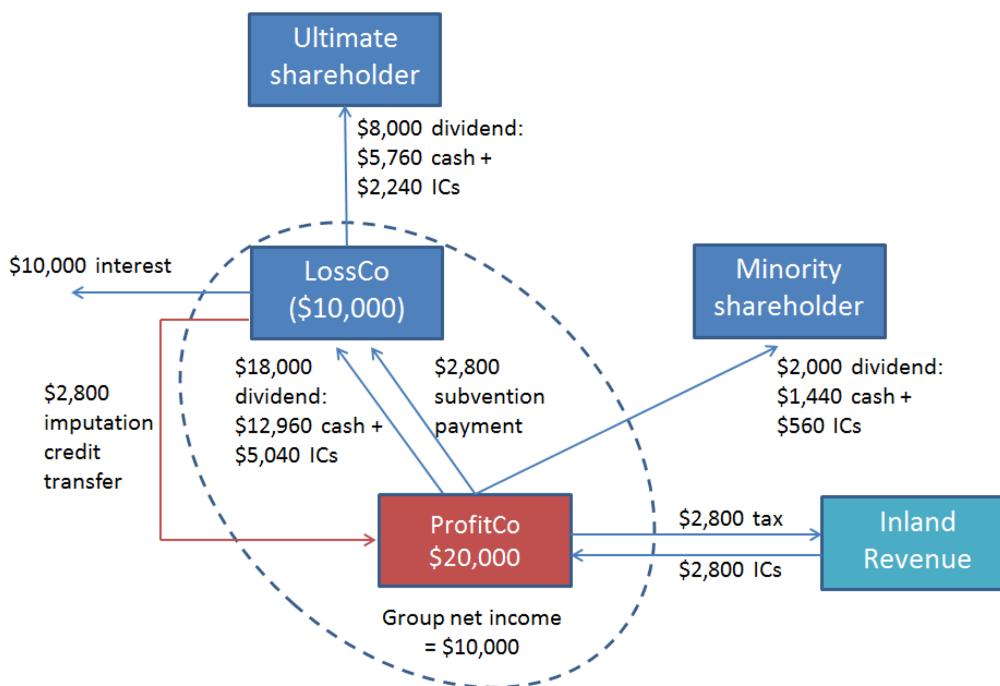
- ProfitCo still has $10,000 of profit after the loss transfer so pays $2,800 tax. It therefore has $14,400 of cash and $5,600[5] of imputation credits which is the same as if no loss transfer had occurred.

- ProfitCo pays 10% of its profits as a dividend to Minority Shareholder. This is $1,440 cash and $560 of imputation credits. As this dividend is fully imputed Minority Shareholder has to no extra tax to pay.

- ProfitCo pays 90% of its profits as a dividend to LossCo. This is $12,960 cash and $5,040 of imputation credits. As this dividend is fully imputed LossCo has to no extra tax to pay.

- LossCo pays its $10,000 interest bill and distributes its remaining $5,760[6] as a cash dividend with $2,240 of imputation credits attached.

- This can be shown in a diagram as:




25. The consequences of this are that $2,800 of tax has been paid on $10,000 of total income and LossCo is left with no remaining imputation credits.

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[5] $2,800 from tax paid and $2,800 from the imputation credit transfer.

[6] $2,800 subvention payment plus $12,960 cash dividend less $10,000 interest payment

26. No additional imputation credits are created by this transfer so that the company that transferred the imputation credits would record a debit in its imputation credit account equal to the amount of credits transferred. The majority[7] of the debit from the imputation credit transfer would be matched by a credit from the imputed dividend received from the profit company. This can be shown by considering the imputation credit account entries for LossCo and ProfitCo (Table 1 and Table 2 refer).

***Table 1: LossCo's imputation credit account***

| | Debit | Credit | Balance | |
|---|---|---|---|---|
| Opening balance | | | 0 | |
| Imputation credit transfer | 2,800 | | 2,800 | Dr |
| Dividend received from ProfitCo | | 5,040 | 2,240 | Cr |
| Dividend paid to Ultimate shareholder | 2,240 | | 0 | |

***Table 2: ProfitCo's imputation credit account***

| | Debit | Credit | Balance | |
|---|---|---|---|---|
| Opening balance | | | 0 | |
| Tax paid | | 2,800 | 2,800 | Cr |
| Imputation credit transfer | | 2,800 | 5,600 | Cr |
| Dividend to ProfitCo | 5,040 | | 560 | Cr |
| Dividend to Minority shareholder | 560 | | 0 | |

27. In some structures the profit company would pay the dividend to another member of the non-wholly owned group rather than to the loss company. This would arise when the loss company did not own the profit company, for example if the loss company and profit company were both owned by a common parent company. In this instance the taxpayer could manage the imputation debit by transferring the imputation credits from the group member that would receive the dividend rather than the profit company.

28. We acknowledge that this option does not fully achieve the main objective if the loss company receives fewer imputation credits attached to the dividend than they transferred as part of the loss transfer. This can occur when the loss transfer as a proportion of the profit company's profit is greater than the ownership percentage of the profit company.

29. Example 3 illustrates this point. It uses the same scenario in Example 2 except LossCo makes a $19,000 loss that is transferred as a $5,320 subvention payment and $13,680 loss offset.

[7] The exact balance between the imputation credits transferred and those received back on a dividend depend on the amount of the loss transferred as a proportion of the profit company's profit, the proportionate ownership interest and the proportion of profits paid as a dividend. This is explained further below.

***Example 3***

- As part of the $5,320 subvention payment and $13,680 loss offset LossCo also transfers $5,320 of imputation credits.

- ProfitCo still has $1,000 of profit after the loss transfer so pays $280 tax. It therefore has $14,400 of cash and $5,600 of imputation credits which is the same as if no loss transfer had occurred.

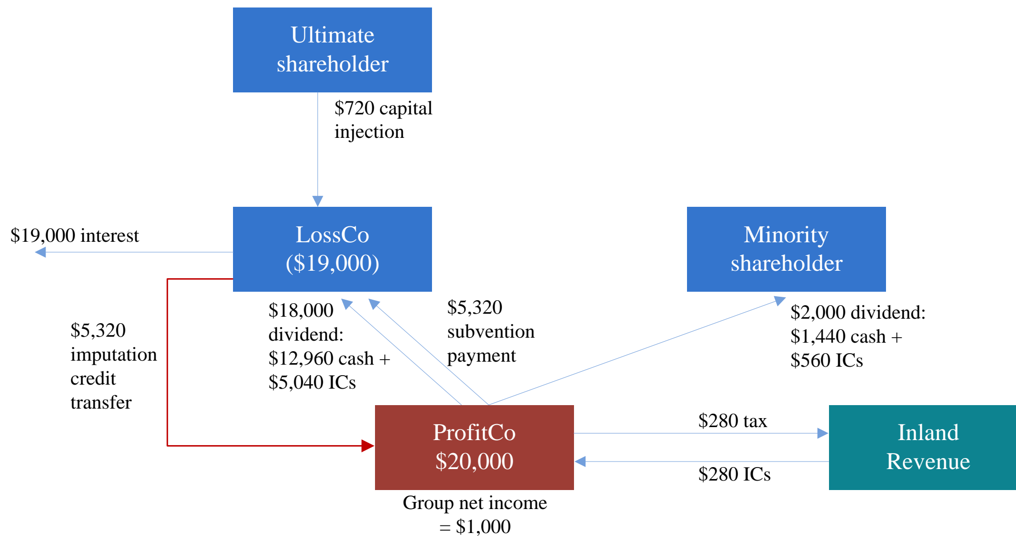
- ProfitCo pays 10% of its profits as a dividend to Minority Shareholder. This is $1,440 cash and $560 of imputation credits. As this dividend is fully imputed Minority Shareholder has to no extra tax to pay.

- ProfitCo pays 90% of its profits as a dividend to LossCo. This is $12,960 cash and $5,040 of imputation credits. As this dividend is fully imputed LossCo has no extra tax to pay.

- LossCo has $18,000 of income which is fully sheltered by imputation credits so has no income tax to pay.

- LossCo needs $720 additional capital[8] from the Ultimate Shareholder in order to pay its $19,000 interest bill.

- This can be shown in a diagram as:




- However, LossCo started with a nil imputation credit account balance, then transferred $5,320 credits to ProfitCo but only received $5,040 credits on the imputed dividend. LossCo therefore, has an imputation credit account debit balance of $280 so will have to prepay tax. To do this it will need to obtain another $280 capital injection from Ultimate Shareholder.

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[8] LossCo would also need a further $280 to return its imputation credit account to nil. This is addressed below.

- Therefore Inland Revenue will collect $560 of tax on only $1,000 of net income. However, LossCo will continue to have tax payments of $280 that could be used to meet a future income tax liability.

30. This concern could be addressed by restricting loss transfers by commonly-owned groups so that the maximum loss transfer was equal to the profit company's profit multiplied by the loss company's ownership interest (in example 3 this would be $20,000 x 90% = $18,000). This would result in the loss company transferring less imputation credits but the profit company paying more tax so the same amount of credits could be attached to the dividend. While this would more accurately reflect the commonly-owned group's share of the profit company's profit, officials are not recommending this change as it would disadvantage many existing commonly-owned groups. Rather than placing restrictions on the proportion of losses able to be grouped, companies for whom this issue may arise could manage this themselves by choosing to group fewer losses.

***Assessment against criteria***

31. This option would meet the main objective and the economic efficiency criterion as it removes the tax disadvantage from the interaction from the two sets of rules.

32. This option fully meets the effectiveness criterion as only those companies that are part of a non-wholly owned group that are also grouping losses would be able to transfer imputation credits.

33. This option fully meets the integrity and coherence criterion. This is because the amount of the imputation credits would be capped at the tax value of the loss transfer (in example 3 19,000 x 0.28 = 5,320) and therefore the tax reduction from the payment of an imputed dividend could only be equal to the tax that would have otherwise been paid if the loss transfer had not occurred. While the initial transfer of imputation credits would create an imputation credit account debit, any risk would be mitigated by: requiring the transfer at the same time the dividend is paid; allowing the recipient of the dividend to transfer the credits rather than the loss company; and strengthening the imputation credit shopping rules.

34. Although this option would introduce an extra degree of compliance and administration costs, this complexity is in many cases less than when compared to the other options as the option relies on the existing imputation system which is widely understood. In addition, it is also a voluntary process so taxpayers can quickly calculate whether it would be cost effective to elect into.

**Option 3: Introduce a targeted exemption for dividends following a loss transfer**

35. Option 3 would operate in a similar way to option 2 as the group would need to identify which dividends were attributable to profits that had been subject to a loss transfer. These dividends would then be non-taxable to their recipient.

36. Option 3 would require a mechanism to track dividends paid and received as all dividends through a chain of companies (including any dividends paid to minority shareholders) would have to retain their tax-exempt status. This mechanism is likely to add considerable complexity to the option. In circumstances where a dividend was partially imputed or where it was partially unimputed for reasons other than the loss transfer, an apportionment mechanism would be required and this apportionment may change as it passes through an ownership chain.

***Assessment against criteria***

37. Provided the proposed tracking mechanism works correctly this option would achieve the main objective of removing the tax disadvantage. However, owing to the complexity of this option it may not be applied correctly in which case the economic efficiency criteria would not be met. There would be potential for a group to both inadvertently understate the degree of exemption which would result in the tax disadvantage not being fully removed, or of the group to inadvertently or intentionally overstate the degree of exemption which would result in obtaining a tax exemption for income that was outside the scope of the proposal.

38. Similarly, the effectiveness criterion might not be met in all cases due to the complexity of the tracking and apportionment mechanism, which could mean the option is applied too narrowly or too widely.

39. Although there are other provisions of the tax acts that allow for exempt income, this option would be relatively unique in that the exemption would have to flow through a number of companies while not maintaining a distinct character[9]. Provided the proposed tracking mechanism is applied correctly it could help to improve the integrity and coherency of the tax system; but because of the potential for this to be applied incorrectly, the integrity and coherency criterion would not be met.

40. Due to the complexity of the tracking mechanism this option would impose high compliance and administration costs so would not meet the efficiency of compliance of administration criterion.

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[9] For example a company could have dividends from two sources with one being exempt and one being taxable.

**Option 4: Align the loss transfer and inter-corporate dividend thresholds**

41. As noted above, the interaction of the two sets of rules with different thresholds is the underlying cause of this problem.

42. Increasing the threshold for loss transfers to 100 percent would prevent a loss transfer in a non-wholly owned group so that the benefit of this loss transfer could not be clawed back when a dividend was paid as no loss transfer would have occurred. However, this measure would then create an incentive for companies to be wholly-owned in order to group tax losses as well as access the inter-corporate dividend exemption. Therefore, this option would not achieve the main objective.

43. An alternative measure under this option would be to align the loss transfer and inter-corporate dividend thresholds at a lower percentage (presumably the current 66 percent loss transfer threshold). This measure would allow a loss transfer to occur in a non-wholly owned group then the profit company to pay a dividend to its shareholders without that dividend being subject to tax. Within this measure the inter-corporate dividend exemption could apply to either the commonly-owned group only or to all investors in a company that was part of a commonly-owned group.

***Assessment against the criteria***

44. Applying the inter-corporate dividend exemption only within a commonly-owned group would not be effective as the minority owner of the profit company would still be taxable on their dividend and the profit company would not have sufficient imputation credits to impute this dividend. It would create tax planning opportunities if a company was allowed to stream imputation credits only to its taxable shareholders, and even if this was allowed the profit company still might not have any imputation credits to attach.

45. Applying the inter-corporate dividend exemption to any investor in a company that was part of a commonly-owned group would achieve the main objective of removing the tax impediment for partial ownership. However, it would also make many tax planning opportunities available as profits could be distributed tax-free to any investor in any company provided it was part of a commonly-owned group.

46. The inter-corporate dividend exemption is based on a full consolidation or single economic unit framework. That is, when all companies are owned by the same shareholders, there is no economic difference between their activities being carried on by a single company or multiple companies with the same ownership. This framework does not apply as aptly to 66 percent common ownership. This is because there is a 34 percent difference in economic ownership. Therefore, extending the inter-corporate dividend exemption to commonly-owned companies is inconsistent with the underlying policy of that rule.

47. While this option achieves the main objective and is arguably the least complex there would need to be additional complexity to counter the tax planning activities that would invariably arise. This option would be much wider in scope than the intended audience and would decrease rather than increase the integrity of the tax system.

48. Therefore, this option would either partially or fully meet each of the criteria.

### Summary of impact analysis

| Option | Main objective and criteria | Fiscal cost/benefits | Costs/risks |
|---|---|---|---|
| Option 1 – status quo | • Does not meet main objective<br>• Meets criterion (a)<br>• Does not meet criteria (b), (c) or (d) | • Fiscal cost – neutral<br>• Avoids adding additional complexity to the tax system | • Increases economic efficiency costs - companies are incentivised to invest in non-wholly owned companies |
| Option 2 – imputation credit transfer *(preferred option)* | • Meets main objective<br>• Meets criteria (a) to (d) | • Fiscal cost – forgone tax from fewer unimputed dividends partially offset by more imputed dividends paid to persons on greater than 28 percent tax rates | • Doesn't fully achieve objective when loss transfer is greater than ownership interest |
| Option 3 – targeted exemption | • Meets main objective<br>• Meets criterion (a)<br>• Partially meets criterion (b)<br>• Does not meet criteria (c) or (d) | • Fiscal cost – same as option 2 | • Highly complex tracking mechanism required<br>• Allowing partial dividend exemptions is not consistent with other approaches within tax legislation |
| Option 4 – lower inter-corporate dividend threshold | • Meets main objective<br>• Partially meets criteria (a) and (d)<br>• Does not meet criteria (b) or (c) | • Fiscal cost – higher than option 2 and possible tax avoidance arrangements | • Affects a much wider selection of taxpayers<br>• Creates significant avoidance opportunities<br>• Inconsistent with underlying policy of the inter-corporate dividend exemption |

**Key:**
Criterion (a) - Economic efficiency, criterion (b) – effectiveness, criterion (c) – integrity and coherence, criterion (d) – efficiency of compliance and administration

## CONSULTATION

49. The preferred option (assessed as option 2 in this RIS) was developed in consultation with the Corporate Taxpayers Group as this issue is particularly relevant to their members.

50. Following development of the preferred option, it was the subject of public consultation in the *Loss grouping and imputation credits* issues paper, which was released in August 2015. Eight submissions were received on this issues paper. These submissions were generally supportive of the proposal.

51. However, several submitters considered that the preferred option did not fully resolve the issue because the loss company did not receive the full value of the imputation credits via an imputed dividend as a result of the existence of the minority shareholder(s). This shortcoming was particularly evident when the loss company is a sister company of the profit company so does not receive a dividend from the profit company.

52. Officials addressed the sister company concern by amending the proposal to allow imputation credits to be transferred from a group company member that receives the dividend from the profit company.

53. As noted under option 2, the wider issue of the preferred option not fully addressing the claw-back could be removed by restricting the amount of the loss transfer. Officials do not recommend introducing this restriction and prefer to let taxpayers manage this issue by grouping fewer losses if it is in their best interests to do so.

## CONCLUSIONS AND RECOMMENDATIONS

54. We recommend option 2 be adopted. Option 2 would significantly mitigate the problem identified and would most closely achieve the main objective, while working within existing tax policy settings and using existing rules and mechanisms. By working within the existing rules and not requiring complicated tracking of payments and loss offsets, option 2 would minimise both compliance and administrative costs. Option 3 and 4 would be much more complex to comply with and administer and could also potentially create tax planning opportunities. Although option 2 does not fully achieve the objective in all instances it would provide taxpayers with the ability to manage this risk.

## IMPLEMENTATION

55. Changes to the imputation rules to facilitate the preferred option would require amendments to the Income Tax Act 2007 and consequential amendments to other tax legislation. These amendments would be included in a tax bill, scheduled for introduction in March 2016.

56. The preferred option would be taxpayer favourable and would be voluntary for loss transfers occurring after the application of the legislation. Taxpayers would be able to elect to apply the imputation transfer rules after all companies involved in the transfer agreed to participate. Imputation credits would be transferred with the loss transfer but would not be recorded as a debit or credit in the respective imputation credit accounts until the corresponding imputed dividend was paid by the profit company.

57. The imputation credit transfer would be recorded in the respective companies' imputation credit accounts using existing forms and processes. The companies would be required to keep track of what imputation credits had been elected to be transferred and if the transfer was invalidated[10] before the payment of an imputed dividend the transfer would not be recorded in the imputation credit accounts.

58. Implementing the preferred option will largely require changes to Inland Revenue's communication and education products. The changes would also require the establishment of an email address for elections so that the use of these rules can be monitored by Inland Revenue. Going forward, Inland Revenue will administer the changes as part of its business as usual processes.

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[10] For example by a breach of continuity or where more than four years passed between the loss transfer occurring and the dividend being paid.

## MONITORING, EVALUATION AND REVIEW

59. In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

60. Inland Revenue also intends to monitor the operation of the proposed changes via risk review of taxpayers electing to transfer imputation credits to ensure the rules operate as intended.

61. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

# Regulatory Impact Statement

## NRWT: Related party and branch lending – bank and unrelated party lending

### Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to ensure that approved issuer levy (AIL) is applied consistently on interest payments to non-residents on third party funding or funding that is economically equivalent to third party funding. Specifically, the options are aimed at addressing the current tax advantage enjoyed by foreign-owned banks compared to New Zealand-owned banks and non-bank borrowers that arises from the application of the NRWT rules to onshore and offshore branches of these foreign-owned banks.

Analysis has been undertaken on existing interest payments by registered banks that are not subject to non-resident withholding tax (NRWT) or AIL but would be subject to these taxes if they were not occurring through an offshore or onshore branch. The fiscal estimates are based on current interest rates but the impact of higher interest rates has also been considered. We have assumed that current offshore borrowing levels would continue although we have considered ongoing regulatory changes in New Zealand and other countries that might reduce the amount of funding sourced through these branches.

It is not possible to accurately determine the impact this additional tax would have on interest rates. If the foreign-owned banks using bank branch structures to avoid paying AIL or NRWT are currently passing on the full benefits of this to domestic consumers, repealing this exemption could cause interest rates to rise by one fiftieth (e.g. from 5.0% to 5.1%). However, officials consider that this is likely to be a maximum possible increase. The banks affected by these changes are competing with other banks that are already subject to AIL on interest payments to non-residents. As a result they may be passing on less than the full benefit of their current exemption to domestic borrowers. Because banks raise funds from a variety of sources, including domestic deposits that are not subject to AIL, for interest rates to increase by any amount close to the maximum, deposit rates would also be expected to rise by a similar amount.

The changes will lead to a more neutral and consistent treatment of the existing AIL rules. They will level the playing field between a number of foreign-owned banks that are using branch structures and both New Zealand owned banks which typically pay AIL as well as most other non-bank borrowers where interest paid to non-resident third party lenders is normally subject to either AIL or NRWT.

The changes will not completely level the playing field in two respects. First, neither NRWT or AIL will apply to respect of interest earned by a foreign bank with an onshore branch even where that interest is not earned by the branch. Second interest on certain widely-held bonds is exempt from AIL and NRWT.

The widely held bond exemption is relatively small; less than $2 million of AIL is being forgone as a result of it. On the other hand, $47 million of AIL is being collected. The judgement has been taken that this change will lead to a more neutral overall tax regime by treating borrowing through banks with branch structures in a way which is more consistent with most other forms of borrowing.

A range of options have been considered and measured against the criteria of economic efficiency, fairness and certainty and simplicity. There are no environmental, social or cultural impacts from the recommended changes.

Inland Revenue considers that aside from the constraints described above, there are no other significant constraints, caveats and uncertainties concerning the regulatory analysis undertaken.

None of the policy options identified are expected to restrict market competition, unduly impair private property rights or override fundamental common law principles.

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

1 December 2015

## STATUS QUO AND PROBLEM DEFINITION

1. The general treatment of interest payments to non-residents is to apply non-resident withholding tax (NRWT) unless the payment is to an unrelated party in which case a 2% approved issuer levy (AIL) can be paid instead of NRWT. NRWT is normally payable at a rate of 10% if the lender's home country has a double tax agreement (DTA) with New Zealand, or a rate of 15% in other cases.

2. Further details on the NRWT and AIL rules are set out in the related RIS *NRWT: Related party and branch lending – NRWT changes* (1 December 2015) (the NRWT RIS).

3. Many non-resident lenders require New Zealand borrowers to gross up their interest payments for NRWT so that the cost of the tax is borne by the borrower rather than the lender. Applying AIL to third party lending helps ensure that taxes on interest do not push up interest rates in New Zealand too much. Paying AIL is a voluntary alternative to NRWT; however, AIL cannot be offset against the lender's income tax liability in their home country[1].

4. International evidence suggests that taxes on interest paid abroad can be passed on in the form of higher interest rates, and it is common for other countries to have measures to limit such taxes for that reason. The AIL option for third party debt is New Zealand's way of achieving this outcome.

5. There are currently three structures involving either a New Zealand branch of a non-resident or the offshore branch of a New Zealand resident that can be used so that neither NRWT or AIL is payable on interest payments to non-residents. These structures are inconsistent with the policy intention of applying NRWT or AIL to interest payments to unrelated non-residents.

### Offshore branch exemption - issues

6. If an offshore branch of a New Zealand resident borrows money from a non-resident lender to fund a business they carry on outside New Zealand, the interest on this funding is not subject to NRWT or AIL (we refer to this as the "offshore branch exemption"). This exemption ensures that the tax treatment of foreign branches of New Zealand residents is consistent with that of foreign incorporated subsidiaries of a New Zealand-resident. This is illustrated in figure 1 below.

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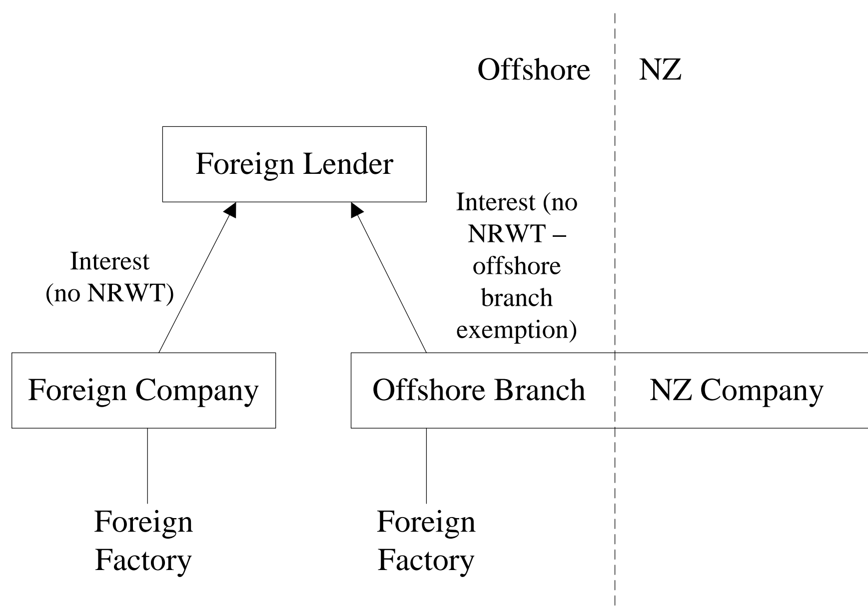
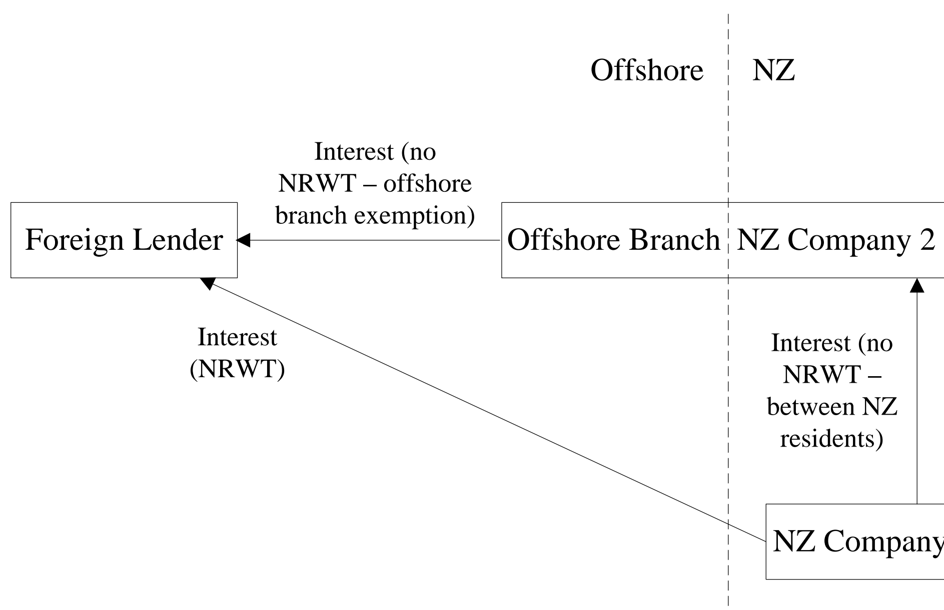
[1] This is mainly because AIL is paid by the borrower not the lender and, unlike NRWT, AIL is not an income tax.

***Figure 1: Offshore branch exemption***




7. However, a business carried on outside New Zealand can include the business of borrowing money for the purpose of lending to New Zealand residents. This allows a New Zealand resident (including a bank) to set up a subsidiary with an offshore branch. This branch can borrow, and make interest payments to, a non-resident without incurring NRWT or AIL then lend that money to another New Zealand resident. This is illustrated in Figure 2 below.

***Figure 2: Offshore branch exemption for New Zealand borrowing***



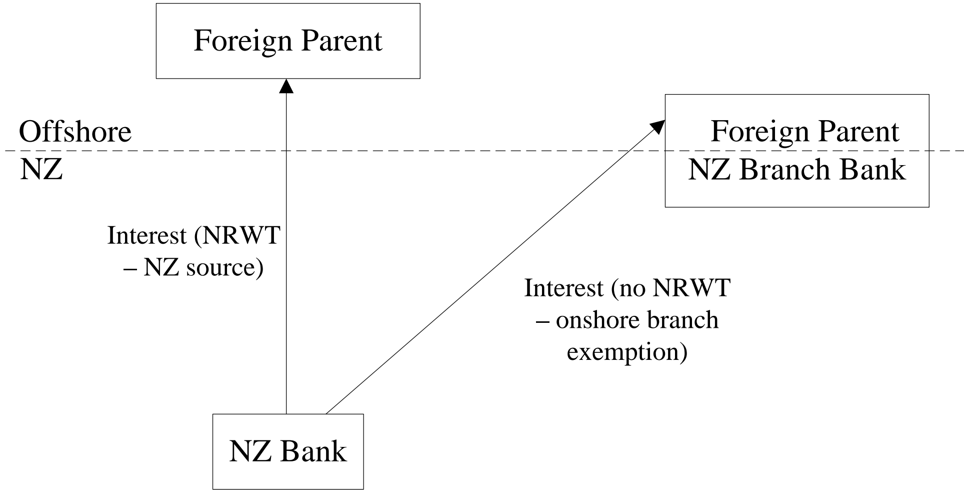

8. This scenario creates a situation in which interest payments on funding borrowed by an offshore branch of a New Zealand resident, who then on-lends to another New Zealand resident, are not subject to NRWT or AIL. This result arises even though interest payments on an equivalent loan by a non-resident to a New Zealand resident would be subject to NRWT or AIL.

**Onshore branch exemption - issues**

9. The onshore branch exemption as it applies to borrowing by non-banks is considered in the NRWT RIS. This RIS only considers borrowing by a New Zealand registered bank.

10. As a result of the onshore branch exemption, interest payments by a New Zealand-resident bank to an associated non-resident lender are not subject to NRWT or AIL where the non-resident has a New Zealand branch. This is illustrated in figure 3 below.

***Figure 3: Onshore branch exemption***




11. This scenario creates a situation where funding borrowed by a New Zealand bank from their non-resident parent is not subject to NRWT or AIL provided the non-resident has a branch in New Zealand. This result arises even though interest payments on an equivalent loan by the non-resident parent without a New Zealand branch would be subject to NRWT or AIL.

**Onshore notional loans - issues**

12. A non-resident bank can borrow offshore for the purpose of funding its worldwide operations and allocate a portion of this funding to its New Zealand branch. The New Zealand branch can then use the funding to make loans and generate taxable income. When calculating its net income taxable in New Zealand, the bank can deduct from the income generated by its New Zealand activities a deemed interest amount, attributable to the borrowing raised offshore and used to fund the New Zealand business.

13. New Zealand is unable to impose NRWT or AIL on any portion of the interest paid on the offshore borrowing by the bank. Currently, NRWT or AIL are not imposed on the interest which the New Zealand branch is deemed (as described above) to pay to the non-New Zealand part of the bank which provides it with funding.

14. The result is that interest paid on funding allocated to a New Zealand branch is not subject to NRWT or AIL even when interest payments on an equivalent loan by a non-resident to a New Zealand resident subsidiary company would be subject to NRWT or AIL.

### Coherence and consistency of the AIL rules

15. These branch structures are available and practical for New Zealand's larger foreign-owned banks but not for New Zealand's domestically-owned banks. New Zealand borrowers seeking funding from overseas have the option of borrowing directly or through a New Zealand bank which may or may not be using these branch structures. Generally non-bank New Zealand borrowers are unable to use the onshore or offshore branch structures explained above so their interest payments to non-residents will be subject to NRWT or AIL. Also, borrowing through New Zealand's domestically-owned banks will be subject to AIL, On the other hand, borrowing from a New Zealand foreign-owned bank that uses these structures will not incur NRWT or AIL.

16. As borrowing in these different ways is highly substitutable, the different forms of borrowing should be subject to the same tax treatment so that tax does not incentivise one behaviour over another. This is not currently the case.

17. In particular, New Zealand banks that are not owned by a foreign bank or do not have sufficient scale to operate an offshore branch cannot make interest payments to non-residents without incurring NRWT or AIL. This creates a tax disadvantage for New Zealand-owned banks when compared to their foreign-owned competitors. Alternatively, if foreign-owned and domestic-owned banks offer equivalent interest rates yet only domestic-owned banks are subject to AIL this may suggest that the tax rules are providing additional profit to foreign-owned banks.

### Zero-rated AIL on widely held NZ dollar bonds

18. AIL can be reduced to zero on interest payments on certain widely-held New Zealand dollar bonds. The existence of the bank branch exemptions was a motivating factor behind the introduction of widely-held bond zero rating. Zero rating removed a bias favouring borrowing through banks using branch structures over firms issuing widely held or listed bonds. There was a concern that this bias was impeding the development of a domestic bond market.

19. If the preferred options in this RIS are enacted, AIL would have to be paid on all interest from offshore borrowing through branch structures except interest paid by a non-group member to the head office of a bank with a New Zealand branch. Accordingly, and particularly if this remaining bank branch exemption is ever removed in the future, the zero rating of widely held bonds could, in the longer run, be reviewed. Finally, it is worth noting that this exemption is very much at the margin with less than $2 million of AIL (i.e., AIL on less than $100 million of interest on widely-issued bonds) escaping tax as a result of this zero rating. By comparison $2,350 million of interest is currently subject to AIL and $47 million of revenue is collected from this tax.

### Cost of capital

20. Other things being equal, there can be attractions in ensuring tax rules do not push up interest rates too much as this can raise the cost of capital, i.e. the hurdle rate of return that firms require to undertake investment. This, in turn, can lead to firms not undertaking certain investments that are attractive at world prices. However, a 2% rate of AIL is an extremely low rate of tax on interest paid abroad and officials see this tiny impost as an acceptable part

of the AIL/NRWT mechanism that New Zealand has chosen to adopt. Officials do not see that cost of capital arguments provide good grounds for allowing an exemption from AIL for foreign-owned banks when this is not more generally available.

21. Although it was not a policy decision to exempt banks from AIL it is possible that the cost of capital is lower as a result of the exemption as banks will have lower net of tax funding costs and this may be reflected in lower interest rates for New Zealand borrowers.

22. Prior to and during the 1990s New Zealand banks, including foreign-owned banks were liable for NRWT or AIL on interest payments as they were not borrowing exclusively through branches. More recently New Zealand-owned banks have continued to be liable for AIL as they cannot access the branch exemptions. These New Zealand-owned banks are competing with the foreign-owned banks so it is not clear that foreign-owned banks will currently be passing on all of the benefits of not paying AIL to domestic borrowers. In this case the foreign-owned banks may not be able to pass all of their additional AIL liability to domestic borrowers in higher interest rates. Instead it may cause a minor reduction in those banks' after-tax profits.

23. It is not possible to determine which of these two scenarios will arise, in part because AIL will be such a small proportion of a bank's total funding cost[2]. To be conservative this RIS proceeds on the basis that the imposition of AIL to foreign-owned banks would result in a very small increase in the cost of capital as a result of higher interest rates being charged by the foreign-owned banks that are currently using branch structures.

24. If the costs were being fully passed on, including being reflected in higher deposit rates, making AIL payable would be expected to increase interest rates by a factor of one fiftieth (e.g. from, say 5.0% to 5.1%). But this is a maximum assumption.

25. To put the size of a 0.1% increase in context this is less than half the minimum change of 0.25% that the Reserve Bank can make to the official cash rate at its regular reviews. Officials have consulted with the Reserve Bank over these changes and they have raised no concerns.

## OBJECTIVES

26. A principal of our broad-based low-rate (BBLR) tax framework is that tax should not incentivise one form of investment over another economically equivalent investment. The current application of the NRWT rules to onshore and offshore branches creates a tax advantage towards foreign-owned banks against New Zealand-owned banks and non-bank borrowers.

27. The main objective of this reform is to reduce or remove this bias and thereby improve the integrity of the NRWT and AIL rules while minimising the effect of the rules on the cost of capital for unrelated party borrowers.

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[2] For example for the 2014 year the general disclosure statements for the five largest banks show total interest expense of $11,515 million.

28. The criteria against which the options will be assessed are:

- *Economic efficiency*: The tax system should, to the extent possible, apply neutrally and consistently to economically equivalent transactions. This means the tax system should not provide a tax preferred treatment for one transaction over another similar transaction or provide an advantage to one business over another. This helps ensure that the most efficient forms of investment which provide the best returns to New Zealand as a whole are undertaken. At the same time there is a concern that taxes should not unduly raise the cost of capital and discourage inbound investment.

- *Fairness*: Taxes should not be arbitrary and should be fair to different businesses. Neutrality and consistency across economically equivalent transactions is likely to also promote fairness.

- *Certainty and simplicity*: The AIL rules should be as clear and simple as possible so that taxpayers who attempt to comply with the rules are able to do so.

29. While all criteria are not equally weighted they are all important. Any change (except for the status quo) would have to improve neutrality and consistency of treatment. This would tend to promote economic efficiency and fairness. At the same time, the measures would also tend to increase the cost of capital in some circumstances so there are trade-offs to consider. Due to the complexity of these transactions, the sophistication of taxpayers who would be subject to the proposed changes, and that AIL only applies on a payments basis, certainty and simplicity is the least important criterion.

## REGULATORY IMPACT ANALYSIS

30. As the onshore and offshore exemptions currently rely on separate rules it is anticipated that separate options would be required to achieve the main objective. The preferred options could be implemented collectively or individually but implementing a single option may not achieve the objective.

31. The range of available options are:

- *Option 1*: Status quo

- *Option 2*: Remove or zero-rate AIL on unrelated party borrowing

- *Option 3*: Introduce a widely offered test to zero-rate AIL

- *Option 4*: Introduce a specific bank exemption from AIL

- *Option 5*: Apply AIL to interest payments made by offshore branches to the extent that they lend to New Zealand (preferred option)

- *Option 6:* Apply AIL to interest payments made to a non-resident that has a New Zealand branch with a banking licence if the lender and borrower are associated (preferred option)

- *Option 7*: Apply AIL to notional loans to a New Zealand branch (preferred option)

- *Option 8*: Defer AIL changes until a review of widely-held exemptions is undertaken

32. If options 5 to 7 are introduced officials considered one additional option:

- *Option 9*: Allow AIL on related party interest payments by banks (preferred option)

33. Officials consider that options 5 to 7 and 9 should be considered as a package as implementing one or two of options 5 to 7 without the third would leave a source of funding by non-residents that was not liable for NRWT or AIL on interest payments and therefore would not achieve the objective.

34. Further detail on each option is provided in the paragraphs below. An assessment of each option against the range of impacts is also included.

35. There are no social, cultural or environmental impacts for any of the options considered.

### Option 1: Status quo

36. The status quo is that the New Zealand operations of most foreign-owned banks do not pay AIL on interest payments that are ultimately to unrelated non-residents whereas most New Zealand-owned banks and non-banks (because they cannot practically operate commercial onshore or offshore branches) are required to pay AIL when they make interest payments to unrelated non-residents.

37. Foreign-owned banks would continue to be not subject to AIL on interest payments to non-residents so there would be no impact on the cost of capital.

*Assessment against criteria – option 1*

38. The current legislation does not provide specific bank exemptions from AIL; however, due at least in part to non-tax reasons they operate structures that can achieve this effect. While this has been the case in some instances for over 20 years, this was not a deliberate policy choice and there are no convincing policy arguments why some banks should not be required to pay AIL when other banks and sectors of the economy are required to do so. The current rules provide a competitive advantage to one group of lenders. Therefore, this option does not meet the economic efficiency or fairness criteria.

39. Because there would be no changes to the existing rules, which are widely understood, this would meet the certainty and simplicity criterion.

### Option 2: Remove or zero-rate AIL on unrelated party borrowing

40. Because a large portion of interest payments by New Zealand residents to unrelated non-residents are by banks that do not currently pay AIL this option would align with this treatment if all interest payments to unrelated non-residents were not subject to AIL. This

treatment could be achieved by either removing AIL completely or reducing the rate from 2% to zero; either of these approaches would have the same practical effect. For the purpose of the remainder of this RIS this is referred to as "zero-rating AIL". This treatment would also be consistent with the zero-rated AIL provisions for widely-held NZ dollar bonds referred to above.

41. The rationale for giving borrowers the choice between AIL (at a rate above 0%) and NRWT is that it allows New Zealand to continue to collect NRWT on interest paid to foreign lenders who are indifferent about paying New Zealand tax, while minimising (though not eliminating) the deadweight cost[3] to the economy arising from taxing other foreign lenders.

42. This rationale would no longer apply if AIL were zero-rated as foreign lenders would no longer have an incentive to have NRWT withheld. Therefore, as well as reducing AIL collected by approximately $47 million per annum this would also reduce NRWT payments by at least $42 million per annum for a total of at least $89 million per annum. These NRWT payments are unlikely to increase borrowing costs and impose negligible costs on New Zealanders. They are likely to be much less costly to New Zealand than replacement taxes would be.

43. Although the reduction in taxes on interest payments to non-residents would lower the cost of capital this would have to be balanced against the reduction in tax revenue which would be much larger than the effect on domestic interest rates due to the reduction in NRWT that has no impact on the cost of capital.

*Assessment against criteria – option 2*

44. This option does not meet the economic efficiency criterion as it would forgo NRWT payments that do not increase the cost of capital which are likely to be much less costly to New Zealand than replacement taxes would be.

45. This option does meet the fairness criterion as all interest payments to unrelated non-residents and by New Zealand banks would not be subject to AIL (or NRWT). For the same reason it would also meet the certainty and simplicity criterion.

### Option 3: Introduce a widely offered test to zero-rate AIL

46. Some countries (for example Australia) allow withholding taxes to be zero-rated if the borrowing is widely offered. This option would essentially be an extension of the existing widely held zero-rated bonds provisions enacted in 2012, so they applied in a much wider range of circumstances.

47. The existing widely held zero-rated bonds provisions allow AIL to be zero-rated only when specific criteria are met. These include that the security is denominated in New Zealand dollars, the issue of the security was a regulated offer under the Financial Markets Conduct Act 2013, and the activities of the registrar and paying agent for the security are carried on through a fixed establishment in New Zealand. While New Zealand banks are not prevented from issuing debt that complies with these requirements, most existing issues will not do so.

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[3] These costs arise from the increased taxes increasing the cost of capital which decreases the amount of investment and therefore economic activity in New Zealand.

48. Officials do not see that the imposition of AIL on widely offered debt would have an impact on the cost of capital that would be significantly different to other international funding sources such as non-widely offered wholesale bonds or private placements. Implementing a widely offered test would impose higher compliance and administration costs to ensure that the required criteria were met and it would be difficult to justify this boundary.

49. Officials expect that support for this option comes from borrowers who would be able to meet a widely offered test rather than there being strong policy reasons for this distinction.

50. This option would codify the existing lack of AIL on most interest payments by foreign-owned banks and remove AIL from a number of New Zealand-owned bank and non-bank borrowers which would reduce tax revenue. However, compliance and administration costs would increase significantly compared to the current rules or other options in this RIS.

*Assessment against criteria – option 3*

51. This option would not meet the economic efficiency and fairness criteria. Although this option would shift the boundary between what interest payments were liable for AIL it would make no effort to remove, or even explain, this arbitrary boundary. Interest payments on widely held bonds would be exempt from AIL whereas an otherwise equivalent interest payment to a single lender would not. Similar arguments regarding a boundary between widely held and closely held debt were made by submitters in relation to the AIL registration proposals considered in the NRWT RIS.

52. The widely offered test could be drafted so that it provided sufficient certainty in its intended application but this would require regular monitoring by issuers to ensure new and ongoing issues continued to be compliant with the tests. Therefore, this option would only partially meet the certainty and simplicity criterion.

**Option 4: Introduce a specific bank exemption from AIL**

53. Currently, most interest payments to non-residents on borrowing by banks are not subject to AIL. However, there are no bank specific rules to achieve this. The tax system could be made more coherent and transparent if a specific exemption were introduced that interest payments by banks should not be subject to AIL (or NRWT). This could be limited to wholesale interest or to all payments. Either option would make no attempt to reconcile why interest paid by banks to non-residents should not be subject to AIL when all other industries were required to pay AIL on their interest payments.

54. Introducing a wholesale bank funding exemption would largely codify the existing outcome with an extension to New Zealand-owned banks and any other bank funding that was not or could not access the branch exemptions. This exemption would require a robust definition of wholesale funding to be developed. Officials estimate the revenue cost of this option would be approximately $1 million per annum.

55. Introducing an exemption for all interest payments by banks would involve forgoing the NRWT and AIL payments currently made by banks which are predominantly on retail deposits. The estimated revenue cost of this option is approximately $62 million per annum. NRWT withheld on retail deposits would almost always be creditable so would normally not be expected to increase interest rates. It is a very efficient form of tax from a New Zealand perspective and it would therefore be undesirable to eliminate it.

56. The argument for a bank exemption is that the imposition of AIL would increase the interest rate charged and therefore the cost of borrowing for New Zealand borrowers. As explained in option 5 and 6 below, we do not consider this would have a material impact on the cost of borrowing and consider it to be an acceptable part of New Zealand's AIL/NRWT mechanism.

57. If it were accepted New Zealand would be better off if banks did not pay AIL due to the effect on the cost of capital, this would also apply to any other industry that borrowed from unrelated non-residents in order to supply New Zealand residents. For this reason, officials do not support either a general exemption from AIL for banks or an exemption limited to wholesale funding.

58. Therefore, officials consider it would be difficult, if not impossible, to justify an exemption for banks without it being extended to cover other industries. This extension would make this option almost the same as option 2 which, as noted above, officials do not prefer.

59. Introducing a wholesale bank exemption would reduce the funding costs of New Zealand-owned banks which could in turn reduce the cost of capital (but, only if these banks passed this reduction through in their lending rates). Introducing a wider banking exemption would also reduce the cost of capital but the effect on government revenue would be much larger which may flow through into cost of capital increases elsewhere in the economy.

*Assessment against criteria – option 4*

60. This option would partially meet the economic efficiency and fairness criteria. Although it would add additional neutrality to the banking sector it would not address neutrality between banks and non-banks.

61. A wide banking exemption would be simple to apply whereas a wholesale bank exemption, depending on how it was drafted, could have some boundary issues over exactly what is wholesale funding. On balance, this option would meet the certainty and simplicity criterion.

**Option 5: Apply AIL to interest payments made by offshore branches to the extent that they lend to New Zealand (preferred option)**

62. The offshore branch exemption, as shown in figure 2 above, results in an interest payment to a non-resident by an offshore branch of a New Zealand resident not having a New Zealand source and therefore not being subject to AIL. The offshore branch exemption was not designed to exempt New Zealand banks from AIL or NRWT (as demonstrated by the fact that the rule existed several decades before its widespread application by the banking industry) and was instead intended to apply a similar tax treatment to interest payments by an offshore branch of a New Zealand resident as that which applies to interest payments by an offshore subsidiary of a New Zealand resident.

63. This option would limit the offshore branch exemption so that an interest payment by an offshore branch of a New Zealand resident to a non-resident would have a New Zealand source if that branch used the money to lend to a New Zealand resident. The offshore branch exemption would be retained if the branch used that money for its foreign operations, that didn't include lending to New Zealand, for example, to build an offshore factory.

64. In practice, this option is unlikely to result in any apportionment issues as we have not observed any offshore branches which borrow for the purpose of lending to New Zealand residents and operating an offshore business that does something other than lending to New Zealand residents. If, in the future, this were the case we expect interest costs could be apportioned on a reasonable basis

65. The consequence of this change would be that an interest payment by the offshore branch would be subject to AIL but the interest payment by the New Zealand borrower to the offshore branch would continue to be an interest payment between two New Zealand residents. This would result in the same amount of AIL paid as if the New Zealand borrower made the interest payment directly to the non-resident without interposing the offshore branch.

66. Officials recognise that there are commercial reasons why a New Zealand bank might wish to establish an offshore branch including, for example, to maintain face-to-face relationships with lenders or to be in a similar time zone. This option would not require a bank to close such an offshore branch. Banks would be free to continue to obtain the commercial benefits currently achieved. However, the cost of operating the branch would no longer be subsidised by a tax saving.

67. Additional costs imposed on banks currently accessing this exemption are not material compared to existing bank funding costs[4] or taxes already applied to the banking sector. While this may have some effect on the cost of capital we consider this to be very minor.

*Assessment against criteria – option 5*

68. This option meets the economic efficiency and fairness criteria as offshore branches would no longer be able to be used to remove NRWT or AIL from interest payments to non-residents.

69. Offshore branches are already aware of the amount of interest payments they make to non-resident lenders. While there are peripheral issues that add complications this option would meet the certainty and simplicity criterion.

**Option 6: Apply AIL to interest payments made to a non-resident that has a New Zealand branch with a banking licence if the lender and borrower are associated (preferred option)**

70. In the NRWT RIS we recommended restricting the onshore branch exemption so it only applied when an interest payment was made to a non-resident with a New Zealand branch if the interest payment was made to the New Zealand branch or the New Zealand branch had a banking licence.

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[4] As noted above the 2014 total interest expense for the five largest banks was $11,515 million.

71. This option considers a further restriction on that exemption so that it would not apply when a New Zealand resident makes an interest payment to an associated non-resident that has a New Zealand branch with a banking licence. The primary application of this restriction would be to apply AIL to interest payments by a foreign-owned New Zealand bank to their offshore parent bank.

72. This structure appears to be used less than the other two branch structures considered in this RIS and so this option would also have a correspondingly lower impact on revenue raised. However, in the absence of this change, and if the other preferred options were enacted, additional funding could be transferred into this structure. The additional costs imposed on banks currently accessing this exemption would not be material compared to existing bank funding costs or taxes already applied to the banking sector. Although this option might have some effect on the cost of capital we consider this to be very minor.

*Assessment against criteria – option 6*

73. This option would meet the economic efficiency and fairness criteria as the onshore branch exemption would no longer be able to be used to remove NRWT or AIL from interest payments to non-residents in a way that would not be available to non-banks.

74. Foreign-owned banks would already be aware of interest paid to their non-resident associated parties and so AIL could easily be applied to these payments. This option would meet the certainty and simplicity criterion.

**Option 7: Apply AIL to notional loans to a New Zealand branch (preferred option)**

75. To the extent that a head office borrows for general purposes, and then uses the funds raised in part to fund its New Zealand branch, the interest paid by the head office on the general purpose borrowings cannot practically be subject to New Zealand NRWT or AIL. This is because it is not possible to identify which funding was used for the New Zealand branch. However, it is relevant that in calculating its New Zealand taxable income, the branch is entitled to a deduction for the deemed interest paid on the deemed loan from head office.

76. Deeming recognises that as a legal matter it is not possible for one part of a single entity to lend money to another. The deeming is a way of allocating to the New Zealand branch a portion of the entity's worldwide borrowing and interest cost.

77. The notional interest proposal involves imposing AIL at 2% on this deemed interest. Australia has a similar provision, which imposes NRWT on 50% of the deemed interest deducted by the Australian branch of a non-Australian bank. (In practice, this means a withholding tax rate of 5%).

78. This option puts a New Zealand branch of a non-resident bank in the same tax position as a New Zealand subsidiary. In the latter case, any loan funding from the parent is an actual, not a notional, loan, and NRWT (or, under our proposals, AIL) already applies to the interest on that loan.

79. The fiscal estimates of this option are identical to those for option 5. This is coincidental and arises from lower principal amounts through the onshore branch but at higher New Zealand dollar interest rates compared to lending via the offshore branch which are in lower interest rates for currencies such as British Pounds and Euros. This foreign dollar lending is then swapped back into New Zealand dollars which generates a similar overall cost to New Zealand dollar lending. However, these swap costs are not subject to NRWT or AIL.

80. The additional costs imposed on banks currently using this funding source are not material compared to existing bank funding costs or taxes already applied to the banking sector. Although this might have some effect on the cost of capital we consider this to be very minor.

*Assessment against criteria – option 7*

81. This option would meet the economic efficiency and fairness criteria as funding allocated to a New Zealand branch would become subject to AIL. This treatment would be consistent with their existing income tax deductions and the income tax and AIL treatment of other forms of funding from non-residents including New Zealand branches that have specific funding allocated to them by their head office.

82. New Zealand branches are already calculating a cost allocation for interest costs on funding allocated by their head office for the purposes of claiming an income tax deduction an so AIL could easily be applied to this amount. Therefore, this option would meet the certainty and simplicity criterion.

**Option 8: Defer AIL changes until a review of widely-issued exemptions is undertaken**

83. There is an argument that the continued existence of zero-rated AIL on widely-held New Zealand Dollar bonds is inconsistent with applying AIL to all other interest payments to unrelated non-residents or non-resident banks. One way to deal with this is to defer making any changes to the three branch structures referred to above until decisions are made on the continued existence of the zero-rated AIL provisions. These decisions would not be made in time for the bill scheduled for introduction in early 2016 and so would result in a delay of at least a year and possibly much longer.

84. Officials do not believe a delay is justified or necessary.

- The zero-rated AIL provisions are currently used by a small number of New Zealand borrowers. In 2013 less than $100 million of interest was zero-rated, meaning that less than $2 million of AIL was foregone. The amount of zero-rated interest has materially declined in each of the two subsequent years. This compares to interest payments (including notional interest) by banks that is not currently subject to AIL of approximately $1,700 million and interest that is already subject to AIL of approximately $2,350 million.

- Due to this difference in relative size between interest on zero-rated bonds and interest paid by banks to non-residents, officials consider that the favourable tax treatment currently applied to the branch structures used by banks has a much larger effect on the neutrality of the tax system than the existing zero-rated AIL provisions.

- The zero-rated AIL provisions were a deliberate policy choice to encourage the development of a New Zealand bond market, whereas the rules applied to banks were an unintended outcome of policy decisions made in the 1960s for other reasons that do not have similar externalities.

- For compliance and administrative reasons, we have not applied AIL or NRWT on interest paid by a non-group member to the head office of a bank with a New Zealand branch. This decision would also need to be reviewed if we were to review the zero rating of widely held bonds.

85. Also, as the NRWT RIS recommends changes to the onshore branch exemption for non-banks and this option involves considering further changes to the onshore branch exemption for banks but in a later period this would result in having to amend the same provisions in the Income Tax Act 2007 twice, and depending on the degree of deferral even potentially introducing amending legislation before the first amending legislation had been enacted. This is less efficient than implementing the changes as part of a single package. As the zero-rated New Zealand dollar bond provisions are entirely separate no similar concerns arise with analysing this as a separate project.

86. Implementing the preferred options after a deferral would eventually raise additional tax revenue but this would necessarily start in a later period than implementing the same changes as part of the current project.

*Assessment against criteria – option 8*

87. For any period where decisions on bank branches have been deferred, or if there was ultimately a decision to permanently defer a decision the application to the criteria would be identical to the status quo i.e. it would not meet the economic efficiency or fairness criteria but would meet the certainty and simplicity criterion.

88. If, following a deferral, the preferred options above were implemented, either with or without changes to the zero-rated AIL provisions, when compared against implementing these options as part of the current project this would partially meet the economic efficiency and fairness criteria as neutrality would eventually be achieved but only following a delay which makes this less desirable than meeting these criteria sooner.

89. As officials have already consulted on these proposals and have recommended that a number of changes be introduced as a result of this project it would not add to certainty if certain parts of these changes were deferred in order to be reconsidered at a later date. Also, due to the potential need to re-amend amending onshore branch provisions as noted in the paragraph above there would be less certainty and simplicity than progressing the preferred options as part of the current project. Therefore, the certainty and simplicity criterion would not be met.

**Option 9: Allow AIL on related party interest payments by banks (preferred option)**

90. Currently, many banks access a portion of their funding by borrowing from a non-resident associated party lender such as their foreign parent bank. This can occur for a variety of non-tax reasons such as it being more efficient for the foreign parent to borrow a large amount then distribute it to its subsidiaries or where the foreign parent's larger balance sheet

and/or higher credit rating allow it to access borrowing or access cheaper borrowing than the New Zealand operations can achieve independently.

91. Officials recognise that related party lending by a bank is unlikely to be a substitute for equity funding and can be distinguished from borrowing by other sectors. As the foreign parent will be entitled to a deduction for their funding costs with likely only a small mark-up on the interest received from their New Zealand operations it is recognised that applying NRWT to the gross interest would be inappropriate.

92. If options 5 to 7 are enacted banks would be required, to the extent they are not already, to pay AIL or NRWT. A consequence of these changes, if implemented by themselves, is it would become uneconomic for a foreign parent to borrow to on-lend to their New Zealand operations and the New Zealand operations would instead attempt to borrow directly even when – in the absence of tax – it may not be economically efficient to do so. To remove this tax disincentive this option would allow a member of a New Zealand banking group (which is already defined for the purpose of the banking thin capitalisation rules) to pay AIL on all interest payments to non-residents even if that non-resident was associated.

93. If options 5 to 7 are not enacted, or option 8 is chosen to defer enactment, we do not recommend this option. The reason for this is the widespread use of the branch exemptions means that foreign-owned banks are not currently paying NRWT or AIL on their related party lending and New Zealand-owned banks do not have related party lending from non-residents. Therefore this option, in the absence of the other AIL changes, would introduce additional legislation that would have no practical effect.

94. In the absence of this option borrowing through a related party – even where in the absence of tax it would be efficient to do so – would incur additional taxes compared to borrowing directly. Therefore, we expect if this option were not implemented foreign-owned banks would source practically all of their funding directly to prevent having to pay NRWT instead of AIL. Therefore, this option is not expected to have any fiscal cost.

*Assessment against criteria – option 9*

95. This option would meet the economic efficiency and fairness criteria as it would remove the tax disadvantage that would arise from a foreign parent borrowing to on-lend to their New Zealand operations when it was economically efficient in the absence of tax to do so.

96. The payment of AIL on interest payments to associated non-residents by a bank is no more complex than withholding NRWT and removes the incentive to structure around NRWT by borrowing directly so certainty and simplicity would be met.

97. A sub-option would be to extend this treatment to other margin lenders such as finance companies. Officials do not support this option as a bank is an easily definable entity and it is much more difficult to create a broad definition that covers non-bank margin lenders that are predominately funded by third party borrowing of a foreign parent while excluding entities that might be funded by the foreign parent's equity. Furthermore, there are only a relatively small number of non-bank lenders in this situation and they are generally not able to access the branch structures that would be removed by the preferred options in this RIS. Therefore, the overall effect on these lenders would be to maintain the status quo.

## Summary of impact analysis

| Option | Main objective and criteria | Benefits | Costs/risks |
|---|---|---|---|
| Option 1 – status quo | • Does not meet main objective<br>• Does not meet criteria (a) or (b)<br>• Meets criteria (c) | • Well established legislation that is widely understood | • Provides an exemption for some banks but not other banks or non-banks without a valid reason for doing so<br>• Does not achieve objective |
| Option 2 – remove of zero-rate AIL on unrelated party borrowing | • Does not meet main objective<br>• Does not meets criterion (a)<br>• Meets criteria (b) and (c)<br>• | • Consistent tax treatment of interest to unrelated non-residents<br>• Lowers cost of capital for some borrowers | • Reduces tax revenue, including in areas that have no impact on the cost of capital |
| Option 3 – introduce a widely offered test to zero-rate AIL | • Does not meet main objective<br>• Does not meet criteria (a) and (b)<br>• Partially meets criterion (c) | • Supported by submitters<br>• Broadly consistent with Australia | • No compelling reason why widely offered debt should be preferred<br>• Increases compliance and administration costs on adhering to arbitrary thresholds |
| Option 4 – introduce a specific bank exemption from AIL | • Does not meet main objective<br>• Partially meets criteria (a) and (b)<br>• Meets criterion (c) | • More consistent than current exemptions but only for banks | • Does not address inconsistency between banks and non-banks. Very difficult to stop extension to other or all industries |
| Option 5 – apply AIL to interest payments made by offshore branches to the extent that they lend to New Zealand *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • Achieves objective with regard to offshore branches<br>• Raises additional revenue | • Internationally novel |
| Option 6 – apply AIL to interest payments made to a non-resident that has a New Zealand branch with a banking licence if the lender and borrower are associated *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • Achieves objective with regard to onshore branches<br>• Prevents circumvention of AIL by structuring into this arrangement if other preferred options implemented<br>• Consistent with other onshore branch changes recommended in NRWT RIS | • May encourage investment into New Zealand directly by foreign lenders |

| Option 7 – apply AIL to notional loans to a New Zealand branch *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • Achieves objective with regard to funding allocated to onshore branches<br>• Raises additional tax revenue<br>• Broadly consistent with Australia | • May encourage investment into New Zealand directly by foreign lenders |
|---|---|---|---|
| Option 8 – AIL defer AIL changes until a review of widely-held exemptions is undertaken | • Does not meet main objective<br>• During deferral criteria are the same as option 1 which includes not meeting criteria (a) or (b)<br>• Partially meets criteria (a) and (b)<br>• Does not meet criterion (c) | • Allows consideration of changes at same time as widely held bonds | • No reason why changes should be aligned with widely held bonds<br>• Allows current inconsistent treatment and effective subsidy of banks to remain for longer |
| Option 9 – allow AIL on related party interest payments by banks *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • Removes a distortion that already exists but will be made worse by other preferred options<br>• Does not have a revenue cost as banks potentially subject to NRWT could borrow in less efficient ways so that NRWT was not payable | • Applies a special rule for banks which may be pressured to extend to other industries |

**Key:**
Criterion (a) – economic efficiency, criterion (b) – fairness, criterion (c) –certainty and simplicity.

98. The increase in compliance costs from options 5, 6 and 7 are expected to be small. These changes will only affect a small number of taxpayers, mostly banks. AIL will be required to be paid on amounts that are already calculated for either accounting or income tax purposes.

99. Options 2 and 4 would be expected to reduce compliance costs as either banks or all unrelated parties would no longer be required to determine whether AIL was payable. Compliance costs for option 3 would increase as any taxpayer relying on a widely-held or widely-offered criterion would be required to undertake ongoing monitoring to ensure that their new and continuing funding met the necessary requirements.

100. The administration costs of options 2 to 7 and 9 would be small as affected taxpayers would file AIL returns under existing systems. The administration costs of option 8 would be higher as it would result in the duplication of policy analysis and parliamentary process that has already been undertaken. It would also require provisions that are recommended to be amended in the NRWT RIS to be further amended following the deferral period.

101. The fiscal estimate of options 5 and 7 are both $12 million per annum. That these numbers are the same is coincidental as a larger amount of borrowing is currently through structures covered by option 5; however this is at lower currency interest rates such as British Pounds, US dollars and Euros. Once this funding is converted back into New Zealand Dollars the total cost is similar to the New Zealand Dollar and Australian Dollar borrowing through the branch structures covered by option 7; however, this foreign exchange cost is not, and will not be, subject to NRWT or AIL. This $12 million estimate is calculated as a $17 million

increase in AIL which will reduce taxable income by the same amount and therefore reduce income tax by $5 million.

102. The fiscal estimate of option 6 has not been separately calculated as we are not aware that there is currently a significant portion of bank funding using this structure. However, if options 5 and 7 were introduced without option 6 it is likely this funding source would increase.

103. The fiscal estimates of options 2, 3 and 4, which are not preferred options, are all negative by between $1 million and at least $87 million per annum depending on which option is chosen.

## CONSULTATION

104. Consultation was undertaken on option 5, 6 and 9 as part of the *NRWT: related party and branch lending* issues paper released in May 2015. 22 submissions were received on the issues paper of which 11 commented on some aspect of these options.

105. Targeted consultation was also undertaken in October 2015 with the New Zealand Bankers' Association (NZBA) and other non-NZBA member banks in relation to option 7.

106. Submissions on option 9 supported this proposal although some considered it should be extended to non-banks. Officials do not support this extension as covered in paragraph 97 above.

107. Submitters on options 5 and 6 in most cases disagreed with the proposals. The primary concerns were that these changes would increase the cost of capital and would be inconsistent with international treatment of interest payments to unrelated parties.

108. With respect to the cost of capital submissions, the first point to note is that many taxes, including the usual company tax, increase the cost of capital. This does not mean that they should all be eliminated. Taxes are necessary to raise the revenue Government needs to finance its spending. What is important is to minimise economic efficiency costs. In order to do that it is important that taxes are applied as consistently and coherently as possible. That is the objective of the proposal.

109. In our view any impact of this proposal on borrowing costs will in any event be minimal. The effects on borrowing costs will depend on the extent to which New Zealand's large foreign-owned banks are passing on the benefits of not paying AIL to domestic borrowers. If the benefits were being fully passed on, including being reflected in higher deposit rates, making AIL payable would be expected to increase interest rates by a factor of one fiftieth (e.g. from, say 5.0% to 5.1%). But this is a maximum assumption. Banks that are not subject to AIL are competing with other lending including lending by New Zealand owned banks. As a result they may be passing on little of the benefits of not paying AIL to domestic customers. In this case, the interest rates they charge are likely to rise by a smaller amount. At the same time the change would be removing the commercial advantage that these large foreign-owned banks have over other lenders.

110. With respect to the submission that the current treatment achieves a similar purpose to NRWT exemptions in other jurisdictions, and if removed should be replaced by an exemption such as those seen in comparable jurisdictions, in our view there is much less justification for such exemptions in New Zealand.

111. Other jurisdictions do not have AIL, and are therefore faced with a choice of 10% or 0%. This is the position in Australia. Although they have 0% for particular situations in domestic law, the relevant exemption for interest paid to banks is only given in a few of their recent treaties – so it does not apply across the board (unlike AIL).

112. Because AIL is only 2%, the deadweight costs it imposes are much less than those imposed by a 10% tax.

113. Imposition of AIL ensures that New Zealand does not give up the opportunity to collect NRWT from lenders who are prepared to pay it without passing the cost on to the New Zealand borrower. For example, if we were to exempt all interest paid by New Zealand banks, we would give up approximately $42 million pa of NRWT which is most likely having no effect on borrowing costs, as well as approximately $20 million pa of AIL.

114. Jurisdictions with wide ranging financial sector-related NRWT exemptions (eg the US, the UK) generally have these because they have global financial sectors, and need to provide exemptions to preserve them. New Zealand does not have a global financial sector, and therefore would reap less benefit from providing an exemption.

115. Experience over the last 25 years demonstrates that the imposition of AIL has not prevented New Zealand borrowers, including some banks, from borrowing from offshore lenders at attractive interest rates.

116. Furthermore, there does not seem to be a great deal of international consensus about what the best basis for an exemption might be. Accordingly, we believe the current AIL/NRWT system serves New Zealand well.

117. While officials have taken submissions into consideration, there are relatively limited choices regarding the implementation of options 5 to 7 so the preferred options continue to be broadly consistent with those originally proposed.

## CONCLUSIONS AND RECOMMENDATIONS

118. We recommend that options 5 to 7 and 9 are introduced. These changes will ensure that AIL is applied consistently across almost all interest payments to unrelated non-residents. As well as raising additional tax revenue they will increase the coherence of the tax system and are not expected to have a significant impact on the cost of capital.

## IMPLEMENTATION

119. Changes to the AIL rules would require amendments to the Income Tax Act 2007, Tax Administration Act 1994 and to any consequential provisions in other legislation. These amendments would be included in a tax amendment bill, planned for introduction in March 2016. We recommend that the preferred options should apply to all new arrangements entered into after the enactment of the legislation.

120. Officials recognise that both borrowing and lending by banks is frequently at interest rates that are fixed for many years and that profit margins are set based on the expectation that both sides of these transactions will be maintained or that break costs will be paid when such arrangements are terminated early.

121. Whether the banks have raised funding from a third party or a related party we recognise that these arrangements cannot be restructured without incurring transaction costs that would limit the profitability of the overall arrangement.

122. In relation to funding raised by an offshore branch this will usually be for terms of up to five years. This also aligns with the terms of many retail mortgage fixed rates. To minimise the effect of these tax changes we recommend that for arrangements entered into prior to the enactment of the legislation the new rules should only apply to interest payments after the start of the sixth year following enactment of the legislation. This will allow most, if not all, existing arrangements to not be subject to the new rules.

123. In relation to funding raised by an associated party from a non-resident with a New Zealand branch bank we recommend that the new rules apply from the date of enactment. This is because these arrangements are used to provide related party funding that has often been structured in this manner specifically to circumvent the NRWT rules.

124. In relation to deemed interest payments on funding allocated to a New Zealand branch we recommend that the new rules apply to interest deductions on existing arrangements from the start of the third year following enactment of the legislation containing these proposals and from enactment date for new arrangements. This delayed application date for existing arrangements recognises that there is, by definition, no specific funding allocated to finance the funding allocated to the New Zealand branch however a period of more than two years following the enactment of the legislation will allow the majority of funding of the head office to have been rolled over in the intervening period.

125. Implementing these changes would require updating a small range of communication and education products.

126. The new rules will be communicated to taxpayers by way of Inland Revenue's publication *Tax Information Bulletin* after the legislation giving effect to the new rules has been enacted.

127. The new rules will be administered by Inland Revenue as part of its business as usual processes.

## MONITORING, EVALUATION AND REVIEW

128. In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

129. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

# Regulatory Impact Statement

## NRWT: Related party and branch lending – NRWT changes

### Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It provides an analysis of options to ensure the correct amount of non-resident withholding tax (NRWT) is paid at the appropriate time on related party lending, lending that is economically equivalent to related party lending, and lending by unrelated parties which have a New Zealand branch.

Inland Revenue has identified a number of arrangements that have been entered into by taxpayers to remove, reduce or defer an NRWT obligation that would otherwise arise if a more conventional loan arrangement were entered into. In some instances, an existing anti-avoidance provision has applied to arrive at a tax treatment consistent with the policy intention but this is not possible for all arrangements. Because of the sophistication of existing financial products an almost infinite variety of different arrangements may be constructed, including many that may be designed in the future if a comprehensive solution is not introduced.

The options in this RIS are intended to comprehensively cover both known and potential avoidance arrangements. They are designed to impose NRWT on a timely basis on related party interest and amounts equivalent to related party interest.

There is a key constraint on the analysis. The fiscal cost estimates of the options are based on the amount of foreign direct investment and conservative assumptions on interest rates compared with NRWT collected over a number of years[1]. Fiscal estimates of the individual options are not available as the modelling estimates the amount of NRWT officials expect should be paid compared to what is paid, rather than what is avoided by particular structures. Furthermore, the fiscal costs of each option cannot be determined on a stand-alone basis as the introduction of rules that removed the tax advantage of a particular arrangement could encourage taxpayers to adopt another arrangement.

A range of options have been considered and measured against the criteria of economic efficiency, fairness, and certainty and simplicity. There are no environmental, social or cultural impacts from the recommended changes.

Inland Revenue is of the view that, aside from the constraint described above there are no other significant constraints, caveats and uncertainties concerning the regulatory analysis undertaken.

[1] Statistics New Zealand data on direct investment debt instruments and NZD equivalent BBB rated 5 year interest rates between 2001 and 2014. Statistics New Zealand direct investment is defined as 10% or more of voting shares in a company. While this definition is different to association for tax purposes it is likely to have a significant degree of overlap.

None of the policy options identified are expected to restrict market competition, unduly impair private property rights or override fundamental common law principles.

Carmel Peters
Policy Manager
Policy and Strategy
Inland Revenue

1 December 2015

## STATUS QUO AND PROBLEM DEFINITION

### Non-resident withholding tax rules

1. Non-resident withholding tax (NRWT) is required to be withheld on certain payments of interest, dividends and royalties. This RIS is concerned with NRWT on interest.

2. In general, New Zealand imposes tax on the worldwide income of New Zealand-residents and the New Zealand-sourced income of non-residents. An interest payment made by a New Zealand resident to a non-resident is an example of New Zealand-sourced income of a non-resident. Although the standard approach is to impose income tax on income it can be difficult to enforce and collect tax from non-residents. To ensure tax on this income is paid, New Zealand (like many other countries) imposes a withholding tax on interest payments. The payer of the interest withholds NRWT from the interest payment and pays it to Inland Revenue, and the balance is paid to the non-resident lender.

3. The NRWT rate on interest is 15% but this rate is usually reduced to 10% for lenders whose home country has a double tax agreement (DTA) with New Zealand. These rates are consistent with international tax practice. The lender will often be taxable on the interest income in their home country and allowed a tax credit for the NRWT withheld in New Zealand. This means that their income tax liability in their home country will be reduced by the NRWT withheld.

4. NRWT is only required to be withheld on arrangements where a number of definitions are met, including "interest", "money lent", "paid" and "non-resident passive income". The increasing sophistication of financial transactions has allowed the development of arrangements that are economically equivalent to debt from a related party, but do not trigger a liability to withhold NRWT on interest payments. In addition, the financial arrangement rules in the Income Tax Act 2007 mean that for New Zealand borrowers, finance cost deductions are calculated on an economic accrual basis. This means deductions can arise even when there is no interest, money lent, or payment that would trigger NRWT for the lender.

#### *Related-party and third-party lending*

5. NRWT is one of several areas of tax law that distinguish between related parties and third parties.

6. A "related party" is one that is associated, as that term is defined in the Income Tax Act 2007. Association recognises that there is, or may be, an ongoing relationship between two entities and covers a wide variety of relationships such as a person with their close relative, a company with its majority shareholder, or a trustee with its trust. The most common relationship between related parties is one company that, directly or indirectly, owns at least 50% of another company.

7. A "third party" is one that is not associated and recognises that two entities are not directly involved with each other. For the purposes of the problem definition, a common third party relationship arises when an individual or company borrows from a bank in which they have no ownership.

8. The distinction between related parties and third parties recognises that the incentives and behaviours of related parties may be different than an otherwise equivalent transaction involving third parties. For example, a person that lends to a related party may be willing to not receive interest payments as they are happy instead to hold an increased receivable from the borrower; whereas, a bank would expect interest payments as they do not wish their exposure to the borrower to increase beyond the agreed amount.

**Approved issuer levy rules for third party lending**

9. In certain circumstances, approved issuer levy (AIL) can replace NRWT on third party lending. AIL is a payment by the borrower that allows the rate of NRWT to be reduced to zero. Paying AIL is voluntary and applies at a lower rate of 2%. Unlike NRWT, however, AIL cannot be offset against the lender's income tax liability in their home country.[2]

10. AIL is levied on third party lending. Applying AIL to third party lending helps ensure that taxes on interest do not push up interest rates in New Zealand too much. There is international evidence that NRWT on third party lending may largely be passed through as a cost to domestic borrowers in higher interest rates rather than being absorbed by foreign borrowers. This is because a very large and important group of foreign lenders including foreign margin lenders may have little or no scope to claim credits for NRWT. (Foreign financial institutions are often described as margin lenders because their profits are made on a small margin between borrowing and lending rates. Because NRWT is levied on the gross interest paid abroad, little may be creditable if gross interest is very large compared to the interest margin).

11. Other countries often have different ways of dealing with this concern and some exempt certain lenders from NRWT. A difficulty with that approach can be in identifying who should be exempt and who should not be. New Zealand's approach of allowing borrowers of third party debt means to elect to pay AIL means that domestic interest rates may be bid up very slightly (by one fiftieth, e.g., from 5.0% to 5.1%) but this avoids the need to make different rules for different third party lenders. In practice it is very difficult to identify exactly which foreign lenders will and which will not be sufficiently sensitive to tax for NRWT to drive up domestic interest rates.

12. AIL would not be required and indeed would not be in New Zealand's best interest if there were a sufficiently large pool of foreign third party lenders who could absorb the costs of NRWT without this being passed on in higher interest rates. Allowing AIL in this circumstance would reduce domestic taxes and increase the cost of borrowing to New Zealand as a whole because the cost of borrowed funds to New Zealand as a whole is the interest paid by New Zealand borrowers net of any domestic taxes that our Government collects on these payments. However, there is unlikely to be this large enough pool of foreign third party lenders and this appears to be borne out by international empirical evidence. Our AIL regime for third party debt is a pragmatic response.

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[2] This is mainly because AIL is paid by the borrower not the lender and, unlike NRWT, AIL is not an income tax.

**Requirement to pay NRWT on related-party lending**

13. The AIL option is not available to related parties. This is consistent with international tax practice including, for example, the OECD model which applies a withholding tax of 10% to related party interest. Officials consider that this treatment remains appropriate.

14. Unlike the case of third party debt the majority of related-party lenders are likely to be foreign taxpaying companies. These will often be able to absorb the costs of NRWT without this necessarily pushing up the cost of capital (i.e., the hurdle rate of return they require to invest in New Zealand). Under OECD conventions New Zealand has a right to levy NRWT in this case. This is justifiable given that New Zealand provides the infrastructure that foreign-owned business operating in New Zealand make use of. Failing to levy tax in this situation would put upward pressure on other tax rates in New Zealand which would create their own costs and be likely to provide a greater burden on New Zealanders.

15. Even where these taxes are not able to be absorbed by a particular investor, there remains a good reason for continuing to levy NRWT on related party interest. Taxes collected on international investment are a source of national income. If we levy lower taxes on one group of foreign direct investors than another, there will be incentives for investment to be undertaken by those paying the lowest amount of New Zealand tax. For a given amount of international investment into New Zealand, this will tend to lower national income. This provides strong grounds for trying to levy tax on different related-party investors into New Zealand that are as neutral and consistent as possible.

16. AIL has never been available as an option for related party lending and officials consider that this continues to be a sensible approach.

17. There is another consideration too. Related party debt is a close substitute for non-deductible equity. Borrowers are entitled to income tax deductions for interest payments on debt but not dividend payments on equity. As a result, there is an incentive for non-residents to invest in their New Zealand related party by way of debt to reduce their New Zealand tax liability. NRWT, along with thin capitalisation rules[3], support a more balanced investment.

18. There is a balancing consideration. The company tax rate, NRWT on interest paid to related parties and thin capitalisation rules can all combine to increase the cost of capital which will discourage investment to some extent. An important goal is ensuring that New Zealand's tax rules are not too onerous and do not discourage investment too much so that New Zealand continues to be a good place to invest. At the same time there are no easy solutions here. There will be costs associated with just about any form of tax and taxes are necessary to finance the government services that New Zealanders expect.

19. The reforms discussed in this RIS are not aimed at overturning the current basic rules applying to third-party and related-party lending into New Zealand but instead at ensuring that they apply in a more consistent and neutral way. In particular, our basic framework involves levying tax on interest paid to a single foreign controller of a domestic company for standard debt contracts. The framework involves a balancing of competing considerations including cost of capital issues and the benefit of consistency and neutrality. There is, for example, no attempt to allow AIL or a lower rate of NRWT if a single foreign controller is unlikely to be

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[3] Thin capitalisation rules restrict the proportion of related party debt that a New Zealand subsidiary of a non-resident owned group can have.

able to claim credits for NRWT and this pushes up the cost of capital. The aim of the current reform is apply consistent rules in situations that are economically equivalent but where NRWT can currently be walked around.

## The problem

20. The main problem is that the tax rules for related party lenders are not being applied on a neutral and consistent basis. This problem arises because:

- There are problems with definition and recognition of income under the NRWT rules;

- Current restrictions on related parties, or those who are economically equivalent to related parties, accessing the AIL rules are not sufficiently robust, which allows structuring into the AIL rules when the policy intention is that the interest payments should be subject to NRWT.

- The AIL requirements are limited, which allows certain New Zealand taxpayers to borrow from non-resident associates and use the AIL rules even though this interest does not meet the legislative requirements.

- Current exemptions from the NRWT rules relating to onshore branches are so wide in scope that they exempt certain interest payments that are not consistent with the policy intention for the taxation of New Zealand-sourced income earned by non-residents.

21. We consider it is in New Zealand's best interest to maintain the NRWT rules but that they should apply consistently to economically equivalent transactions. Applying the rules more neutrally and consistently will help ensure that investment is undertaken in ways which will generate the best return to New Zealand as a whole rather than in ways where it is possible to sidestep NRWT. Allowing NRWT to be sidestepped in the case of related party lending provides incentives for assets to migrate to firms paying lower amounts of tax in New Zealand. This is likely to be economically inefficient and unfair. The reforms that are proposed are aimed at reducing these distortions.

## Scale of the problem

22. Inland Revenue estimates that the amount of NRWT paid is approximately 75% of the amount that should be paid. This allows an inference that the current law provides an uneven playing field where a small number of foreign-owned firms that are not paying NRWT are subject to less tax than their competitors.

23. The Government currently collects around $180 million per annum from the combined NRWT and AIL rules applying to interest. For the 2014 year this was $135 million NRWT on interest and $47 million AIL.

24. The 2014 Statistics New Zealand international investment position data shows that debt instruments held by direct investors in New Zealand entities were approximately $49 billion.

## OBJECTIVES

25. The main aim of the reform is to ensure that New Zealand's tax rules for related party lenders are applied on a neutral and consistent basis. This would mean having rules that ensure the return received by a non-resident lender from an associated borrower (or a party that is economically equivalent to an associated borrower) will be subject to NRWT and, at a time, that is not significantly later than when income tax deductions for the funding costs are available to the borrower.

26. The desired outcome is that amounts that are economically equivalent to related party debt should be taxed consistently with more use of standard debt instruments as originally anticipated by the existing NRWT rules. For example, bonds where interest payments are made regularly (including where the interest is capitalised into the debt) should have a similar NRWT treatment to zero-coupon bonds that pay no interest for 30 years with a very large interest payment built into the final payment on maturity.

27. The options in this RIS have been subject to consideration by tax policy officials for a number of years, as the deficiencies in the NRWT rules are widely known. This project is not part of, but is consistent with, the approach taken by the OECD base erosion and profit shifting (BEPS) work.

28. The criteria against which the options will be assessed are:

- *Economic efficiency*: The tax system should, to the extent possible, apply neutrally and consistently to economically equivalent transactions. This means the tax system should not provide a tax preferred treatment for one transaction over another similar transaction or provide an advantage to one business over another. This helps ensure that the most efficient forms of investment which provide the best returns to New Zealand as a whole are undertaken. At the same time there is a concern that taxes should not unduly raise the cost of capital and discourage inbound investment.

- *Fairness*: Taxes should not be arbitrary and should be fair to different businesses. Neutrality and consistency across economically equivalent transactions is likely to also promote fairness.

- *Certainty and simplicity*: Although the NRWT rules are necessarily complicated, they should be as clear and simple as possible so that taxpayers who attempt to comply with the rules are able to do so.

29. While all criteria are not equally weighted they are important. Any change (except for the status quo) would have to improve neutrality and consistency of treatment. This will tend to promote economic efficiency and fairness. At the same time, the measures will also tend to increase the cost of capital in some circumstances so there are trade-offs to consider. Due to the complexity of these transactions, the sophistication of taxpayers who enter into them and the rules that cover them, and the fact that taxpayers are generally able to choose to enter into more simple transactions as an alternative to those dealt with by these rules, officials would see economic efficiency and fairness as the most important criteria.

30. The options do not deal with all tax issues arising from related-party debt. In particular, they do not deal with cross-border hybrid issues. The timetable for dealing with those issues is linked to the OECD's BEPS timetable. Consultation is likely to commence on them by early 2016.

## REGULATORY IMPACT ANALYSIS

31. A range of options and the status quo have been assessed in this RIS for addressing the problems identified in paragraph 20. Owing to the complexity of the NRWT rules and the variety of structures that must be covered by them it is not possible to design a single option to address the entire problem definition.

32. Two options are assessed as "general options" because they potentially address more than one of the identified problems. Eight options are grouped according to the specific problems they seek to address and this format is consistent with how these problems and options were presented in the May 2015 officials' issues paper *NRWT: related party and branch lending*.

33. The options are:

- **General options**
  - Option 1: Status quo
  - Option 2: Specific anti-avoidance rules
- **Problems with the definition and recognition of income under the NRWT rules**
  - Option 3: Extend definitions applying to the NRWT rules (preferred option)
  - Option 4: More closely align NRWT with the financial arrangement rules (preferred option)
  - Option 5: Defer income tax deductions until NRWT is paid
- **Defining when payments are to a related person**
  - Option 6: Thin capitalisation style acting together test (preferred option)
  - Option 7: Back-to-back and multi-party reconstruction rules (preferred option)
- **Eligibility for AIL**
  - Option 8: AIL registration changes (preferred option)
  - Option 9: Requiring upfront proof of non-association before allowing AIL
- **How branches interact with the NRWT rules**
  - Option 10: Onshore branch changes (preferred option)

34. If a general option is relevant to one of the specific problems it will be mentioned in the discussion of that problem. Although the general options have not been separately listed in each specific category their exclusion is not intended to imply that the preferred option was the only available option.

### General options

#### *Option 1: Status quo*

35. Under this option, the current NRWT and AIL rules would remain unchanged.

36. Some submitters suggested retaining the status quo for an undetermined period before considering options following or concurrent with the OECD's BEPS project work. Officials did not consider that any additional information would arise from the BEPS project that would fundamentally alter the conclusions reached in this review. Therefore, officials do not support any deferral.

*Assessment against criteria – status quo*

37. The deficiencies in the current NRWT rules create an incentive for taxpayers to enter into complex arrangements to achieve tax benefits that would not be available under transactions that would otherwise be entered into but for the differing tax treatment. Therefore, this option would not meet the criteria of promoting economic efficiency or fairness.

38. Owing to the use of structures that are often challenged under existing anti-avoidance provisions this option would fail the criterion of promoting certainty and simplicity.

***Option 2: Specific anti-avoidance rules***

39. This option would introduce one or a series of anti-avoidance rules that would apply to arrangements which had either the intention or effect of removing or delaying an NRWT (or AIL) liability. This option would apply in addition to the existing anti-avoidance provisions.

40. To the extent the anti-avoidance rules are effective they would raise additional revenue.

*Assessment against criteria – option 2*

41. To the extent the anti-avoidance rules apply on a different (and uncertain) boundary to the status quo and the other options, this option would not fully meet neither the criterion of promoting economic efficiency nor that of promoting fairness.

42. An anti-avoidance rule that was intended to apply to a broadly similar range of transactions as the specific provisions considered in the other options would incur higher compliance and administration costs (for example due to the cost of tax disputes) than under the status quo and preferred options.

43. Anti-avoidance rules are generally a second best approach when compared with a more general principles-based approach. Such rules create uncertainty for taxpayers and Inland Revenue and can involve considerable expense, particularly when the disputes process is required before a reassessment can be made. This option would be associated with greater uncertainty and complexity, compared with the status quo.

**Problems with definition and recognition of income under the NRWT rules**

44. This problem relates to the inconsistencies in the rules for income tax and NRWT which allow borrowers to obtain income tax deductions for financing costs while deferring or removing the NRWT liability on interest payments or amounts that are economically equivalent to interest payments to a non-resident related party lender.

***General options***

45. The only general option that merits specific discussion here is option 2. Some submitters favoured the adoption of this option for addressing the specific problem.

However, officials do not support this option on the basis that it would require specific anti-avoidance provisions to cover transactions where taxpayers would seek to argue that the arrangement was structured in a manner for commercial reasons in order to be effective. Even if these commercial reasons were accepted, it is possible for these transactions to be inconsistent with the policy intention underlying the interaction of the NRWT and financial arrangement rules.

46. For example, a New Zealand resident borrower with no or limited cash flow could borrow money from its parent using a zero coupon loan, or using a loan that capitalises interest. Both types of loan are commercially justified, but the former defers the NRWT on the interest until the loan is repaid, whereas the latter does not. From an economic efficiency and fairness standpoint this is not desirable. In order for this option to be effective it would have to apply comprehensively. This would result in an anti-avoidance provision applying in almost all of the same scenarios in which the preferred option applied but without providing the same degree of certainty.

47. Option 2 is likely to be less effective in promoting economic efficiency and fairness than the preferred options (option 3 and 4). There would also be greater compliance and administration costs of applying the provisions which would likely result in a higher burden on the economy for equal or less tax. For these reasons, this option is not preferred.

***Option 3: Extend definitions applying to the NRWT rules***

48. Under this option current definitions in the NRWT rules would be extended to apply to arrangements that are economically equivalent to those arrangements which are covered by the current definitions.

49. These extensions would apply to arrangements involving associated persons and for the purpose of the NRWT rules. Transactions with genuine unrelated parties have less scope to circumvent the existing rules as arms' length lenders would usually require returns on their investment within reasonable timeframes; whereas, related parties can generate their return on investment in other ways, such as an unrealised increased value of their wholly owned subsidiary. Limiting these changes to the NRWT rules removes the need to consider the impact of these changes on other areas of tax law, which have not had similar concerns identified.

50. Because this option would result in more arrangements being subject to NRWT it would increase revenue.

*Assessment against criteria – option 3*

51. This option would achieve the criterion of promoting economic efficiency as it would impose NRWT on transactions that are not currently subject to NRWT but are economically equivalent to those that already are. A balancing consideration is that this option could increase the cost of capital but only for borrowers that are structuring around the existing rules and only to the level that applies to economically equivalent transactions. On balance officials consider this would promote economic efficiency.

52. The greater neutrality across economically equivalent transactions will achieve the criterion of promoting fairness.

53. The certainty and simplicity criterion would be met because taxpayers who have the ability to enter into such transactions would be able to apply the new rules with little difficulty. In addition, taxpayers would have an incentive to revert to less complex transactions which have the same tax treatment.

***Option 4: More closely align NRWT with the financial arrangement rules***

54. Under this option the NRWT and financial arrangement rules would be more closely aligned. This means NRWT would apply to income arising on an economic accrual basis when a transaction had a larger than acceptable level of deferral between accrued income and interest payments. The rules would not apply to arrangements involving third parties or related parties that had interest payments that broadly aligned with the economic accrual of that income, including when interest was paid on an arrears basis[4] after the balance date before which part of the income accrued in.

55. Currently, many transactions will eventually have the correct amount of NRWT paid but can achieve a significant timing advantage by deferring the timing of the interest payment compared to the economic accrual of the income under the financial arrangement rules.

56. As explained in option 3 this timing advantage generally only arises between related parties due to the different commercial pressures compared to unrelated party lending. Owing to the complexity of this option we only considered these changes in relation to certain related party transactions rather than a wholesale refocusing of the NRWT rules.

57. In order to broadly align the time when income and expenditure are recognised, the two options available are to accelerate the income or defer the deductions. These are considered under option 4 and option 5.

58. Option 4 involves determining which arrangements could be subject to these proposals and only capturing the subset of these arrangements where NRWT is paid beyond an acceptable deferral compared with the corresponding income tax deductions.

59. For these particular arrangements an amount of income that would be liable to NRWT would be calculated for the non-resident lender consistent with the deductions available to the borrower under the financial arrangement rules. In accordance with the existing rules this non-resident interest income should exclude foreign exchange movements.

60. Although this option would accelerate the payment of NRWT it would, when measured in the currency that the loan was denominated in, have no impact on the amount of NRWT payable on an arrangement, the amount of foreign tax credits available to the lender, and deductions available to the borrower.

61. This option would accelerate the payment of NRWT on transactions so that the timing is similar to income tax deductions and the NRWT treatment of other economically equivalent transactions. Consequently, there would be a revenue gain.

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[4] Interest is typically paid on an arrears basis. This means that it is paid at some point after being earned. For example, a 5 year loan that makes its first interest payment at the end of the first year on income accrued up to that date.

*Assessment against criteria – option 4*

62. This option would achieve the criterion of promoting economic efficiency as the liability for NRWT would broadly align with the economic accrual of the income and income tax deductions. It would increase the cost of capital in some circumstances but only to align this better with the cost of capital on economically equivalent transactions. It will mean economically equivalent borrowing will be taxed in a similar manner irrespective of the timing of interest payments.

The greater neutrality across economically equivalent transactions would also achieve the criterion of promoting fairness.

63. Owing to the complexity of this option it would prima facie only partially meet the certainty and simplicity criterion. However, these rules would only be applied by sophisticated taxpayers and the NRWT liability would broadly approximate their income tax deductions and so these rules could be applied correctly by almost all taxpayers. This option could provide an incentive for taxpayers involved in such arrangements to revert to less complex transactions that have the same tax treatment, but require less complex rules.

***Option 5: Defer income tax deductions until NRWT is paid***

64. This option would take the opposite approach to option 4, in that there would be no changes to the NRWT rules but would still require rules to identify certain funding arrangements which had an unacceptable deferral compared with the corresponding income tax deductions. The difference is, for these arrangements, changes would be required to either the financial arrangement rules or the provisions that allow a deduction for financial arrangement expenditure so that income tax deductions would be deferred until NRWT was paid. Rather than forfeiting income tax deductions, these deductions would be carried forward to a future period when NRWT was eventually paid.

65. This option has the advantage of leaving the NRWT rules unchanged so that borrowers do not face any tax liabilities that cannot be immediately met by way of reducing a payment to the lender. However, this option would create a number of income tax complications that officials consider are undesirable.

66. These complications include:

- The financial arrangement rules are designed to give an accurate measure of a person's income or expenditure from financial arrangements in order that a person's tax liability can be calculated. Deferring deductions would reduce this accuracy, which could in turn create difficulties. For example, deferral allows a company in tax loss to artificially preserve the interest deductions, in situations when it might otherwise be eliminated by an ownership change.

- If deferral were applied to a related party loan in a foreign currency, it would not make sense to apply deferral to the recognition of foreign currency movements on the loan, since these are not subject to NRWT in any event. Furthermore, if the loan is hedged, deferral of recognition of foreign currency movements could create a timing mismatch. Deferring part of the expenditure but not all would be complex.

- It would be difficult to integrate this option with the thin capitalisation regime. Deferral would prima facie mean that interest economically incurred in one year would give rise (or not) to an additional amount of income under the thin

capitalisation rules depending on the borrower's debt/equity ratio in the later year when the interest is paid, rather than in the year it economically accrues. That would not be desirable.

67. This option is not considered to be economically efficient as it changes the income tax treatment of interest deductions away from when they economically accrue. It also provides differing incentives for the lender to have NRWT paid on their behalf depending on the income tax position of the borrower.

68. This option would raise additional revenue but not as much tax as option 4. Although a small number of borrowers may have deductions deferred which would result in income tax at 28% rather than NRWT at 10%, in practice this would only occur when the borrower is in a tax loss so that the deduction deferral would not affect current year income tax payable.

*Assessment against criteria – option 5*

69. Economic efficiency and fairness would be improved over the status quo but these criteria are only partially met as full neutrality might not be achieved depending on the borrower's income tax position as noted above. At the same time this option would increase the cost of capital in fewer circumstances.

70. These rules should only be introduced if the complications mentioned above are resolved. Although this might be possible it would result in even more complex rules than the other options so the certainty and simplicity criterion would not be met.

**Defining when payments are to a related person**

71. This problem relates to the ability of interest payments to unrelated parties to be subject to AIL instead of NRWT. There are numerous arrangements in which the ultimate lender and borrower are associated (or economically equivalent to associated) but any interest payment made by the New Zealand borrower is not paid to an associated non-resident and so AIL is available.

***General options***

72. A specific anti-avoidance provision (option 2) was suggested by some submitters to resolve the back-to-back and multi-party arrangement concerns (see below for explanation of these). However, such a provision is not favoured by officials. Although option 2 might meet the economic efficiency and fairness criteria by the same degree as the preferred option for addressing this problem it does so with much less certainty. As mentioned earlier, a specific anti-avoidance provision would likely have a greater impact on the cost of capital because of the additional cost of challenges as to whether the provision applied. Officials also consider that a specific anti-avoidance provision would not be a viable option for addressing the issue of "acting together".

73. Some submitters favoured the status quo (option 1) over an acting together rule. There are commercial reasons why some taxpayers would be unable to substitute between other structures identified in this RIS and this structure, such as a desire to retain 100% ownership and control of a New Zealand subsidiary. However, officials consider this option would not meet the economic efficiency and fairness criteria. If two or more non-resident investors act together to control a New Zealand company this structure would be economically equivalent to a single non-resident investor with the same ownership. It would be economically

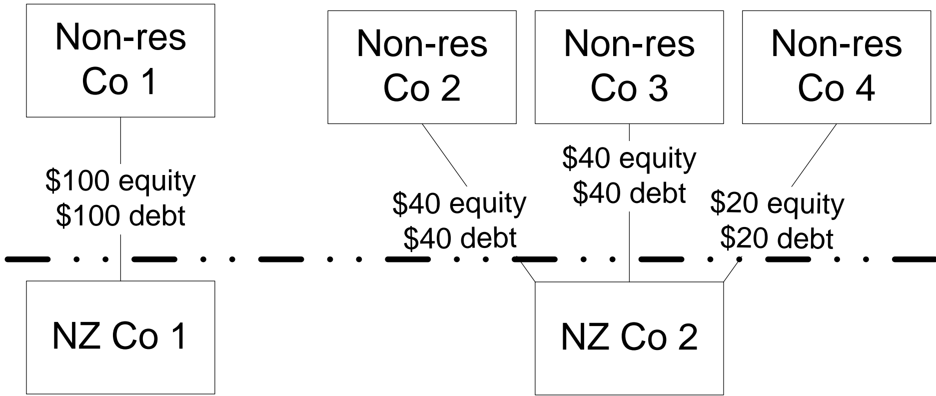
inefficient for a business with a single owner to face a tax disadvantage compared to one with two or more owners that are acting in an otherwise equivalent manner.

***Option 6: Thin capitalisation style acting together test***

74. New Zealand borrowers can elect to pay AIL instead of withholding NRWT on interest payments to non-residents provided the borrower and lender are not associated. A lender and borrower will generally be associated if one company, directly or indirectly, owns 50% or more of the other. This is a measure of the extent to which the lender and borrower are commonly controlled.

75. However, if two or more companies, who are not associated with each other, but make decisions as if they were a single person, collectively hold 50% or more of the shares in, and lend to, a New Zealand company this can be economically equivalent to them controlling the New Zealand company without them being associated with it, so that AIL is still available on the shareholder loans.

76. This can be shown in the following example:




77. In this example interest payments by NZ Co 1 to Non-res Co 1 would not be eligible for AIL as these companies are associated. Interest payments by NZ Co 2 to Non-res Co 2, Non-res Co 3 and Non-res Co 4 would be eligible for AIL as none of these companies is associated with each other or with NZ Co 2. When considered together Non-res Co 2, Non-res Co 3 and Non-res Co 4 are economically equivalent to Non-res Co 1 and so should be subject to the same tax treatment.

78. A similar issue existed for thin capitalisation before the introduction of non-resident owning body provisions for the 2015-16 and later income years. A non-resident owning body is made up of a group of non-residents[5] that have one or more characteristics which indicate they are acting together to debt-fund a New Zealand company. The owning body is essentially treated for thin capitalisation purposes as a single person with the ownership interests of the group.

79. This option would introduce a similar measure into the AIL rules. This would mean that if there is a group that is acting together, and if considered as a single entity would be associated with the New Zealand borrower, the borrower would be ineligible to pay AIL on interest to a member of the group. This option would not involve changes to the association

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[5] It can also include certain New Zealand resident trusts.

rules and so a member of the group or the group as a whole would not become associated solely because of this option. This option would allow interest payments on lending which is not part of the group activity to qualify for AIL.

80. Other measures under this option include whether the group should comprise both residents and non-residents or only non-residents and whether ownership interests should be calculated based on the highest of the four ownership tests (which would be consistent with thin capitalisation) or the average of these tests (which would be consistent with the associated person rules).

81. It would be possible to define an acting together group including resident members but only apply the AIL restrictions to the non-resident members of that group (the resident members not deriving non-resident passive income). This was the proposal in the issues paper. However, submitters were opposed to this measure and considered that if an acting together test were adopted it should only apply to a group of non-residents. Submitters raised the possibility of the rules applying when non-residents only have an extremely minor interest in the New Zealand company. To meet this concern, officials revised the proposed measure so that it would only apply when a borrower is controlled by a group of non-residents who are acting together. This is consistent with the existing thin capitalisation test.

82. There are four shareholder decision-making rights which are the right to participate in decision making concerning: dividends; the company constitution; varying capital of the company and appointing directors. The existing thin capitalisation test looks at the highest of these four ownership interests while the existing associated person rules look at the average of these interests. As taxpayers would always prefer to not be treated as acting together, and the average interest test would be a more difficult threshold to breach than the highest interest test[6] the average measure would be the preferred option of potentially affected taxpayers.

83. The advantage of the average test is that it would generally more accurately reflect the control a shareholder has over a company. The disadvantage is that it would leave open the possibility of aggressive structuring. For example, having three of the decision-making rights over 50% and one much lower so that on average the shareholder and the company would be below 50% and so would not be associated.

84. As the existing AIL requirements rely on the associated person rules, and therefore the average of the shareholder decision-making rights, officials consider it is more consistent to also apply the average of the shareholder decision-making rights to the acting together requirements.

85. This option would impose NRWT instead of AIL on certain interest payments but only in relation to arrangements that are economically equivalent to those that are already subject to NRWT. This option would raise additional revenue.

*Assessment against criteria – option 6*

86. This option would promote economic efficiency by imposing NRWT on interest payments to groups of non-residents that are economically equivalent to a single related party lender. A balancing consideration is that this would increase the cost of capital but only to the

[6] Except when all four decision-making rights are the same in which case both tests have the same outcome.

level that applies to economically equivalent transactions. On balance officials consider this would achieve the criterion of promoting economic efficiency.

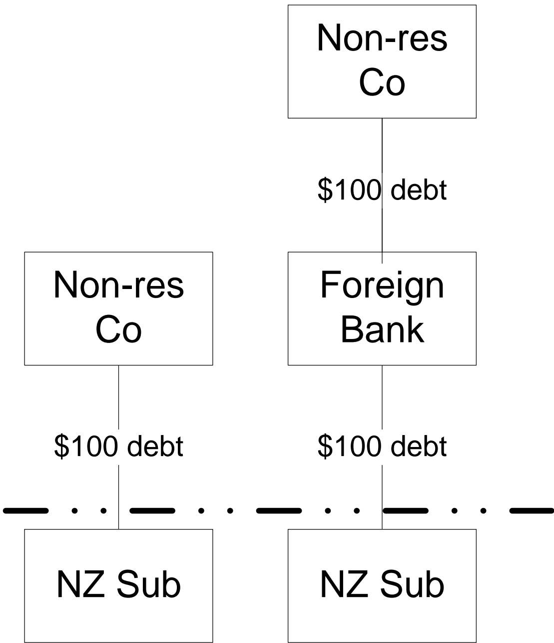
The greater neutrality across economically equivalent transactions will achieve the criterion of promoting fairness.

87. This option relies on a variant of the existing non-resident owning body definition in the thin capitalisation rules. Although this test complex it is an existing provision and for most taxpayers it would be clear whether it applies or not. Therefore, the certainty criterion would be met.

***Option 7: Back-to-back and multi-party reconstruction rules***

88. As the AIL rules apply the legal form of the associated person rules rather than their economic substance they currently do not apply when an associated borrower and lender interpose an unrelated party. For example, a New Zealand borrower could borrow from an unrelated finance company that has an agreement to be funded by a deposit from a non-resident that is associated with the New Zealand borrower. Although such an arrangement is vulnerable to the general anti avoidance rule, the exact parameters of this rule are uncertain and it is not desirable to rely on it when specific rules can sensibly be used.

89. This arrangement can be shown in the following example:




90. In this example, if Non-Res Co lends money to its NZ Sub any interest payments would be subject to NRWT. However, if Non-Res Co puts money on deposit with a Foreign Bank and the Foreign Bank lends the same amount to NZ Sub the interest payment by NZ Sub would be eligible for AIL (subject to the non-application of an anti-avoidance rule).

91. Similar structures can also be applied to arrangements that are economically equivalent to, but are not, a loan that meets the necessary definitions for NRWT purposes. For example, a bank could lend to a New Zealand company then agree to sell the repayment obligation to the New Zealand company's foreign parent. Economically, this arrangement is equivalent to a loan from the foreign parent to the New Zealand company, but is not currently subject to NRWT as it is not an interest payment on a loan from a related non-resident.

92. Option 7 involves introducing a specific set of tests that would identify arrangements that have the appearance of providing funding from a non-resident to an unrelated New Zealand borrower but the funding is ultimately provided by an associated party and the economic effect of the structure is in whole or part equivalent to a direct loan from that associated party. When these tests are met the tax treatment of the arrangement would be recharacterised to reflect the economic substance as a loan from an associated party.

93. If an arrangement is economically equivalent to a New Zealand borrower being partially funded by an associated non-resident and partially by a third party this option would only apply to the extent of the associated party funding.

94. While this option could slightly increase the cost of capital it would raise additional tax from taxpayers who are structuring around the existing NRWT rules.

*Assessment against criteria – option 7*

95. This option removes one avenue to enter into a tax avoidance arrangement and strengthens existing anti-avoidance provisions that might already apply to such a transaction. This option would achieve greater economic efficiency despite possibly pushing up the cost of capital slightly certain investors who circumvent the existing rules. However, the impact would be consistent with existing taxes already applying to equivalent transactions and, on balance, officials consider that this will satisfy the criterion of promoting economic efficiency. The greater neutrality across equivalent transactions will also satisfy the criterion of promoting fairness.

96. The effect of these rules would be similar to reconstructing under an anti-avoidance provision. However, the rules would provide greater certainty to taxpayers and Inland Revenue, as well as provide parliamentary guidance on how the anti-avoidance provisions should be applied to this type of transaction. Therefore, the certainty and simplicity criterion would be met.

## Eligibility for AIL

97. AIL is not intended to be available for interest payments to associated parties. However, officials are aware of a number of instances where AIL has been paid by associated parties that claim to be unassociated. These instances can only be prevented if they are identified by Inland Revenue's investigations unit which, outside of the larger cases, would not be cost effective.

### *General options*

98. Submitters favoured the status quo (option 1) for addressing this problem, but officials did not.

99. The status quo would not meet the economic efficiency and fairness criteria, as taxpayers (particularly those with relatively low borrowing amounts) would be aware that their tax position could not be cost effectively audited to ensure it was correct. The tax system relies on voluntary compliance and if there is an incentive not to comply with the tax law it is not efficient for this to be retained.

### *Option 8: AIL registration changes*

100. Option 8 would restrict who can register a security for AIL to replace the current rules which allows any person to register a security. This restriction would only allow security registrations where there was a low risk of the registration being on associated party lending. Two requirements would be needed to provide for this restriction namely; the borrower and/or lender must be subject to either regulatory or public oversight so that abuse of AIL would be highly unlikely, and the amount of the borrowing must be sufficiently large that further review by Inland Revenue could be cost effectively undertaken.

101. Officials consider that a publicly listed company undertaking a private placement and a closely held company borrowing from a foreign bank are examples of low risk registrations. These and many other examples would be able to continue to register securities under this option.

102. One disadvantage with this option is that it could restrict access to AIL for legitimate third party foreign borrowing, such as an individual borrowing from a foreign business associate. However, officials are not aware of a suitable distinction to draw between these cases and cases when AIL is accessed inappropriately. Officials expect that relative to the amount of lending that might continue to be eligible for AIL these transactions would be very small. This would be balanced against the extra tax paid by borrowers currently inappropriately accessing AIL.

*Assessment against criteria – option 8*

103. This option would promote both economic efficiency and fairness. This is because taxpayers who are choosing not to apply the existing law would no longer have this choice and they would have to pay a consistent amount of NRWT like other taxpayers with economically equivalent arrangements.

104. The certainty and simplicity criterion would be met as taxpayers would be able to determine whether they or their lender are on the list of approved borrowers and/or lenders.

### *Option 9: Requiring upfront proof of non-association before allowing AIL*

105. Under this option the registration process would include a requirement that would provide that the borrower and lender are not associated. Inland Revenue would confirm this requirement is met before completing the registration or, alternatively, rely on the existing legislation and apply greater audit resources to ensure that when AIL has been paid the parties are not associated.

106. Confirming this information, under either approach, would be time consuming because taxpayers who are willing to pay AIL when they know it is not available are often willing to provide incomplete or incorrect documentation to suggest their tax position is correct. Inland Revenue would usually have to seek documentation from foreign tax jurisdictions using information exchange facilities in a DTA which can be a time consuming process. If New Zealand does not have a DTA with a foreign country it would be much more difficult, if not impossible, to obtain this documentation.

107. A further complication is the low value of many AIL payments. For example, during the 2014 calendar year there were 1,667 taxpayers who paid AIL; however, 1,299 of these paid less than $1,000 and 1,468 paid less than $5,000.

108. This option would have a lower impact on the cost of capital for the limited number of borrowers who are borrowing from third parties but will not meet any of the categories in the approved list. However, it would impose much more significant compliance and administration costs on all borrowers, including those who would easily meet the categories in the approved list.

109. Although this option is likely to result in a small increase in tax paid this would be more than offset by the additional resource requirements to implement it which would either require additional funding or the refocusing of resources from other areas where they can be more cost effectively employed.

*Assessment against criteria – option 9*

110. This option would meet the economic efficiency and fairness criteria provided the review by Inland Revenue is comprehensive and arrives at the correct outcome. It would provide certainty to taxpayers who should be aware that they are borrowing from associated parties and the lender is liable for NRWT. To the extent Inland Revenue is unable to accurately determine whether all borrowers and lenders are associated (as is currently the case) the economic efficiency and fairness criteria would not be satisfied. Therefore, this option would only partially meet these criteria.

111. To the extent the review by Inland Revenue is comprehensive this option would increase certainty as all approved issuers would be aware their securities would be reviewed to ensure they are not with related parties. Therefore, this criterion would be met.

**How branches interact with the NRWT rules**

112. An interest payment is not non-resident passive income if the non-resident recipient has a New Zealand branch. This rule is known as the onshore branch exemption, which has existed since the introduction of NRWT in 1964. The exemption was intended to cover the situation at the time when most of New Zealand's banking sector operated as New Zealand branches of foreign parents. This meant that New Zealand mortgage borrowers did not need to have a different tax treatment depending on whether they borrowed from a New Zealand bank or a New Zealand branch of a foreign bank.

113. However, the legislation did not take into account borrowing from a foreign company with a New Zealand branch that was not involved in the lending transaction. Under the current legislation the existence of the New Zealand branch that is not involved in the arrangement means interest payments which are not to the branch are not subject to AIL or NRWT. This is the case even when the structure is otherwise identical to a structure that would generate non-resident passive income and the lack of non-resident passive income results in a permanent reduction of New Zealand's tax base.

114. The branch rules create an incentive for a foreign lender to establish a New Zealand branch or to channel funding through a foreign company that has a New Zealand branch. As these transactions are economically equivalent to lending by a foreign company that does not have a New Zealand branch officials consider the tax treatment of the two transactions should be the same.

*General options*

115. In certain instances, a specific anti-avoidance rule (option 2) could be effective as it would correctly tax a structure that had been entered into to avoid NRWT or AIL. However, there would be many arrangements that have legitimate commercial reasons for why a particular structure was entered into. Option 2 would not be economically efficient or fair if it did not apply to all transactions and would not certain or simple if there was an uncertain boundary between where the anti-avoidance rule applied and where it didn't. Option 2 would not less efficient compared with measures aimed at correcting the legislation that causes the issue.

***Option 10: Onshore branch changes***

116. Option 10 would alter the onshore branch exemption so that non-resident passive income arises on an interest payment to a foreign company, unless the interest is paid to the New Zealand branch of the foreign company[7].

117. Additional tax would only be imposed on transactions involving non-residents with New Zealand branches that are not involved in the transaction that are economically equivalent to transactions that are already subject to tax. This option would raise additional revenue.

*Assessment against criteria – option 10*

118. This option would be economically efficient and fair as all interest payments by a New Zealand resident to a non-resident would be subject to NRWT or AIL irrespective of whether the non-resident had a New Zealand branch that is not involved in the transaction. At time the cost of capital may rise but only to the level that applies to economically equivalent transactions.118. Borrowers from lenders with a branch would be aware they were borrowing from the branch if this is the case and the existence of a branch not involved in the transaction would become irrelevant. Therefore, the certainty criterion would be met.

*Scope of option – borrowing from foreign banks*

119. The onshore branch exemption also applies when a New Zealand resident borrows from a foreign bank with a New Zealand branch[8] (usually to acquire or refinance foreign property). The onshore branch exemption in this situation means the New Zealand borrower does not have to pay AIL or withhold NRWT and instead the foreign bank pays New Zealand income tax on the lending margin on that loan. Officials estimate that there are approximately 3,000 borrowers who do not have an AIL or NRWT obligation because of the onshore branch exemption.

120. Officials consider that the application of the onshore branch exemption is not a permanent solution to this issue as the majority of foreign banks do not have a New Zealand

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[7] Separate rules would apply to New Zealand branches of non-residents which held a banking licence. This is discussed further below, and is also considered in the AIL RIS (*NRWT: Related party and branch lending – bank and unrelated party lending*).

[8] It also requires the New Zealand borrower to not have a permanent establishment in that other country, which will be the case in most instances.

branch[9]. However, officials do not consider it is possible to develop a robust solution to this issue as part of the current project. Therefore, the option to restrict the onshore branch exemption as covered above should not apply if the New Zealand branch holds a banking licence and the borrower is not associated with the non-resident.

### Summary of impact analysis

| Option | Main objective and criteria | Benefits | Costs/risks |
|---|---|---|---|
| Option 1 – status quo | • Does not meet main objective<br>• Does not meet criteria (a), (b) or (c) | • Fiscal cost – neutral<br>• Avoids adding additional complexity to the tax system | • NRWT is perceived as a voluntary tax by those with the resources and desire to avoid it |
| Option 2 – specific anti-avoidance rules | • Meets main objective<br>• Partially meets criteria (a) and (b)<br>• Does not meet criterion (c) | • If successfully applied this option would achieve policy intent | • Taxpayers will have limited certainty whether rules apply which will increase compliance costs<br>• Will be difficult to apply where there are non-tax reasons for a particular structure) |
| Option 3 – extend definitions applying to the NRWT rules *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • More closely aligns with income tax treatment which will assist taxpayers to comply<br>• Prevents structuring around existing definitions | • Limiting scope to related parties results in a wider definition for related parties than third parties |
| Option 4 – more closely align NRWT with the financial arrangement rules *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • More closely aligns with income tax treatment and economic incidence of interest<br>• De minimis and allowing payments in year after deductions will limit application | • Complex and internationally novel<br>• Taxpayers with revenue derived towards end of investment will have to finance tax payments in advance of interest |
| Option 5 – defer income tax deductions until NRWT is paid | • Does not meet main objective<br>• Partially meets criteria (a) and (b)<br>• Does not meet criterion (c) | • No need to change NRWT rules<br>• Addresses cash flow concerns for businesses with revenue derived towards end of investment | • Very complex and internationally novel<br>• Deductions will no longer match economic incidence which causes problems for thin capitalisation and continuity<br>• May breach anti-discrimination clauses in some DTAs<br>• Not particularly effective for taxpayers with a tax loss |

[9] Although very few foreign banks have a New Zealand branch these branches represent the foreign banks that New Zealand residents are most likely to borrow from. Therefore, officials consider it likely that the majority of lending by foreign banks to New Zealand residents when measured by the value of lending is covered by the onshore branch exemption.

| Option 6 – thin capitalisation style acting together test *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • Treats groups that act like a single investor the same as a single investor<br>• Broadly consistent with existing thin capitalisation test | • Some taxpayers may be uncertain whether they are acting together |
|---|---|---|---|
| Option 7 – back-to-back and multi-party reconstruction rules *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • More certainty than an anti-avoidance rule<br>• Reduces complexity for taxpayers who know they can no longer structure around the rules | • May impose obligations on interposed party that is not aware of wider arrangement |
| Option 8 – AIL registration changes *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • Supports policy intention of AIL/NRWT boundary<br>• Very low compliance and admin costs for borrowers who can meet approved criteria | • A small number of genuine third party borrowers will be unable to pay AIL |
| Option 9 – requiring upfront proof of non-association before allowing AIL | • Does not meet main objective<br>• Partially meets criteria (a) and (b)<br>• Meets (c) | • All genuine third party borrowers will continue to be able to pay AIL | • Will cost far more to enforce and will impose higher compliance costs on all borrowers than the additional revenue raised |
| Option 10 – onshore branch changes *(preferred option)* | • Meets main objective<br>• Meets criteria (a), (b) and (c) | • Fairer treatment by ignoring branch when that branch is not involved in the transaction<br>• New rules will be consistent with existing rules for lenders without a New Zealand branch<br>• Only practical solution to this issue | • Requires a carve-out for third party borrowers from foreign banks for practical reasons |

**Key:**
Criterion (a) – economic efficiency, criterion (b) – fairness, criterion (c) – certainty and simplicity, criterion

121. The fiscal estimate of the preferred options is $33 million per annum once fully implemented. As noted in the Agency Disclosure Statement this fiscal estimate cannot be broken down into an estimate for each individual option due to data limitations as well as the ability for taxpayers to substitute between structures that currently circumvent the NRWT rules. In comparison the status quo would maintain the current revenue amount which in the 2014 year was $180 million. The fiscal estimate for options 2, 5 and 9 which are the non-preferred options also cannot be individually calculated; however, we expect these would be revenue positive but to a lesser amount than the preferred options.

122. The combined effect of the preferred options is to improve economic efficiency by applying a consistent tax treatment to economically equivalent related party funding transactions. This will remove the current tax incentive to enter into complex transactions to achieve a more beneficial tax treatment.

123. There would be no direct increase in administration costs from implementing preferred options 3, 4, 6, 7, and 10, as they would rely on taxpayers using existing NRWT and AIL forms and systems. Option 5, which is not a preferred option, would also have no direct effect on administration costs. Option 8 would require the AIL security registration form to be amended to include the additional information but the impact of this measure would be minimal. The administration costs for options 2 and 9 would impose additional administration costs from the Commissioner of Inland Revenue being required to confirm that those options are being complied with. The combined effect of the preferred options would increase compliance which should reduce administration costs overall, as less resources would be required to identify and review complex funding structures.

## CONSULTATION

124. The main consultation has been through the *NRWT: related party and branch lending* officials' issues paper, which was released in May 2015. Officials have consulted further with a number of submitters to attempt to address the concerns raised. We have also consulted with the Ministry of Business, Innovation and Employment and Callaghan Innovation. For the most part, we have addressed the main feedback from consultation in the analysis section of this RIS.

125. One of the major concerns raised by submitters was that increasing NRWT might increase the cost of capital to New Zealand, on the basis that it would increase the before tax return which foreign investors would require from their New Zealand investments.

126. As has been noted above, the cost of capital is only one element in a broader economic efficiency story. While the cost of capital will be likely to rise in some circumstances this will only be to the level that applies in situations that are economically equivalent. The greater neutrality achieved across different investors and different transactions will tend to promote both fairness and economic efficiency.

127. However, a number of changes have been made to the issues paper proposals which are intended to minimise their effect on the cost of capital. These changes include:

- Further refinement of the safe-harbour calculations for whether NRWT is required to be paid on an accrual basis;

- Limiting the acting together changes so they only apply when the New Zealand borrower is controlled by non-residents that are acting together; and

- Additions to who can register a security for AIL including a category for a lender which makes over $500,000 of interest payments per annum.

128. Another major concern was the ability for foreign lenders to claim foreign tax credits for NRWT paid on an accrual basis, under a DTA. Submitters did not identify any specific instances where this would be a problem but expressed that it may arise. Officials have conducted further analysis of this and have not identified any areas of concern over the ability to claim a foreign tax credit due to NRWT being imposed on an accrual basis.

## CONCLUSIONS AND RECOMMENDATIONS

129. It is recommended that a number of complementary changes be introduced to the NRWT and AIL rules. Options 3, 4, 6, 7, 8 and 10 when considered as a package should result in a coherent NRWT system that applies to interest payments made to associated parties and other entities that are economically equivalent to associated parties.

## IMPLEMENTATION

130. Changes to the NRWT rules would mainly require amendments to the Income Tax Act 2007 and Tax Administration Act 1994. These amendments would be included in a tax amendment bill, which is currently planned for introduction in March 2016.

131. Implementing these changes would require updating a small range of communication and education products.

132. The new rules will be communicated to taxpayers by way of Inland Revenue's publication *Technical Information Bulletin* after the legislation giving effect to the new rules has been enacted.

133. The new rules will be administered by Inland Revenue as part of its business as usual processes.

### Application dates

134. Options 3, 4, 6 and 7 should apply to arrangements entered into after enactment of the legislation and all arrangements entered into before the enactment date should apply the new rules from the first day of the taxpayer's income year after the date of enactment.

135. Option 10 should not apply until the start of the sixth income year after the date of enactment for all existing arrangements entered into by a New Zealand borrower where the interest is not subject to NRWT because of the onshore branch exemption but under the new rules would be eligible for AIL. The proposed delay is intended to recognise that the New Zealand borrower has entered into third party funding on commercial terms which cannot easily be cost effectively restructured and the New Zealand borrower often will not have sufficient information to determine if the onshore branch exemption will continue to apply or whether AIL will now be required.

136. The recommended application date for option 10 when a New Zealand borrower is borrowing from an associated non-resident should be the enactment date of the legislation. This option should apply to arrangements entered into both before and after the date of enactment.

137. The AIL registration process in option 8 should apply to AIL registrations after the date of enactment. Interest paid on arrangements registered for AIL before the date of enactment, that do not meet the new requirements, will be subject to AIL on any interest payments made more than one year after that date.

138. Appropriate transitional rules should ensure that the new rules apply to existing arrangements on a prospective basis only.

## MONITORING, EVALUATION AND REVIEW

139. In general, Inland Revenue monitoring, evaluation and review of tax changes would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

140. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the GTPP.

# Regulatory Impact Statement

## Related parties debt remission

### Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

It addresses the question of whether the remission of debt between certain associated persons should continue to be asymmetrically taxed and, if not, how this current asymmetric treatment should be resolved.

Currently, the remission of debt between certain associated persons such as a parent company and its subsidiary means the subsidiary (the debtor) is taxed on the value of any debt remitted and the parent (the creditor) is denied a deduction for the debt remitted – the tax outcome is asymmetric. However, there is no real net economic income to tax – neither the value of the group of companies nor the ownership of the subsidiary has changed.

The design of the policy options in this RIS was informed by public feedback on initial proposals contained in the February 2015 Officials' Issues Paper *Related parties debt remission*, and extensive informal discussions with the representatives from the tax community before and after the release of the paper. This feedback also confirmed the problem definition and provided guidance as to the direction of the analysis. The major outstanding issue in the issues paper was the question of what to do with debt associated with inbound investment. The issues paper considered the various arguments and left this particular question open to submissions. This matter is addressed in this RIS.

This project will, at least at the margin, make it easier for New Zealand subsidiaries of foreign companies to deduct payments for interest expense. This reduces the New Zealand tax base. The tax policy work programme project on thin capitalisation will help counter this by further considering New Zealand's thin capitalisation rules as a result of the BEPS (OECD's base erosion and profit shifting project).

There are no other key gaps, assumptions, or dependencies concerning the analysis.

The policy options will not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles (as referenced in Chapter 3 of the Legislation Advisory Committee Guidelines).

Jim Gordon
Policy Manager, Policy and Strategy
Inland Revenue

18 August 2015

## STATUS QUO AND PROBLEM DEFINITION

1. This Regulatory Impact Statement (RIS) covers options for improving the debt remission rules in the Income Tax Act 2007.

### Debt remission

2. Debt remission is the extinguishing of a debtor's liability by operation of law or forgiveness by the creditor.

3. Debt can be remitted when the debtor:

- is discharged from making remaining payments;
- is insolvent or liquidated;
- enters into a deed of composition with its creditors that results in full remission; or
- has no obligation to make payments when, because of the passage of time, the debt is irrecoverable or unenforceable.

4. The Income Tax Act 2007 provides that the remission of debt causes the debtor to derive remission income under the base price adjustment (BPA) of the financial arrangement rules. The purpose of the debt remission rules is to recognise the fact that the forgiveness of a debt increases the wealth of the debtor.

### Bad debt deductions

5. When the debtor and creditor are not associated persons and the creditor is in the business of holding or dealing in such debt, the creditor generally obtains a deduction for a bad debt under the bad debt rules. This means that a debt remission transaction has a symmetrical result; there is income to one party, and a deduction to the other party.

### Associated persons

6. The Tax Acts have a usual presumption that taxpayers deal with each other at arm's length. However, where two taxpayers are connected this presumption falls away and there are a number of particular tax rules that govern transactions between the two taxpayers. Examples of associated persons include:

- Two companies where, directly or indirectly, a single shareholder owns 50% or more of the companies;
- Companies and non-corporate shareholders who own 25% or more of them;
- Partners and their partnerships; and
- Close relations (e.g. brothers).

### Associated persons cannot claim bad debt deductions

7. An associated person creditor is denied a bad debt deduction for the principal of a debt.

8. This associated persons bad debt deduction rule has been in place in one form or another since the financial arrangements rules were introduced in 1986. A shareholder has a choice of investing in a company or partnership by way of debt or equity. The reason for the associated person bad debt prohibition is that allowing a deduction for a bad debt would bias investment towards debt, as all gains from the investment will be able to be attributed to the equity investment only, whereas losses could be attributed over both equity and debt resulting in a one sided tax deduction from the amount that can be attributed to the debt.

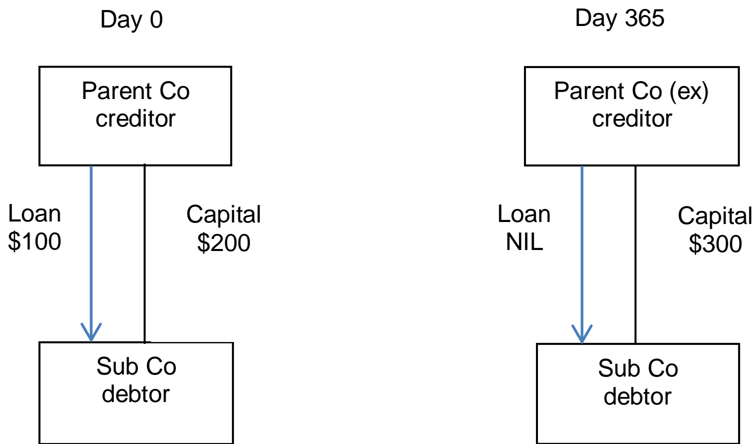
**Debt remission between associated persons is therefore asymmetrical, despite no increase in wealth**

9. The combination of these two sets of rules – the debt remission income rules and the denial of bad debt deductions for associated persons rules, means that a debt remission between these two parties results in an asymmetric result. There is income to one party, but the other party cannot claim a deduction. There is often, however, no change in wealth of the group of associated persons, and therefore no economic transaction that ought to be taxed.

10. The asymmetric taxation outcome is best illustrated in the wholly-owned group of companies scenario. The parent company (the creditor) lends to a subsidiary (the debtor) and sometime later this loan is remitted (perhaps because the subsidiaries balance sheet needs shoring up). The debt remission is an intra-group transaction that does not change the wealth or ownership of the group in any way. The debtor derives taxable debt remission income but the creditor is denied a bad debt taxation deduction.

11. The example below illustrates the core problem. On Day 0 Parent Co lends $100 to Sub Co. On day 365 the debt is remitted so that the capital of Sub Co is increased to $300 and the loan balance reduces to zero. The result is the same if the debt is capitalised.

***Example 1***




**Capitalising debt, rather than remitting debt**

12. Until recently, rather than remitting debt, and facing this asymmetric result, some taxpayers choose to capitalise debt instead on the basis that this did not result in asymmetric taxation outcomes. Capitalising debt is literally the conversion of debt into equity or capital.

**Choosing to capitalise, rather than remit, debt might amount to tax avoidance**

13. A recent Inland Revenue legal interpretation has concluded that if this debt capitalisation does not result in an effective change of ownership of the debtor this could be tax avoidance and, if so, is to be reconstructed as a remission of the debt.

14. The main concerns with this interpretation (the status quo) applying to these types of debt capitalisations are:

- Doubt about the certainty of the result – in what circumstances would debt capitalisation be interpreted as tax avoidance; and

- More complexity and cost to avoid the inappropriate asymmetric taxation outcome – much more complicated and subtle restructuring would be needed to avoid the taxation consequences and this would be economically inefficient.

**Scale of the problem**

15. Inland Revenue could potentially seek to review past debt capitalisations and argue that at least some of them are tax avoidance. This could result in a windfall tax gain for the Government in respect of transactions where there is no economic income. For example, officials are aware of two loans each totalling about $750 million of debt previously advanced by non-resident owners that have been capitalised. Given the likelihood of a legislative solution Inland Revenue is not presently considering these transactions.

16. The legal interpretation potentially affects entities which range in size from the mom and pop partnership or look through company, to large corporate groups of companies. Although debt capitalisation is not an everyday transaction, feedback from tax specialists suggests that it occurs reasonably frequently.

**Secondary problem**

17. There is a further issue concerning inbound investment and its associated debt. Interest expense on inbound debt is a key Base Erosion and Profit Shifting (BEPS) concern and the OECD is working on thin capitalisation proposals. Allowing cross border debt remission to be tax free means that the thin capitalisation rule would be relied upon even more to govern debt and interest levels on inbound debt.

18. This is because allowing debt remission will, at the margin, make it easier for New Zealand subsidiaries of overseas companies to deduct interest expense. This reduces the New Zealand tax base. The tax policy work programme project on thin capitalisation will counter this by helping to ensure that only appropriate interest deductions are claimed by these New Zealand subsidiaries.

**Problem definition**

19. The root cause of this problem is not debt capitalisation itself. Rather it is the existence of an asymmetric result when associated persons perform a debt remission transaction and there is no increase in wealth of the group. Debt capitalisation is only relevant because of the legal interpretation that says that sometimes it can be tax avoidance, and if so is reconstructed as debt remission income.

20. The status quo is not sustainable as the asymmetric taxation outcome where there is net change of wealth or ownership is inappropriate. Further, it potentially creates complexity and cost for taxpayers and does not help New Zealand's reputation as being a reasonable, stable and certain place to do business.

## OBJECTIVES

21. The current tax policy framework is framed around a broad-base low-rate (BBLR) concept – that is, taxation should be fair and equitable and should, to the extent possible, be based on taxing economic income. This framework is important as it provides taxpayers with certainty as to outcome.

22. The asymmetric taxation outcome in situations where there is no economic change in wealth or ownership does not accord with this BBLR framework. The only way to correct this situation is to amend the tax law.

23. The key objectives of this review are:

a) To ensure that the tax rules applying to debt remission are fair and equitable and in accord with the broad base low rate paradigm;

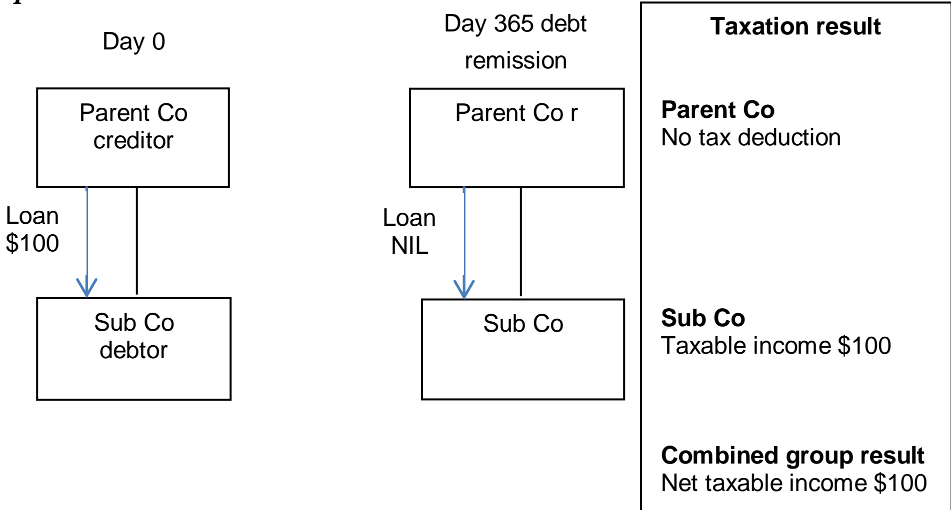
b) To ensure that the tax rules applying to debt remission only taxes net economic income of an "economic group" – that is, where there has been an economic change in net wealth or ownership.

24. Both these objectives rank equally.

## REGULATORY IMPACT ANALYSIS

25. The problem is best illustrated:

***Example 2***



26. There are two options for resolving the problem:

- Option 1: Turn off the debtor's debt remission income (Sub Co no longer has $100 taxable income in Example 2); or

- Option 2: Allow the creditor a bad debt deduction (Parent Co gets a $100 tax deduction in Example 2).

27. As can readily be seen there are no other options.

28. Turning off the debtor's debt remission income (Option 1) is the best solution because:

- If the debtor is insolvent (as is often the case) it would likely not be able to pay tax on the debt remission income, whereas Option 2 would allow the creditor a bad debt tax deduction. This situation would result in an asymmetric taxation position (bad debt deduction, but in practice no debt remission income) but this time in favour of the taxpayer.

- If the creditor is not a company (and therefore is not able to group losses) and the debtor is a company owned by the creditor, Option 2 allows the creditor a bad debt deduction which it might not be able to utilise (perhaps because their only income is from imputed dividends from the company), but the debtor would have a real tax liability.

- Option 2 would not offer a symmetric solution as the creditor's bad debt deduction would be outside the New Zealand tax base – that is, the remission income would be in New Zealand, but not the corresponding Option 2 deduction.

**Addressing the issue of cross-border debt**

29. As noted in the status quo section of this RIS, there is a question of whether any legislative solution applying to domestic debt should also apply to inbound debt.

30. Interest expense from debt associated with non-resident owners is a key BEPS issue being considered by the OECD. Allowing non-resident owners of New Zealand companies to remit (or capitalise) debt without consequence will likely, at least at the margin, make it easier to deduct interest expense (because it doesn't have to be paid in cash).

31. New Zealand (and a number of other countries) has thin capitalisation rules that limit the debt to equity ratio in order to restrict profits being inappropriately reduced by interest expenses. This rule, along with the transfer pricing rules, is the primary limitation on excess interest deductions being taken in New Zealand.

32. The OECD BEPS review will lead to further consideration of our thin capitalisation rules. The likely results of this are further amendments that will reduce the risk of allowing the remission or capitalisation of inbound debt.

33. Further, although there are a number of marginal examples of inbound owner's debt (where the debt to equity ratio exceeds a standard commercial ratio), there are also examples of debt capitalisations where the underlying debt to equity ratio does not cause policy concerns. Devising a debt remission rule to target just the inappropriate debt capitalisations would be difficult and arbitrary.

34. Also, the recent amendments to the thin capitalisation so that they now apply to investors “acting together” have buttressed the thin capitalisation rules, and, at least at the margin, the non-resident withholding tax proposals that are currently being consulted upon will also help in this regard.

35. Acknowledging that the primary method of limiting interest deductions on inbound debt is and should be thin capitalisation, we consider that on balance the debt remission changes should also apply to inbound debt as well as to domestic debt.

**Summary of impacts of Option 1**

36. Option 2 is not considered as it is ineffective at solving the core problem.

37. There are no fiscal impacts associated with Option 1 because taxpayers are not presently paying tax based on the status quo. Given the policy decision that debt capitalisations should not be taxed, it would be appropriate to back date any legislative amendment so as to provide the private sector certainty. Thus, the Government may forgo a windfall fiscal gain but there would be no actual impact on the fiscal position (note that there is a small fiscal gain from one of the technical changes that will be made as a result of this project).

38. The extension of the preferred solution to inbound debt is not predicted to have fiscal consequences, but this assumes that New Zealand’s thin capitalisation rules will be further considered as a result of the BEPS review.

39. Removal of the present asymmetrical taxation outcome is expected to reduce compliance costs on a go-forward basis over the status quo. This is because it is equitable, simple and certain and taxpayers will not need to structure transactions to get to this end result. Further, the retrospective removal of the suggestion that tax advisers and their clients might have been involved in tax avoidance transactions will be welcome.

40. Option 1 is not expected to have any ongoing administrative implications for Inland Revenue.

41. There are no environmental, cultural or social implications associated with Option 1.

## CONSULTATION

42. The usual taxation GTPP (the generic tax policy process) has been followed in full. The consultation has been both formal, by way of the February 2015 Officials’ issues paper *Related parties debt remission*, and informal. The matter was first drawn to our attention by Chartered Accountants Australia and New Zealand (CAANZ) in late 2013. At about the same time Inland Revenue’s Office of the Chief Tax Council (OCTC) also referred the matter to Inland Revenue’s Policy and Strategy division.

43. Since then there have been many informal discussions with tax lawyers and accountants. These have been both before and after the formal consultation. The initial discussions focused on how important the matter was, and how distortionary the asymmetric effect would be. Later discussions (after the release of the issues paper) have focused on the inbound debt issue and on the detail.

44. The issues paper was released in February 2015 and was very positively received, notwithstanding that it left the question of inbound debt open. Eight submissions were received. CAANZ, the New Zealand Law Society, the Corporate Taxpayer Group, KPMG, Chapman Tripp and EY, as well as two single office accounting firms.

45. Through both the formal and informal consultation there has been a total consensus between officials and the private sector on the high level problem definition and the answer. Once the problem was defined there has been a private sector consensus on how to treat inbound debt, although, at least informally, the risks in this space have also been mentioned and officials' reservations acknowledged.

46. Two senior accountants have peer reviewed the proposals as they have developed and their views have helped shape the final conclusions.

47. In addition, there have been presentations to the private sector on the policy issues and potential fixes that were very well received – most notably in November 2014 at the CAANZ Tax Conference, but also at the conference of the New Zealand branch of the International Fiscal Association in March 2015.

## CONCLUSIONS AND RECOMMENDATIONS

48. Option 1 – turn-off debtor's remission income is the only effective option because it addresses the present asymmetric debt remission problem in all appropriate situations where there is no change in net economic wealth or ownership.

49. In contrast Option 2 is ineffective at preventing the mismatches between income and expenditure that have the potential to occur.

50. In addition, the preferred option should also apply to inbound debt.

## IMPLEMENTATION

51. The proposed changes will be announced by the Ministers of Finance and Revenue following Cabinet approval. At the same time brief informal discussions with the private sector on the detail of the proposals will continue.

52. Legislation to give effect to the proposed changes will be included in the next omnibus taxation bill, which is expected to be referred to the Finance and Expenditure Committee for consideration, which typically involves receiving submissions from the public. Enactment is expected in the second half of 2016.

53. Both the Bill's commentary (as the Bill is introduced), and Inland Revenue's Taxation Information Bulletin that follows the enactment of the Bill, will detail the proposals. Furthermore, although it is beyond Inland Revenue's control, it is very likely that the private sector tax education courses will cover the matter off in some detail.

54. Internally Inland Revenue will adopt its usual practices in informing staff of the amendments.

55. No particular implementation or compliance issues are expected to arise.

56. Once enacted the proposed changes will be administered by Inland Revenue as part of its business as usual.

## MONITORING, EVALUATION AND REVIEW

57. The private sector reaction to the proposals will be monitored and evaluated, particularly for inbound debt. This will be through the usual tax return review process, which already has some focus on inbound debt situations.

58. As well tax policy advisors will continue to issues with debt associated with inbound investment with the private sector taxation community. Also, the private sector can be relied upon to bring to official's attention any problems in applying the amendments.

# Regulatory Impact Statement

***Relationship between double tax agreements and anti-avoidance rules***

## Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue. It provides an analysis of options to address the uncertainty in the current law as to the relationship between the anti-avoidance rules in New Zealand's tax legislation and New Zealand's double tax agreements (DTAs).

The issue affects a small number of taxpayers. However, the amounts of tax at stake can be significant depending on the transaction involved. The argument that the DTA prevents the general anti-avoidance rule (GAAR) from applying has been an issue in eight disputes within the past five years. The total tax in dispute for those eight disputes was $105 million. Most or all of this tax has or will be collected pursuant to Inland Revenue's current interpretation of the law. But the proposed change would put the matter beyond doubt.

The question of whether the provision that empowers New Zealand's DTAs prevents the anti-avoidance rules in New Zealand's income tax legislation from applying has not been tested by a New Zealand court. However, the analysis in this RIS has been informed by Inland Revenue's view of the current law, arguments by taxpayers in recent disputes, and the approach that Inland Revenue has taken in those disputes. Feedback from consultation has also helped to inform this analysis and our view of the law.

The preferred option will specifically provide in law that New Zealand's DTAs do not prevent the anti-avoidance rules from applying.

The preferred option will not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles.

Carmel Peters
Policy Manager, Policy and Strategy
Inland Revenue

4 February 2016

## STATUS QUO AND PROBLEM DEFINITION

1. New Zealand, like many other countries, has a general anti-avoidance rule (GAAR) in its income tax legislation. New Zealand's GAAR effectively overrides other provisions of the tax legislation to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit. New Zealand also has specific anti-avoidance rules (SAARs) which override other provisions of the tax legislation in specific avoidance situations.

2. Anti-avoidance rules potentially apply to all income tax transactions, including those with an international dimension (that is, New Zealand residents investing offshore or non-New Zealand residents investing in or through New Zealand).

3. Double tax agreements (DTAs) are international treaties that are entered into between governments primarily to prevent double taxation on cross-border income. The tax incidence for taxpayers using international transactions can be reduced where there is a DTA between the taxpayer's country of residence and the country from which the income is sourced.

4. There is a lack of clarity in the current legislation. This is due to an apparent conflict between the general anti-avoidance rule and the provision which empowers New Zealand's DTAs. The provision in the Income Tax Act 2007 (ITA 2007) which governs the domestic implementation of DTAs states that DTAs override the other provisions of the ITA 2007. However, the ITA 2007 also states that the GAAR has overriding effect. There may also be a similar issue in relation to specific anti-avoidance rules (SAARs). The legislation is not explicit as to the ordering between the provision that governs the domestic implementation of DTAs and the anti-avoidance rules.

5. Inland Revenue's view is that a DTA does not prevent the GAAR or a SAAR from applying. In Inland Revenue's view, the GAAR should first be applied to establish the relevant fact situation. New Zealand's domestic tax law and the DTA then apply to that recharacterised fact situation. If the proceeds of a share sale, for example, is recharacterised as a dividend under domestic law due to the application of the GAAR, then the dividend provisions of domestic law and the dividend article of the relevant DTA would apply, rather than the article of the DTA which deals with disposal of property. Similarly, a SAAR should first be applied to establish the relevant fact situation.

6. Further, where there is mischief arising through misuse of provisions in the DTA (such as treaty shopping), Inland Revenue considers that, if the criteria for the GAAR applies, the GAAR can be used to reconstruct the arrangement to give the appropriate tax outcome for New Zealand purposes.

7. However, it has been argued by some taxpayers (including in recent disputes that have been considered by Inland Revenue's Disputes Review Unit) that DTAs override the GAAR, which would mean that the GAAR cannot be applied in an avoidance situation where a treaty provision is also used. There has been no New Zealand case law on this issue to date.

8. The lack of clarity in New Zealand's legislation contrasts with Canada and Australia, who amended their legislation to explicitly ensure that DTAs do not override the GAAR. As New Zealand's legislation is silent on whether DTAs override the GAAR, it has been suggested that there might be a possible inference that "*the New Zealand Parliament is*

*content to allow New Zealand taxpayers to use structures that employ the provisions of tax treaties to avoid New Zealand income tax.*"[1]

9. More recently (2014) the United Kingdom also amended its legislation to explicitly provide that DTAs do not override the GAAR.

10. Accordingly, if no similar amendment is made to New Zealand's tax legislation, a lack of action by the New Zealand Government may support the argument that DTAs override New Zealand's GAAR. In other words, a lack of legislative action is likely to increase the uncertainty given the responses from Canada, Australia and the United Kingdom.

11. As a result of this uncertainty, some taxpayers may argue that DTAs override the anti-avoidance rules and as a consequence tax avoidance arrangements cannot be prevented by relying on an anti-avoidance rule.

12. Because of the lack of an express provision, some taxpayers may be encouraged to engage in tax avoidance behaviour in an international context if those taxpayers can argue that their behaviour is sheltered by international tax agreements. In contrast, taxpayers are prohibited from engaging in tax avoidance behaviour where there is no DTA.

13. Further, the lack of an express provision in the current legislation may lead to arguments about the appropriate application of penalties if taxpayers can make an argument that their behaviour is sheltered by international tax agreements. Penalties are applied to discourage tax avoidance behaviour.

14. Accordingly, the status quo is likely to encourage certain taxpayers to enter into avoidance arrangements.

15. This has a negative impact on fairness between taxpayers.

16. The lack of certainty means that disputes can involve more of Inland Revenue's legal resources (i.e., increased hours). Compliance costs for taxpayers are, in theory, higher for taxpayers under this option, although it should be noted that these compliance costs may be offset by the potential for lower income tax liability.

**Scale of the problem**

17. The issue affects a small number of taxpayers. However, the amounts of tax at stake can be significant depending on the transaction involved. The argument that the DTA prevents the GAAR from applying has been an issue in eight disputes within the past five years. The total tax in dispute for those eight disputes was $105 million. Most or all of this tax has or will be collected pursuant to the Commissioner's current interpretation of the law. However, the proposed change would put the matter beyond doubt.

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[1] See discussion in Elliffe, Craig and Prebble, John (2009) "General Anti-Avoidance Rules and Double Tax Agreements: A New Zealand Perspective," *Revenue Law Journal*: Vol. 19: Iss. 1, Article 4.

## OBJECTIVES

18. The overarching goal of the reform is to reduce tax avoidance in an international context.

19. Within this context the options will be assessed against the following criteria:

- Efficiency and integrity: The preferred option should minimise the distortions to taxpayer decision making and opportunities for tax avoidance and tax arbitrage between jurisdictions.

- Fairness: The preferred option should, to the extent possible, be fair - this involves both horizontal equity (which is, fair treatment of those in similar circumstances) and vertical equity (which is, fair treatment of those with differing abilities to pay tax).

- Compliance and administrative costs: The preferred option should minimise, to the extent possible, administrative and compliance costs.

20. All criteria are important but within this context the efficiency and integrity and fairness criteria are particularly significant.

## OPTIONS AND IMPACT ANALYSIS

21. Two options are discussed below.

- Option 1: This option would retain the status quo – that is, there would be no change to the tax legislation to clarify whether the GAAR or SAARs override the DTA.

- Option 2: This option would amend the tax legislation to clarify that the GAAR or SAARs override the DTA.

22. A further option was briefly considered but discounted. This option would have explicitly provided that DTAs override the GAAR and SAARs. This option was discounted because it did not meet the objective of preventing tax avoidance.

### Option 1 (status quo)

23. The first option would retain the status quo. That is, no change would be made to the legislation to clarify whether anti-avoidance rules override the DTA. Inland Revenue would retain its interpretation. This may be tested in a future court decision.

24. It is not clear whether the status quo meets the objective of reducing avoidance in an international context. As noted above, Inland Revenue considers that under current law the anti-avoidance rules do override the DTA.

#### *Efficiency and integrity*

25. The lack of an express provision in the current legislation may lead to arguments about the appropriate application of penalties if taxpayers can make an argument that their

behaviour is sheltered by international tax agreements. Penalties are applied to discourage tax avoidance behaviour.

26. Accordingly, the status quo is likely to encourage certain taxpayers to enter into avoidance arrangements. This undermines the integrity of the tax system.

27. This option is likely to have a negative effect on efficiency, as it may result in reduced efficiency if businesses' resources are diverted into creating such arrangements.

***Fairness***

28. As noted above, some taxpayers may be encouraged to engage in tax avoidance behaviour in an international context if those taxpayers can argue that their behaviour is sheltered by international tax agreements. In contrast, taxpayers are prohibited from engaging in tax avoidance behaviour where they cannot rely on a DTA. This has a negative impact on fairness.

***Administrative and compliance costs***

29. This option is likely to be administratively more costly for Inland Revenue than option 2, as the lack of certainty means that disputes can involve more of Inland Revenue's legal resources (i.e., increased hours). This option therefore has a negative impact on administrative costs.

30. Compliance costs for taxpayers are, in theory, higher for taxpayers under this option, although it should be noted that this may be offset by the potential for lower income tax liability.

**Option 2 (amend the tax legislation)**

31. The second option would amend the income tax legislation to clarify that the anti-avoidance rules override the DTA. This option meets the objective of reducing avoidance in an international context.

***Efficiency and integrity***

32. Inland Revenue considers that this option provides more certainty than the status quo. It would remove the arguments about the appropriate application of penalties, as taxpayers would be unable to argue that their avoidance behaviour is sheltered by international tax agreements. This improves the integrity of the tax system.

33. This option is likely to have a positive effect on efficiency, as it may increase efficiency if fewer resources are diverted into creating tax avoidance arrangements.

***Fairness***

34. Taxpayers would be prohibited from engaging in tax avoidance behaviour regardless of whether there is a DTA. This would have a positive impact on fairness between taxpayers.

### *Administrative and compliance costs*

35. This is likely to be administratively less costly for Inland Revenue than the status quo, as increased certainty should mean that disputes are less likely. Where they do arise, they should involve less of Inland Revenue's legal resources (i.e., increased hours). This option therefore is likely to reduce administrative costs.

36. Compliance costs for taxpayers are, in theory, lower for taxpayers under this option, although it should be noted that this may be offset by potentially higher income tax liability.

## CONSULTATION

37. Inland Revenue has discussed option 2 with the Ministry of Foreign Affairs and Trade, the New Zealand Law Society, Chartered Accountants Australia and New Zealand, and the Corporate Taxpayers Group.

38. Several issues were raised during these discussions. One issue was whether the proposal was consistent with New Zealand's international obligations under its DTAs, because New Zealand commits to providing relief from double taxation for residents of the other state in certain circumstances. As noted above, Inland Revenue considers that this is the position under New Zealand's domestic law.

39. Officials consider that option 2 is consistent with New Zealand's DTA obligations. New Zealand's DTAs are based on the OECD's Model Tax Convention. The OECD's Commentary to the Model Tax Convention (the "OECD Commentary") is an important part of context in which these DTAs are internationally understood. The Commentary notes that States do not have to grant the benefits of a DTA where the DTA has been abused, although the Commentary also notes that it should not be "lightly assumed" that a taxpayer is entering into an abusive transaction. The OECD Commentary notes that, for some countries, their domestic GAAR (or similar rules) applies to their DTAs. Examples of countries that have made the relationship explicit include Australia, the United Kingdom and Canada. The OECD Commentary further notes that, where the GAAR is used to determine the proper construction of facts to which the DTA would apply (which Inland Revenue considers is the current legal setting in New Zealand), then there is generally no conflict.

40. A concern was raised that since the GAAR is not a "bright line" test, the proposal could add to uncertainty. As noted above, Inland Revenue's current practice and interpretation of the law is that the GAAR does apply. Officials' view is that option 2 will reduce uncertainty by making it explicit that anti-avoidance rules can apply. Further, we note that the GAAR applies to all other situations and the growing body of case law provides considerable guidance to taxpayers.

41. A suggestion was that it was not necessary to clarify the law. Rather, Inland Revenue could simply make a statement of its view. We consider that this would not resolve the problem, as the Commissioner's view is not binding upon taxpayers.

42. A further suggestion was that the work should be undertaken after New Zealand's response on BEPS has been finalised. Officials do not consider that it is appropriate to delay this work. Implementing option 2 is not contingent on New Zealand's responses to the BEPS proposals. It will clarify the existing position which would remove arguments about the

appropriate application of penalties. Further, option 2 would make it clear to other DTA partners that New Zealand's law meets the criteria in Action 6 of the BEPS plan. This may give New Zealand additional flexibility to meet the minimum international standards to prevent treaty abuse.

## CONCLUSIONS AND RECOMMENDATIONS

43. Option 1 (status quo) is not supported because it is unlikely to meet the objective of reducing avoidance in an international context. Furthermore, this option is likely to have a negative effect on the integrity of the tax system, fairness, and administrative costs.

44. Officials support option 2. The legislative amendment proposed under this option will clarify that the provision which empowers DTAs does not prevent the GAAR (or the SAARs) in the ITA 2007 from applying, consistent with Inland Revenue's current approach.

45. Option 2 would meet the objective of reducing tax avoidance in an international context and is likely to have a positive effect on integrity of the tax system, fairness, and administrative costs.

## IMPLEMENTATION PLAN

46. The preferred option will require amendments to the ITA 2007. It is proposed that these amendments be included in the first omnibus tax bill in early 2016 and apply from the date of Royal assent.

47. When the amendments are introduced to Parliament, commentary will be released explaining the amendments, and further explanation of their effect will be contained in a *Tax Information Bulletin*, which will be released shortly after the bill receives Royal assent.

48. Inland Revenue will administer the proposed changes. The proposals will have no systems implications for Inland Revenue but may result in some additional administrative costs, such as costs associated with publications to communicate the changes. These costs are expected to be insignificant and can be met within existing baselines.

## MONITORING, EVALUATION AND REVIEW

49. Inland Revenue will closely monitor the effectiveness of the proposed changes in the first 12 months of operation.

50. In general, any changes identified as necessary following enactment would be added to the tax policy work programme, and proposals would go through the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995. Opportunities for external consultation are built into various stages of the process. In practice, any changes identified as necessary following enactment will be considered for inclusion in the tax policy work programme, and proposals would go through the GTPP.

## Regulatory Impact Statement

## Remission income, tax losses and insolvent individuals

## Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address inconsistencies in the taxation law relating to the carry-forward of tax losses and the fresh-start principle of insolvency law.

The options are considered in the light of the objectives of:

- neutrality of the tax system in relation to investment decisions;
- the efficiency of the tax system; and
- the objectives of insolvency law.

For the purpose of our analysis, we assumed that the tax system should complement the objectives of insolvency law in relation to the fresh-start principle.

The estimate of nil fiscal impact is based on current outcomes in practice. Published data indicates about 3,000 individuals annually are subject to insolvency procedures and obtain relief from debts under the fresh-start principle of insolvency law. Because of data limitations in identifying all taxpayers who may benefit from the fresh-start principle, it is not possible to determine the number of insolvent individuals who have carried-forward tax losses. However, as the objective of the policy proposals is for the tax system to better support the objectives of insolvency law, this limitation has not impacted on the analysis or conclusions.

The policy proposals were provided to a targeted audience, but no material matters were raised in feedback.

None of the policy options considered have environmental or cultural impacts, and nor were there any significant constraints, caveats and uncertainties concerning the regulatory impact analysis, other than the data limitations noted above.

None of the policy options considered would restrict market competition, reduce the incentives for business to innovate and invest, unduly impair private property rights, or override fundamental principles of common law.

Peter Frawley

Policy Manager, Policy and Strategy

Inland Revenue

9 / 11 / 2015

## STATUS QUO AND PROBLEM DEFINITION

### Current regulatory environment

1. Under long-standing policy, a person is able to carry forward unused tax losses from year to year, to offset against net income in a future tax year. However, this ability to carry forward tax losses has always been contingent on the debtor fully satisfying his or her liabilities for expenses incurred that have been taken into account in calculating past tax losses.

2. Allowing a person to carry forward tax losses is based on the assumption that a person would continue in business and make sufficient profits to absorb earlier losses. This is consistent with key policy objectives for the tax loss carry-forward rules, which is to encourage entrepreneurial risk-taking and that Governments share in the rewards of that business through taxes.

3. If a person is unable to continue in business and be sufficiently profitable to absorb earlier tax losses, it is possible for that person to become insolvent and be unable to satisfy debt obligations as they fall due. If an insolvent person is unable to satisfy those debt obligations, they may obtain relief from their debts by being declared bankrupt or by entering into arrangements under alternatives to bankruptcy, such as occurs on completion of the "no-asset procedure" under the Insolvency Act 2006, or under a deed of compromise with creditors.

4. In general, the intervention of insolvency law in contract law is intended to protect the honest, but unfortunate debtor from his or her creditors, through discharge from debts after a period to enable a fresh start ("the fresh-start principle").

5. However, the fresh-start principle is not solely concerned with "resetting" the insolvent person's financial liabilities to zero. It also involves the insolvent individual:

- surrendering his or her capital for equitable distribution among creditors (subject to minimal retentions for family maintenance); and
- being able to resume economic activity, free of the burden of past debt (other than certain debts, such as child support debt), with only a minimal level of personal assets.

6. The basis of the fresh-start principle is that the insolvent person surrenders rights to property they own in exchange for the subsequent cancellation of debts on discharge from bankruptcy. The purpose of this trade-off is to encourage insolvent individuals to again become productive, benefitting both themselves, and society as a whole.

### Current law and practice: income tax

7. Under current income tax law, a person is required to satisfy his or her income tax obligations in relation to income derived. Normally, it is clear that the person who derives the income is also required to satisfy those income tax obligations, including filing returns of income.

8. On being declared bankrupt, the person receives a new Inland Revenue number. This practice is to enable Inland Revenue and the bankrupt to distinguish between income tax obligations before and during bankruptcy.

9. There are three sets of income tax rules relating to carried-forward tax losses of a person who is declared bankrupt:

- First, tax losses of an insolvent individual may be carried forward into the period of bankruptcy and applied against income derived during bankruptcy. This may result in a refund of tax, which is part of the bankrupt estate. Inland Revenue is required to pay that refund to the Official Assignee who would include this in distributions to creditors. Under current tax and insolvency law, this is the only means by which creditors receive the benefit of the bankrupt's carried forward tax losses.

- Second, the Commissioner of Inland Revenue is obliged to write off tax debt that is unrecoverable from the bankrupt estate. If tax debt of a bankrupt is written off, any carried forward tax losses are correspondingly reduced.

- Third, on discharge from bankruptcy, most of the bankrupt's outstanding debts are cancelled (there are some exceptions to this principle, in particular, child support debt) and remission income may arise to the extent of the person's carried-forward tax losses.

10. Under remission income rules in the Income Tax Act 2007, if a bankrupt has previously carried on a business, some of the debt cancelled on discharge from bankruptcy may be recovered as remission income. The intended effect of these remission income rules is to reduce the amount of carried forward tax losses.

11. These remission income rules apply on discharge from bankruptcy if expenses incurred by the bankrupt are included in the calculation of past tax losses. The operation of the remission income rules is consistent with the long standing policy that the carry-forward of tax losses is contingent on satisfying debts incurred relating to deductions included in past tax losses.

12. After the application of these rules, if a discharged bankrupt has a carried forward tax loss remaining, under current law, any remaining tax loss is then able to be used to offset against his or her future income.

### Current law and practice: the insolvent individual and the Official Assignee

13. The Official Assignee is responsible for administering the application of insolvency law for individuals. Under insolvency law, there are two main procedures that can result in an insolvent person being released from all debts under the Insolvency Act 2006:

- bankruptcy; and

- the no-asset procedure.

14. On being declared bankrupt, all assets of the bankrupt are vested in the Official Assignee by operation of law, and become property of the bankrupt's estate. During bankruptcy, any property received by the bankrupt is also vested by operation of law in the Official Assignee and becomes property of the bankrupt estate.

15. Under insolvency law, property vesting in the Official Assignee includes income derived by the bankrupt during bankruptcy. This income is usually earned from personal exertion during bankruptcy and usually consists of salary or wages. However, this rule of vesting is subject to the bankrupt being permitted to retain sufficient income and certain assets to a level that is necessary for family maintenance. In practice, the Official Assignee generally permits a bankrupt to retain salary or wages earned, but the bankrupt can be asked to contribute to the bankrupt estate from after-tax income. In addition, all tax refunds arising during the period of bankruptcy belong to the Official Assignee.

16. As a matter of practice, the Official Assignee does not file returns of income on behalf of the bankrupt or for the bankrupt's estate. We understand that this practice is based on the view that the Official Assignee is not an agent for the bankrupt and that the administration of the bankrupt estate is covered by the exemption from income tax for public authorities in the Income Tax Act 2007.

17. The no-asset procedure is an alternative to bankruptcy for insolvent individuals with low levels of provable debt (up to $40,000) and no realisable assets (other than minimal levels of assets for family maintenance and tools of trade). This procedure is administered by the Official Assignee, and the insolvent individual must obtain approval to enter the procedure. Provided the individual complies with requirements relating to spending and credit during the term of the no-asset procedure, on completing the term of the no-asset procedure (usually one year), those provable debts are wiped. This procedure does not apply to student loan or child support debt.

## The problems

18. In general, where the tax system interfaces with non-tax policy objectives, the tax system seeks to give outcomes that are complementary to the non-tax policy objectives.

19. However, the policy and operational objectives for current tax rules for insolvent individuals are not well-aligned with the policy objectives of insolvency law, and in particular the fresh-start principle. This gives rise to a number of technical and administrative issues, as follows:

- inconsistent treatment of tax losses carried-forward into bankruptcy;
- inconsistency with the policy for carrying-forward tax losses being contingent on satisfying expenses incurred that have been included in past tax losses;
- some tax deduction and timing rules do not give neutral outcomes when a person is declared bankrupt; and
- the carrying forward of tax losses on discharge from bankruptcy is potentially non-neutral in relation to both investment decisions and the treatment of discharged bankrupts;
- the insolvency law rule that treats income derived by the bankrupt as property of the Official Assignee results in uncertainty over who is responsible for filing returns of income for the bankrupt; and

- business records of a person declared bankrupt are to be given to the Official Assignee and not retained by the taxpayer, which is inconsistent with the requirements of taxation law.

20. If the value of carried-forward tax losses is significant and those tax losses are not fully realised during bankruptcy (through tax refunds), a discharged bankrupt has access to a valuable tax asset. Under income tax law, a tax loss that is carried-forward after discharge from bankruptcy is a tax asset that benefits the taxpayer in future years by reducing tax on income derived in the future. This retention of a potentially valuable tax asset beyond discharge from bankruptcy is inconsistent with the fresh-start principle which holds that the cancellation of debts on discharge from bankruptcy is in exchange for the insolvent debtor surrendering assets for the benefit of creditors.

21. In practice, carried-forward tax losses generally result from past expenses, many of which are funded by debt. Allowing tax losses to be carried forward, if those losses are funded by debts that cancelled on discharge from bankruptcy, would be inconsistent with the long-standing policy that tax losses should only be able to be carried forward if the taxpayer fully satisfies debts for expenses incurred relating to past tax losses.

22. On being declared bankrupt, all property of the bankrupt vests in the Official Assignee. Some timing, valuation and deduction rules apply on disposals of tax-base property, which would include a disposal by way of assets vested in the Official Assignee. The technical application of these rules can result in losses and gains being included in the bankrupt's taxable income despite those losses and gains on vesting having no connection with the past business of the bankrupt. It is not intended that being declared bankrupt should result in such non-neutral tax outcomes. Such an outcome would be inconsistent with the policy objectives of:

- income tax law in relation to gains or losses arising from disposals of tax-base property; and

- insolvency law, which does not intend deductions for losses or income to arise on a person being declared bankrupt.

23. The ability for carried-forward tax losses to survive bankruptcy may also influence investment decisions. Assuming all other things to be equal, as tax losses currently survive bankruptcy, the use of the sole trader business structure would likely be preferred over a company structure because tax losses of a company are extinguished on liquidation.

24. This non-neutral outcome arises because the remission income rules that apply on discharge from bankruptcy do not apply to all forms of debt. For example it does not apply to a fixed term loan (a financial arrangement) used to finance the purchase of trading assets but does apply to trade debt. Therefore it is likely that a taxpayer would prefer to finance the business trading activity with a debt that would not be subject to the remission income rules (which would mean that carried-forward tax losses are not reduced on discharge from bankruptcy). This is illustrated in the example set out in paragraph 36.

25. A horizontal equity concern is that the tax system currently allows the future tax benefit of carried-forward tax losses (an asset) to be retained following discharge from bankruptcy. This means that the discharged bankrupt with carried-forward tax losses has an advantage compared to a discharged bankrupt who does not have carried forward tax losses. This is a non-neutral outcome arising from current income tax law.

26. Under income tax law, it is normally clear who has derived income. However, under insolvency law, income derived by a bankrupt during the period of bankruptcy is technically property of the Official Assignee, but subject to the bankrupt being able to retain a sufficient amount of that income for family maintenance purposes. This gives rise to uncertainty about who has derived that income. The main administrative problem arising is that it is unclear who is responsible for the income tax obligations for income derive by a bankrupt during the period of bankruptcy.

27. Another administrative and compliance issue arises due to insolvency law requiring business records of a bankrupt to be vested in the Official Assignee. The Official Assignee's practice is not to file returns of income on behalf of the bankrupt individual as the Official Assignee is not the agent for the bankrupt, but serves to administer the bankrupt's estate on behalf of the creditors and not for the benefit of the bankrupt. Consequently, neither the bankrupt nor Inland Revenue have ready access to the necessary information to determine whether a carried forward tax loss exists either on being declared bankrupt or on being discharged from bankruptcy.

28. Published data indicates that in each year about 3,000 individuals are subject to insolvency procedures in recent times and obtain relief from debts under the fresh-start principle of insolvency law. Because of data limitations in identifying all taxpayers who may benefit from the fresh-start principle, it is not possible to determine the number of insolvent individuals who have carried-forward tax losses. However, as the objective of the policy proposals is for the tax system to better support the objectives of insolvency law, this limitation has not impacted on the analysis or conclusions.

## OBJECTIVES OF THE POLICY REVIEW

29. The main objective of this review is to ensure that tax policy outcomes support the objectives of insolvency law. Specifically, the review considers, and to what extent, carried-forward tax losses of an insolvent person should be cancelled –

- on discharge from bankruptcy or completion of the no-asset procedure (Insolvency Act 2006); and
- on remission of debt occurring within alternatives to bankruptcy under statutory or common law.

30. The options considered in this RIS are evaluated against the following criteria:

a. maintaining the coherency of the tax system, including horizontal equity;

b. consistency with the objectives of insolvency law

c. minimising tax and compliance costs for taxpayers;

d. minimising administration costs for the Official Assignee; and

e. minimising administration costs for Inland Revenue.

31. The review is not intended to alter the general tax treatment for partial remission of debt under statutory or common law alternatives to bankruptcy.

32. We also note that trade-offs will inevitably be made across the various criteria. For example, clarifying that the bankrupt is responsible for satisfying income tax obligations for income derived during bankruptcy meets criterion (a) but may result in an increase in compliance costs for the taxpayer (criterion (c).

## REGULATORY IMPACT ANALYSIS

33. Three options, including the status quo are considered in this RIS for addressing the problems. The options are as follows:

- Option 1 –An insolvent individual who becomes bankrupt continues to apply the current remission income rules. These rules apply if some, or all, debt is remitted or cancelled under any procedure of insolvency law, but do not apply to all types of debt. Tax losses may continue to be carried-forward on discharge from bankruptcy.

- Option 2 – An insolvent individual who is released from all debt under any procedure of insolvency law will have their carried-forward tax losses cancelled. The remission income rules that apply on discharge from bankruptcy would no longer apply.

- Option 3 – An insolvent individual who has been released from all debt under any procedure of insolvency law will have their carried-forward tax losses cancelled, but only to the extent of business debts that have been cancelled. The remission income rules that apply on discharge from bankruptcy would no longer apply.

### Analysis of options

***Option 1: status quo***

34. Under option 1, the current law and practice would remain unaltered.

*Maintaining the coherency of the tax system, including horizontal equity*

35. Option 1 permits a bankrupt to carry tax losses forward after being discharged from bankruptcy, at which time debts of the bankrupt are released and the bankrupt is given a fresh start.

36. Option 1 is inconsistent with the objective that the tax system should be neutral in relation to investment decisions. In particular, the loss carry-forward rules relating to insolvent persons provides an incentive for taxpayers to prefer:

a. the sole trader business structure over a company business structure (this is because under current tax law, carried-forward tax losses survive bankruptcy of an individual but do not survive liquidation of a company; and

b. funding their business with either personal savings, or debt to which the remission income rules do not apply. This is illustrated in the following example.

*On discharge from bankruptcy, assume a bankrupt has a carried-forward tax loss of $500. Under current tax law, the amount of tax losses that could be carried forward after discharge from bankruptcy would differ, according to the type of business funding adopted, as follows:*

| ***Business funded by*** | ***Amount of business funding*** | ***Tax loss to carry-forward*** |
|---|---|---|
| • *personal savings* | *$500* | *$500* |
| • *debt subject to remission income rules* | *$500* | *$0* |
| • *debt not subject to remission income rules* | *$500* | *$500* |
| • *debt, 60% of which is subject to remission income rules* | *$500* | *$200* |

37. Option 1 is inconsistent with the long standing tax policy for the carry-forward of tax losses that the carry forward of tax losses is contingent on satisfying debts for expenses incurred that have been included in past tax losses.

38. The technical ability to carry forward tax losses beyond discharge from bankruptcy results in non-neutral tax treatment for discharged bankrupts with tax losses as compared to discharged bankrupts who do not have tax losses. This is inconsistent with the principle of horizontal equity and consequently impacts on the coherency of the tax system.

39. Under the status quo, it is still possible for a range of timing, valuation, and deduction rules to apply on a person being declared bankrupt. Some market value rules may result in the bankrupt being required to include, in calculating their taxable income, the value of property vested in the Official Assignee. This is results in a non-neutral tax treatment for the bankrupt solely from the process of bankruptcy.

*Consistency with the objectives of insolvency law*

40. Continuing with the status quo, which allows tax losses to be carried forward following discharge from bankruptcy, would result in income tax law continuing to be inconsistent with the fresh-start principle and provide non-neutral outcomes as between discharged bankrupts. These problems are set out in paragraph 19 of this RIS.

*Minimising tax and compliance costs for taxpayers*

41. Currently taxpayers incur the cost of engaging an accountant to determine if tax losses exist on being declared bankrupt or on discharge from bankruptcy. It is not possible to determine the scale of these costs due to data limitations.

42. Outcomes from Inland Revenue's administration of insolvents indicate that very few taxpayers have tax losses on discharge from bankruptcy and that often there are insufficient business records available to establish whether tax losses exist. No material change is expected in tax and compliance costs for taxpayers under option 1.

*Minimising administration costs for the Official Assignee*

43. Currently, the Official Assignee's administration costs for insolvent individuals relate to insolvency procedures under the Insolvency Act. Due to data limitations, the scale of these costs is not able to be determined. No material change is expected in administration costs for the Official Assignee under option 1.

*Minimising administration costs for Inland Revenue.*

44. Inland Revenue's main administration costs relate to clarifying who has the obligation to file returns of income in relation to income derived by a bankrupt during the period of bankruptcy. No material change is expected in administration costs for Inland Revenue under option 1.

***Option 2 – cancel all tax losses of an insolvent individual on being released from all debt under any procedure of insolvency law***

45. Under option 2, the remission income rules in the Income Tax Act would no longer apply to a person discharged from bankruptcy or who completes the "no-asset procedure" under the Insolvency Act 2006. In addition, carried-forward tax losses of a person released from all debts under any procedure of insolvency law would be cancelled. Typically, this would occur on being discharged from bankruptcy or completing the "no-asset procedure" of the Insolvency Act 2006.

46. In addition:

- The tax rules relating to disposals of tax-base property would be amended to give a tax-neutral treatment for assets vested in the Official Assignee on a person being declared bankrupt; and

- the tax rules would be clarified to ensure a bankrupt is responsible for satisfying income tax obligations relating to income derived during bankruptcy.

47. A partial release of debt may also occur under any procedure that is an alternative to bankruptcy. These procedures are intended to assist the debtor and his or her creditors by reducing debts to a level that can be managed. Existing remission rules in the Income Tax Act 2007 would continue to apply to partial remissions of debt, and carried forward tax losses may be used to offset that income. The fresh-start principle does not apply in these situations, as all debts are not fully released and the debtor is not generally required to surrender assets in exchange for that partial remission. After applying the remission income rules to partial remission of debt, any remaining balance of carried-forward tax losses remain available for carry-forward.

*Maintaining the coherency of the tax system, including horizontal equity*

48. Option 2 is consistent with the objective that the tax system should be neutral in relation to investment decisions. This option does not prefer any particular business structure as it results in carried-forward tax losses being cancelled irrespective of whether a sole-trader or company business structure is selected.

49. Option 2 also does not result in a preference for any particular type of business funding. It applies equally whether the business funding comes from personal savings, business debt, or debt that is not subject to the remission income rules. This is illustrated in the following example:

*On discharge from bankruptcy, assume the bankrupt has a carried-forward tax loss of $500. Under option 2, the cancellation of tax losses is neutral across all funding choices.*

| ***Business funded by*** | ***Amount of business funding*** | ***Tax loss to carry-forward*** |
|---|---|---|
| • *personal savings* | *$500* | *$0* |
| • *business debt* | *$500* | *$0* |

50. Option 2 is consistent with the policy that the carry-forward of tax losses is contingent on debts that relate to deductions included in past tax losses being fully repaid and improves the coherency of the tax system.

*Consistency with the objectives of insolvency law*

51. Option 2 is consistent with the fresh-start principle of insolvency law. This is because the tax benefit (a tax asset) is surrendered as part of the process of being discharged from bankruptcy.

*Minimising tax and compliance costs for taxpayers*

52. Option 2 will result in taxpayers not needing to determine if tax losses exist on discharge from bankruptcy and this eliminates a potential wasted expense (the cost of engaging an accountant to determine if tax losses exist on discharge from bankruptcy). In addition, the taxpayer would not need to determine the tax effect of assets vesting in the Official Assignee.

*Minimising administration costs for the Official Assignee*

53. The Official Assignee's administration costs would be unchanged under option 2.

*Minimising administration costs for Inland Revenue.*

54. Inland Revenue's administration costs would decrease in the following areas, but due to data limitations it is not possible to determine the scale of the overall effect:

a. the law would be clarified to ensure that the bankrupt is responsible for filing returns of income for income derived during the period of bankruptcy;

b. it would no longer be possible for disputes to arise on whether carried forward tax losses exist on discharge from bankruptcy (although in practice this rarely occurs); and

c. the law would be clarified to provide that:

- the rules relating to vesting of tax base property in the Official Assignee would be amended to give a tax-neutral treatment for the person declared bankrupt. This clarification is to ensure that no tax costs or benefits arise for the bankrupt as a result of being declared bankrupt. This improves consistency with the objectives of insolvency law; and

- the bankrupt is responsible for filing returns of income for income derived during the period of bankruptcy. This clarification is likely to reduce the number of contacts with bankrupts.

***Option 3 – cancel tax losses partially to the extent of business debts cancelled under any procedure of insolvency law***

55. Under option 3, the remission income rules in the Income Tax Act would no longer apply to a person discharged from bankruptcy or who completes the "no-asset procedure" under the Insolvency Act 2006. In addition, carried-forward tax losses of a person released from all debt under any procedure of insolvency law would be cancelled, but only to the extent the debts released are debts of the business activity. Typically, this would occur on being discharged from bankruptcy or completing the "no-asset procedure" of the Insolvency Act 2006.

56. In addition:

- the tax rules relating to vesting of tax base property in the Official Assignee would be amended to give a tax-neutral treatment for the person declared bankrupt; and

- the tax rules would be clarified to ensure that a bankrupt is responsible for satisfying income tax obligations relating to income derived during the period of bankruptcy.

57. A partial release of debt may also occur under any procedure that is an alternative to bankruptcy. These procedures are intended to assist the debtor and his or her creditors by reducing debts to a level that can be managed. Existing remission rules in the Income Tax Act 2007 would continue to apply to partial remissions of debt, and carried forward tax losses may be used to offset that income. The fresh-start principle does not apply in these situations, as all debts are not fully released and the debtor is not generally required to surrender assets in exchange for that partial remission. After applying the remission income rules to partial remission of debt, any remaining balance of carried-forward tax losses remain available for carry-forward.

*Maintaining the coherency of the tax system, including horizontal equity*

58. Option 3 is inconsistent with the objectives of the fresh-start principle and with the objective that the tax system should be neutral in relation to investment decisions. This inconsistency arises if carried-forward tax losses exceed business debts because that excess of the carried tax loss may continue to be carried forward after the bankrupt is released from all debts under insolvency law. Therefore, this option results in a preference for:

- the sole trader business structure over the company business structure (because not all carried-forward tax losses are cancelled for the sole trader); and
- funding for the business being from either personal savings, or from private debt. This is illustrated in the following example:

*On discharge from bankruptcy, the bankrupt has a carried-forward tax loss of $500. The effect of option 3 on carried-forward tax losses would differ as follows:*

| *Business funded by:* | *Amount of business funding* | *tax loss to carry-forward* |
|---|---|---|
| • *personal savings* | *$500* | *$500* |
| • *business debt* | *$500* | *$0* |

59. Option 3 is inconsistent with the objectives of horizontal equity as it results in a debtor who is released from all debt continuing to be able to carry forward tax losses. That outcome is inconsistent with the coherency of the tax system.

*Consistency with the objectives of insolvency law*

60. Under option 3, some tax losses may continue to be carried-forward after the debtor is released from all debt. This would occur to the extent carried-forward tax losses exceed business debts cancelled on discharge from bankruptcy. In this respect, option 3 is inconsistent with the fresh-start principle of insolvency law as the benefit of carried forward tax losses (a tax asset) is still available to the discharged bankrupt.

*Minimising tax and compliance costs for taxpayers*

61. Option 3 will result in taxpayers being required to determine which debts cancelled on bankruptcy are business debts. The fungibility of money may make this analysis difficult to achieve or result in an incentive to treat a debt raised for personal and business purposes to be treated as being mainly on personal account. This incentive arises because the lower the level of business debt, the lower the amount of carried forward tax losses that are cancelled. This is an increase in compliance cost.

62. However, taxpayers would no longer be required to determine the tax effect of assets vesting in the Official Assignee. This is a decrease in compliance cost. Overall, it is expected that the cost of identifying the level of business debt would outweigh the cost of determining the tax effect of assets vesting in the Official Assignee. Due to data limitations, it is not possible to determine the scale of these costs.

*Minimising administration costs for the Official Assignee*

63. The Official Assignee's administration costs would be largely unchanged under option 3. However, as the bankrupt's business records of a business in existence prior to bankruptcy would vest in the Official Assignee, there could be some increase in compliance cost for the Official Assignee if, prior to being discharged from bankruptcy, a bankrupt seeks to determine if he or she has carried-forward tax losses.

*Minimising administration costs for Inland Revenue.*

64. Inland Revenue's administration costs would be likely increased under option 3. This is because the Department would need to engage with the bankrupt in determining both the level of debt that is business related and the amount, if any, of carried forward tax losses.

65. Inland Revenue's administration costs would decrease in the following areas, but due to data limitations it is not possible to determine the scale of the overall effect:

a. the law would be clarified to ensure that the bankrupt is responsible for filing returns of income for income derived during the period of bankruptcy;

b. it would no longer be possible for disputes to arise on whether carried forward tax losses exist on discharge from bankruptcy (although in practice this rarely occurs); and

c. the law would be clarified to provide that:

- the rules relating to disposals of tax base property in would be amended to give a tax-neutral treatment for the person declared bankrupt in relation to the vesting of that property in the Official Assignee. This clarification is to ensure that no tax costs or benefits arise from being declared bankrupt for consistency with the objectives of insolvency law; and

- the bankrupt is responsible for filing returns of income for income derived during the period of bankruptcy. This clarification is likely to reduce the number of contacts with bankrupts.

## Impacts of each feasible option

66. The impacts of each feasible option against the objectives of the review and the economic, fiscal, compliance and administrative impacts are summarised in Table 1: *Summary of analysis: objectives and impacts.*

*Table 1 Summary of analysis: objectives and impacts*

| Description | Meets criteria (paragraph 30 refers) | IMPACTS | | | | | Recommendation |
|---|---|---|---|---|---|---|---|
| | | Economic impact | Fiscal impact | Compliance impacts | Administration impacts | Risks | |
| Option 1: Status quo/ | (a) and (b) are not met.<br>(c), (d) and (e) are met. | Gives preference to sole trader business structure over company business structure.<br>Gives preference to fund business from personal savings and debt not subject to remission income rules.<br>Inconsistent with policy for carrying forward tax losses. | Nil | Although there is a potential for wasted expenses to arise in determining whether carried forward tax losses exist, there is no change in compliance costs as this is the effect of the status quo. | Ongoing uncertainty about application of tax law to bankrupts, including compliance obligations and the tax treatment of assets vested in the Official Assignee. | Inconsistencies between law and policy remain.<br>Uncertainty about the application of the law to bankrupts may give rise to wasted expenses. | Does not address the problem.<br>Not recommended. |
| Option 2: Cancel carried forward tax losses if all debts cancelled under insolvency law/ | (a) to (e) are all met. | Has neutral effect.<br>Consistent with policy for carrying forward tax losses. | Nil | No change in compliance costs would be expected as the outcome is largely consistent with current outcomes in practice. | A potential minor decrease in administration costs, as the value of carried forward tax losses on discharge from bankruptcy would no longer be a disputable matter. | No risks identified. | Addresses the problem.<br>Consistent with policy objectives.<br>Recommended method. |
| Option 3: Cancel carried-forward tax losses to the extent business debts cancelled under insolvency law. | (a) to (e) are not met. | Gives preference to sole trader business structure over company business structure.<br>Gives preference to fund business from personal savings and debt not subject to remission income rules.<br>Inconsistent with policy for carrying forward tax losses. | Nil. | A net (small) increase in compliance costs would be expected, The scale of this net increase is not able to be determined due to data limitations. | There is a risk of increased administration costs relating to determining the value of carried-forward tax losses. | Inconsistencies between law and policy remain.<br>Risk of dispute between administrators and taxpayer on whether carried-forward tax losses exist. | Does not address the problem.<br>Not recommended. |

### Economic impacts

67. Option 2 is the only option that is consistent with the policy objectives of ensuring that the tax system is neutral in relation to investment decisions. This option is also the only option that is consistent with the long-standing policy that tax losses may only be carried forward if debts relating to deductions included in past tax losses have been fully satisfied.

### Fiscal impacts

68. Information provided by Inland Revenue's administration of insolvent individuals indicates that most taxpayers:

- do not have tax losses to carry-forward on discharge from bankruptcy; or
- do not have sufficient business records to determine whether carried-forward tax losses exist on discharge from bankruptcy; or
- are not willing to meet the cost of determining whether carried-forward tax losses exist on discharge from bankruptcy.

69. Consequently, option 2 is not expected to result in a fiscal impact. If option 3 were selected, there is a potential that taxpayers may seek determine that carried forward tax losses exist. Our view is that the amount of these tax losses would be immaterial.

### Compliance impacts

70. There is expected to be a minor reduction in compliance impact from adopting option 2. This is because the law will be made more certain in relation to:

- the tax treatment of tax-base property vested in the Official Assignee; and
- the tax treatment of carried forward tax losses on being released from all debts under procedures of the Insolvency Act 2006.

71. However, if option 3 were adopted, compliance costs would be expected to rise, as taxpayers are required to self-assess their tax losses. In particular, a discharged bankrupt would need to have sufficient business records of the pre-bankruptcy business to establish:

- that carried forward tax losses existed on being declared bankrupt; and
- the amount of business debt that has been cancelled on discharge from bankruptcy.

### Social, cultural or environmental impacts.

72. None of the options have social, cultural, or environmental impacts.

## CONSULTATION

73. Policy proposals were provided in a targeted consultation letter to the Accident Compensation Corporation (ACC), Chartered Accountants: Australia and New Zealand (CAANZ), the New Zealand Law Society (NZLS), and the Official Assignee. The consultation was limited to interested parties on the basis that the proposal related to complex technical aspects of the relationship between insolvency law and taxation legislation.

The consultation letter set out policy proposals on the relationship between insolvency law and the carry forward of tax losses that arose prior to insolvency by either:

- a discharged bankrupt; or
- an insolvent individual released from the full amount of a debt under the "no-asset procedure" (an alternative to bankruptcy under the Insolvency Act 2006).

74. The policy proposals were:

a. Whether, and to what extent, carried-forward tax losses of an insolvent person should be cancelled:
   - on discharge from bankruptcy or on completion of the no-asset procedure; and
   - to the extent partial remission of debt occurs under other alternatives to bankruptcy?

b. Whether the differences in the income tax treatment of cancelled debts on discharge from bankruptcy result in an incentive to fund business activity in a particular way, in order to preserve carried-forward tax losses?

c. Should timing, valuation, and deduction rules relating to disposals of assets in the Income Tax Act 2007 apply to assets vested in the Official Assignee?

d. Should there be clarification of the income tax treatment of the bankrupt and the Official Assignee during the period of bankruptcy?

75. The consultation letter also set out an analysis of the economic impact of the status quo. That analysis indicated that under current law, the tax system was not neutral in relation to investment decisions when considering the ability to carry forward tax losses on discharge from bankruptcy.

76. The ACC submitted that it had no concerns with the policy proposals.

77. CAANZ observed that

- Some practitioners were not aware that bankrupts are technically able to carry forward tax losses that arose prior to being adjudicated bankrupt.
- In this respect, CAANZ noted that a person declared bankrupt receives a new Inland Revenue number (tax number). CAANZ acknowledged that the two tax numbers are to assist the Commissioner to distinguish between tax obligations of the bankrupt for the periods before and after bankruptcy.

78. Given that no submissions were received opposing or suggesting modifications to the policy proposals, it was concluded that the proposals to cancel all carried-forward tax losses of a person released from all debts under insolvency law should be preferred (option 2).

## CONCLUSIONS AND RECOMMENDATION

79. We recommend option 2, under which:

- Carried-forward tax losses of a natural person are cancelled on discharge from bankruptcy;
- The vesting of tax base property in the Official Assignee on a person being declared bankrupt would have a tax-neutral effect for the bankrupt:
- Tax administration law would be clarified to ensure that the bankrupt is responsible for filing returns of income during his or her period of bankruptcy.

80. The proposals would be consistent with:

- the objectives of insolvency law;
- the coherency and neutrality of the tax system; and
- the long-standing policy for the carry-forward of tax losses.

## IMPLEMENTATION

81. The recommended option would be included in the first available tax bill scheduled for introduction in 2016.

82. The proposal would apply to persons discharged from bankruptcy on or after the date of Royal Assent of the enabling legislation. No transitional provisions are considered necessary as the impacts would be prospective from the date the enabling legislation is first introduced into the House. When introduced into Parliament, commentary will be released explaining the amendments. Normal submission processes occur when the bill is referred to the Finance and Expenditure Committee.

83. The effect of the law would be communicated to affected taxpayers in a Technical Information Bulletin to be released shortly after the bill receives Royal asset.

84. Inland Revenue will administer the law as part of its business as usual process.

## MONITORING, EVALUATION AND REVIEW

85. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design and implement tax policy since 1995.

86. The final stage in the GTPP contemplates the implementation and review stage, which can involve post-implementation review of the legislation and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme and proposals would go through the GTPP.

87. Inland Revenue's normal assurance activity will evaluate and review that the preferred option achieves its intended policy objectives, as set out in paragraph 30 of this RIS.

# Regulatory Impact Statement

## Review of closely held company taxation

### Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address the key concerns with the look-through company (LTC) rules and the dividend rules as they apply to closely held companies more generally. These key concerns can be grouped into three themes: rules which impose unnecessary compliance costs, rules which restrict legitimate commercial practice and rules which fail to achieve their intended policy objectives.

A range of policy options are considered to address the key concerns. The options are intended to simplify the rules and reduce compliance costs for closely held companies, while ensuring the rules are robust and in line with stated policy.

The proposals discussed were developed in the context of the wider tax policy framework for closely held company taxation to ensure they were consistent with the framework. However, questions as to the wider policy settings such as whether closely held companies in general should be able to distribute capital gains tax-free during the course of business, not just on liquidation (some closely held companies are already able to do this), were considered too complex and better handled through the standard tax work programme process at a future date.

Because of data limitations it is not possible to accurately forecast some of the costs (including compliance, administrative and fiscal costs) which may result from some of the proposals due to difficulty in estimating likely behavioural changes. For example, with regard to the proposed liberalisation of the tainted capital gains rule, it is difficult to reasonably estimate the number of companies with tainted gains which are choosing not to liquidate as a result of the tax impost that would arise. Wherever possible, the analysis provides fiscal implications arising from the proposals as forecasted.

Some of the recommended options will give rise to some additional compliance and administrative costs (as noted in the detailed options analysis) but it is difficult to provide precise estimates. The precise cost for companies and their shareholders resulting from, for example, the recommended changes to the LTC eligibility criteria or, alternatively, as a result of a choice to transition to another business model, will depend on the chosen model.

We note that the LTC regime is elective, so business owners have a choice to move into an alternative business form which does not have the same tax features and limitations. Various factors may influence this decision, such as the desire to use tax losses personally versus the familiarity with the corporate structure and the advantages of limited liability, which make full and accurate analysis of behavioural changes impossible.

Equally it is difficult to estimate the likely administrative costs to Inland Revenue as a result of on-going enforcement or monitoring activity required where the integrity of the rules is not strengthened. For example, if the proposed changes to the LTC entry tax are not progressed there is a potential risk of this rule being taken advantage of as part of tax avoidance

arrangements; this would result in additional administrative costs in both detection and enforcement activities.

There are no other significant constraints, caveats or uncertainties concerning the analysis undertaken.

None of the policy options restrict market competition, impair property rights, reduce incentives for small businesses to operate, or override fundamental common law principles.

Geoff Leggett
Senior Policy Advisor, Policy and Strategy
Inland Revenue

2 December 2015

## EXECUTIVE SUMMARY

1. Small closely held companies represent a significant proportion of New Zealand's 400,000 companies. The tax treatment of companies is generally different than that applied to individuals, including sole traders. Certain types of closely held companies are able to apply specific tax rules to help bridge the boundary between the two tax approaches. Therefore, the policy intent of these specific rules is to ensure that tax consequences do not discourage incorporation of businesses.

2. In 2010 the Government made major changes to the rules used by many closely held companies, including the introduction of a full flow-through vehicle, LTCs. Subsequently, in response to concerns, the Government undertook to review the LTC rules alongside aspects of the dividend rules applying to closely held companies more generally. In September 2015, Inland Revenue released an issues paper titled *Closely held company taxation issues* which suggested a package of proposed changes.

3. The policy development of the various options has been informed by both targeted consultation, over several years with representatives of the Chartered Accountants of Australia and New Zealand (CAANZ) tax advisory group. The Treasury were also involved in the policy development of the recommended proposals and agree with the conclusions.

4. The issues paper acknowledged that a number of problems exist with the way that the LTC rules operate and feedback was sought on various amendments to address them, the problems included in relation to the rule that limits an owner's deductions to the amount that they have at risk (the deduction limitation rule) and how debt remission is treated under a LTC or partnership. Officials also sought feedback on several proposals aimed at better targeting the LTC rules to ensure their use remained in line with the underlying policy intent, through tightening up some of the eligibility criteria.

5. Outside of LTCs, the issues paper outlined proposals in response to concerns raised regarding the dividend rules that apply to other closely held companies, primarily in relation to resident withholding tax obligations and the treatment of capital profits arising from transactions with associated parties.

6. A total of seventeen submissions were received in response. Some focussed on particular proposals or technical detailed queries, while others provided comment on the package more broadly. Submitters were generally supportive of the proposals which addressed technical errors and amended or removed rules. On the other hand, the proposals designed to ensure that the use of LTCs is better targeted at the originally intended audience were generally perceived as unnecessary or overly restrictive.

7. The proposals and alternative options have been reconsidered in light of submissions and a number of amendments are now recommended, all of which are expected to be positively received. For example, transitional and grand parenting arrangements are recommended to assist those affected by the proposed tightening of the LTC qualifying criteria. Also the proposal to limit the rule that taxes capital gains on asset sales to associated persons has been significantly expanded.

8. Our preferred options, and the details of the various proposals, are outlined further below. Given the wide ranging and technical nature of the proposals this RIS is, of necessity, detailed. As noted above, the concerns with the current settings can be grouped into three themes. To assist readers, the proposals, analysis and recommendations have been grouped under those themes.

9. If approved, the preferred options will require legislative changes to the Income Tax Act 2007. We recommend any legislative changes be included in the omnibus taxation bill scheduled for introduction in March 2016. Most changes would apply from the start of the 2017-18 income year, although some would be back dated. We note that the bill will be subject to a further public consultation process as part of the select committee process.

10. Several options are recommended to address these problems, and analysis of these options is summarised below.

11. We note that there are some minor proposals, primarily remedial or technical in nature, which have been identified during the review. These proposals are listed in appendix 2, but due to their minor or remedial nature no further options analysis has been provided in this RIS.

12. There are also a number of amendments which were either considered at the time of the review but subsequently not progressed, or raised by submitters in response to the issues paper; which are not discussed in this RIS. Officials have recommended that these amendments either be declined or progressed as a separate project on the basis that the issues are considered too complex and are better handled through the standard tax policy work programme process at some future date. A list of these issues, and a brief summary of official's decisions on them, is contained in appendix 3.

## STATUS QUO AND PROBLEM DEFINITION

### Summary of current settings

13. The review of the taxation issues facing closely held companies has focussed primarily on the following rules:

- the LTC rules – including the rules governing the LTC eligibility criteria, transitions into the LTC regime, the deduction limitation rule and the debt remission rule as it applies to LTCs;
- the qualifying company rules – in particular whether QCs should be retained or repealed;
- the wider dividend rules including the resident withholding tax obligations for closely held and ordinary companies, the tax treatment of cash and non-cash dividends and shareholder salaries;
- and the operation of the rule which treats capital gains made on transfers of property between associated persons as taxable upon liquidation, referred to as the 'tainted capital gains rule'.

14. The QC and LTC rules were designed to alleviate some of the tax disadvantages that can arise from incorporation for closely held businesses. The broad objective of these rules is that operators should face similar taxation consequences regardless of the business structure

through which they chose to operate; for example a builder operating in their own name or as an incorporated business.

15. The QC rules, which date back to the early 1990's, allow for ordinary company taxation of profits (that is, profits are taxed at the standard company tax rate with subsequent distributions being taxed at shareholders' personal tax rates with imputation credits attached) but with tax-free flow through of capital gains. Before 2011 QCs could also elect to be loss-attributing qualifying companies (LAQCs) for tax purposes which allowed the company's losses to flow through to shareholders for offset against their other income.

16. Once the top personal rate was no longer aligned with the company rate there was a concern that the QC regime went beyond the objective of removing the tax disadvantages from incorporation, and in fact provided a potential tax advantage. Consequentially, in Budget 2010 the Government announced its intention to abolish QCs and LAQCs. Due to stakeholder concerns raised at the time, the decision was made to only abolish LAQCs. Existing QCs were grandparented for the time being until a wider review of the dividend rules applying to closely held companies could be completed. At the end of the 2014 income year there were still around 70,000 QCs.

17. As part of the 2010 changes, the LTC rules were introduced as an alternative tax vehicle for closely held companies. They enable the LTC to be treated as a company for legal purposes but treated like an individual, sole trader or partnership for tax purposes. It is therefore "looked through" for tax purposes, with its income and expenditure being attributed back to shareholders and taxed at their personal tax rates. Untaxed gains, such as capital gains, earned at the company level are able to flow through tax free to the owners and likewise company losses can be utilised by the owners against their other income.

18. For closely held companies that are neither LTCs nor QCs, standard company tax rules apply.

### Problems with the current tax settings

19. Several issues were noted during the review of the rules referred to above. These issues can be grouped as follows:

- **Rules which impose unnecessary compliance costs** – this includes some of the LTC rules which are overly complex to apply (for example the deduction limitation rule);

- **Rules which restrict commercial practice** – this includes rules which are inflexible or restrict non-tax driven legitimate commercial practice which would occur but for the rules (for example the rule which restricts a LTC from having more than one class of share and the tainted capital gains rule); and

- **Rules which fail to achieve their intended policy objectives** – this includes both current rules which are not operating in line with intended policy or allow for unintended tax advantages, as well as current rules which are not robust enough and can be easily circumvented (for example the LTC eligibility criteria which are not sufficiently targeted in some areas to protect the integrity of the regime).

20. The specific details of these rules and the current problems are discussed further below under these three headings. We note, however, that some of the problematic rules could have been grouped under more than one heading.

***Rules which impose unnecessary compliance costs***

21. Several of the rules were, upon review, seen to be imposing unnecessary compliance costs. These rules and the specific concerns relating to them are discussed below.

*Deduction limitation rule*

22. To ensure LTCs cannot be used to generate deductions in excess of the money that owners have at risk in the company, the rule restricts an owner's ability to utilise LTC deductions against their other income when the deductions are greater than their economic losses from the LTC. This rule is referred to as the deduction limitation rule.

23. The rule results in undue compliance costs in many cases as it requires each LTC owner to calculate their 'owner's basis' annually, which requires owners to keep track of what they have invested in and withdrawn from the business and all income and expenditure attributed to them while they have been an owner. Over time this would require LTC owners to maintain records well beyond the standard record keeping requirements for tax information. The calculation must be completed by every owner even though most will not have their deductions constrained by it because their share of expenditure is less than their owner's basis.

24. Moreover the rule has some technical issues in the way that it is drafted which can mean that it restricts deductions in some situations when all costs would be deductible if earned directly by the owners, which is not in line with the intended policy behind the LTC rules (namely, to parallel the tax treatment under direct ownership).

*RWT on dividends between companies*

25. The payment of passive income, such as dividends and interest, to resident recipients is subject to an obligation to account for RWT, which is withheld by the company at the time of payment and paid to Inland Revenue in the month following payment. For dividends a flat rate of 33% applies (less any imputation credits) and for interest, the RWT rate varies according to the recipient's personal tax rate.

26. As a result of the lowering of the company tax rate to 28%, when a company pays a fully imputed dividend (that is a dividend from retained earnings previously taxed at 28%) the dividend is still subject to an additional 5% RWT (a total of 33%). For dividends paid to corporate shareholders (who will be subject to the company tax rate of 28%) this obligation to withhold RWT results in an initial over-taxation (of the additional 5%) of these dividends.

27. Unless the two companies are part of the same wholly-owned group or the recipient company holds a certificate of exemption from RWT, this over-taxation may give rise to additional compliance costs for both the paying company, which must account for the additional RWT to Inland Revenue, and the recipient company, which is required to seek a refund when the RWT credit cannot be used.

*RWT on concurrent cash and non-cash dividends*

28. When a company pays a non-cash dividend, such as a taxable bonus issue, the dividend is still subject to RWT. The legislation requires the non-cash dividend to be grossed up because the RWT cannot practically be withheld from the non-cash amount.

29. When a company pays a non-cash dividend concurrently with a cash dividend both dividends are subject to RWT. The legislation treats the two dividends separately and requires the non-cash dividend to be grossed up and the RWT applied on the gross amount. This gross up is required even when the concurrent cash dividend is sufficient to cover the RWT obligation on both dividends. This gross-up can therefore result in the RWT obligation across both dividends being higher than it should.

***Rules which restrict commercial practice***

30. As discussed, several of the rules were, upon review, seen to be inflexible or overly restrictive of non-tax driven legitimate commercial practice. These rules and the specific concerns relating to them are discussed below.

*LTC restriction on share classes*

31. Currently, in order to simplify the attribution of income and expenditure to shareholdings of look-through owners, LTCs can only have one class of share. This rule is overly restrictive in the light of the policy objective.

32. This limitation can restrict legitimate commercial structuring or generational planning and inhibit some companies from becoming LTCs. A parent, for example, because of their industry expertise, may want to retain control of the decision-making process when children are introduced into the business. It would be reasonable to do this through having shares that carry different voting rights. The current requirement is particularly problematic when the different classes of shares carry the same entitlements to distributions.

*Tainted capital gains*

33. Capital gains derived at the company level cannot be distributed tax free by ordinary companies, except upon liquidation. The tainted capital gain rule taints a capital profit if it is realised by a sale of a capital asset to an associated person (for example a group company or a significant shareholder) making it taxable upon liquidation, unless the gain is derived by a close company and arises during the course of liquidation.

34. The policy rationale for this rule is that sales of assets between associated persons (for example sales within a group of companies) can be for the purposes of creating additional amounts of capital reserves that can be distributed tax-free, rather than for general commercial reasons. This would allow a company to distribute ‘capital profits’ tax free in lieu of dividends, which would have been taxable.

35. The restriction dates back to the 1980s. Due to various tax system changes which have taken place over time (in particular, the introduction of the imputation regime and a comprehensive definition of dividend) the rule may have less relevance today.

36. In practice the tainting rule can capture genuine transactions when the sale is not tax driven, for example the transfer of an asset as part of a genuine commercial restructure. The

restriction, therefore, extends beyond its intended ambit, and companies can often be inadvertently caught by the rule, resulting in their being unable to be subsequently liquidated without a tax impost.

*Options for taxing shareholder salaries*

37. Shareholder-employees of close companies often do not derive regular amounts of salary or wages, or do not get paid in regular periods throughout the income year which can make compliance with the PAYE rules difficult. This is because the PAYE rules are designed for circumstances when employees' salaries are known at the start of the income year and remain steady (received in monthly or fortnightly payments) throughout the year.

38. For smaller companies the remuneration of shareholder-employees often depends on the performance of the business, and therefore the annual salary will not be known until well after year end. To alleviate this issue the current rules allow for shareholder-employees, who do not derive regular amounts of salary or wages or do not get paid for regular periods, to treat all amounts of income they receive through the year as not subject to PAYE, subject to certain conditions. As a result, the amounts received are taxable in the employee's tax return and may give rise to provisional tax obligations.

39. This rule may not adequately relieve the compliance costs incurred by shareholder-employees as it may not suit the myriad of shareholder-employee circumstances where paying a combination of PAYE and provisional tax might be preferable. There is no option, however, to pay a combination of PAYE and provisional tax, the rule is all or nothing.

***Rules which fail to achieve their intended policy objectives***

40. As discussed, several of the rules were, upon review, not operating in line with intended policy. This could mean that the rules are either not operating as intended or allow for unintended tax advantages or the rules may not be robust enough which has resulted in their use for purposes which are inconsistent with their policy intent. These rules and the specific concerns relating to them are discussed below.

*LTC eligibility criteria*

41. The eligibility criteria limit the type of entity that can elect to become and continue to be a LTC. Broadly, to be a LTC, in addition to having only one class of shares, an entity must be a New Zealand tax resident company with no more than five "look-through counted owners". Each shareholder has to be a natural person, a trust or another LTC. There are no restrictions on foreign ownership of LTCs, nor on foreign income earned by LTCs.

42. When determining the number of look-through counted owners the rules:

- count close relatives as a single owner;
- look through to the ultimate shareholder(s) when LTCs are owned by other LTCs;
- for LTCs owned by trusts, count trustees (grouping multiple trustees as one) or beneficiaries or both, depending on the nature of the distribution and whether LTC income is distributed by the trust in full.

43. A LTC that fails to satisfy the eligibility criteria during an income year, loses its LTC status from the beginning of the income year, and is unable to elect into LTC treatment for the remainder of that year and the two subsequent income years. Given that LTC owners are

deemed to directly hold the LTC's assets and liabilities, loss of LTC status means that the LTC assets are deemed to be disposed of by the LTC owners. This deemed disposal can trigger tax consequences, such as depreciation claw-back, for the owners.

44. These eligibility criteria were reviewed against the "target audience" for the LTC regime to ensure that the use of the LTC rules is appropriate in light of the policy intent underlying their design.

45. From a policy perspective, LTCs were intended to be used as investment vehicles for closely controlled (meaning five or fewer counted owners) New Zealand businesses which, for commercial reasons, preferred to make the investment through the corporate structure but that could otherwise have genuinely been made directly by an individual or small group of individuals, including through a family trust.

46. This means LTCs were not intended to be widely held vehicles, although the rules do envisage use by close family groups by allowing for all 'relatives' to be counted as one look-through owner (for example children, siblings and spouses).

47. The eligibility criteria are closely held companies, are overly liberal in several areas which has the potential to undermine this intended policy outcome. In particular, in relation to LTCs owned by trusts (including trusts with corporate beneficiaries), charities and Māori authorities, the current rules could allow for LTCs to be in effect widely held.

48. For LTCs held by trusts the current rule is limited in that it only counts beneficiaries who have received distributions of LTC income as 'beneficiary income' (being income which has not been taxed in the hands of the trustees) rather than all distributions that they receive sourced from any income of the trust. This allows for multiple beneficiaries to benefit from the LTC income but not become 'counted owners' by, for example, receiving only distributions of 'trustee income'.

49. Further, because of the fungibility of money, it is only really possible to nominally trace the source of a distribution to test whether they are derived from a direct or indirect beneficial interest in a look-through interest. This means that the test which counts look-through owners based on the source of income which is distributed can be easily undermined, as income can be made to appear to be distributed from one particular source, but this may bear no semblance to what has happened in reality. In practice a dollar distributed by a trust may be sourced from any funds of the trust.

50. A trust that owns a LTC can currently have a corporate beneficiary but direct ownership by companies, other than other LTCs, is expressly prohibited. The trust is looked through and the shareholders of the corporate are counted if it receives any beneficiary income. This, coupled with the stated problems in the current trust counting rules as described above, unintentionally provides widely held non-LTC corporates with a way to circumvent the prohibition on direct ownership.

51. The current rules also allow for charities and Māori authorities to hold LTC interests, either directly or indirectly through a trust. Both charities and Māori authorities have potentially wide pools of beneficiaries and are, therefore, conceptually not part of the LTC target audience.

52. Finally, although LTCs are envisaged primarily as a structure for domestically focussed companies, currently there are no rules which restrict foreign investment by LTCs or foreign

ownership of LTCs (i.e. having non-resident shareholders). This combination unintentionally allows for LTCs to be used as conduit investment vehicles (vehicles used by foreigners to invest in foreign markets generating income which is generally not taxable in New Zealand).

53. There are reputational risks with allowing such conduit structures, and there is some anecdotal evidence that LTCs have been used to facilitate illegal activity, though they are not the only vehicle to be so used.

*LTC entry tax*

54. Given that a LTC can distribute its capital and reserves tax free to its shareholders, the LTC rules provide for a "LTC entry tax" when a company elects to become a LTC. The LTC entry tax calculation attributes income to the shareholders based on a notional liquidation of the company.

55. The rule triggers a tax liability on un-imputed retained earnings by deeming the company that elects into the LTC regime to have been liquidated immediately prior to conversion, except that there is no actual disposal or deemed disposal of assets. Thus, for example, revenue account property conceptually transfers at tax book value, and not market value, meaning that unrealised gains and losses are not crystallised.

56. This adjustment is intended to ensure that reserves that would be taxed to shareholders if distributed before entering the LTC regime and that would be able to be distributed tax-free once the company becomes a LTC, are taxed to shareholders at the time of entry.

57. The LTC entry tax rule has several issues in the way that it operates. The rate applicable to the 'entry tax' is 28%, to the extent that the company's retained earnings are fully imputed. Under the LTC entry tax formula this income is regarded as being finally taxed at 28%. It is only the untaxed reserves that are taxed at the shareholder's personal tax rates. This provides a tax advantage for shareholders whose top personal tax rate exceeds 28% (that is on the 30% or 33% marginal tax rate). Similarly this disadvantages shareholders whose personal tax rates are below 28%. The 28% rate was used in the formula to reduce compliance costs.

58. In the extreme example this differential in the rate has led to cashed up companies electing into the LTC regime and then subsequently liquidating, which means the income remains taxed only at the 28% rate (but we note that this might be seen as tax avoidance in some cases).

59. The entry tax adjustment also produces an incorrect outcome for QCs which convert to LTCs. This issue is discussed further in appendix 2, along with other remedial amendments.

*Debt remission in the LTC context*

60. Debt remission, being the extinguishing of a debtor's liability by operation of law or forgiveness by the creditor, gives rise to debt remission income to the debtor under the financial arrangement rules. Under present tax law, debt remission produces taxable income to the debtor, but usually no tax deduction is available to the creditor as it is generally treated as a capital loss.

61. Proposals to address this asymmetric treatment of the remission in certain circumstances form part of a separate policy project and are not discussed further in this RIS. The proposals

in this RIS focus only on the problems which arise from the interaction of the LTC (and partnership) rules with the financial arrangements rules that produce the remission income.

62. When an owner of a LTC remits debt owed to them by the LTC, all the LTC owners derive debt remission income as the LTC is looked through. This includes the owner that remitted the debt who is required to pay tax on their share of the remission income, despite the fact that they have actually made an economic loss (to the extent of the portion that is "attributed" to the other shareholders). Generally, the creditor shareholder is unable to claim a deduction for the bad debt. Overall, this results in over-taxation of the owner who remitted the debt, which is not an appropriate tax policy outcome.

63. There is a further issue regarding the recognition of debt remission income in circumstances where the LTC elects out of the LTC regime or is liquidated. This issue is discussed further in appendix 2.

*QC status*

64. Since the 2010 decision to grandparent QCs there has been a question around what to do with the remaining grandparented QCs. As part of the closely held company review officials considered the role of QCs and the desirability of retaining QCs. The decision was reached that existing QCs should continue to be grandparented, on the basis that requiring all remaining QCs to convert to LTCs, or failing that to ordinary companies, would not only impose significant compliance costs on those businesses but would also not be practical as the LTC requirements might not be suitable for many QCs.

65. This means that while no new QCs can be created, existing QCs can continue until they are either liquidated, elect out of the QC regime or fail to meet the QC eligibility criteria. This can provide them with a permanent tax advantage. This advantage would be due primarily to the potential tax deferral on income that is taxed until distribution at the company tax rate rather than the shareholders' personal rates and the favourable treatment of capital gains relative to ordinary companies.

66. This permanent tax advantage could lead to a desire to trade the QC for tax purposes which has the potential to lead to undesirable tax behaviour, and is inconsistent with Parliament's clear intention to restrict new persons entering the QC regime. In effect a new QC can be created by simply replacing the shareholders of an existing QC.

## OBJECTIVES

67. The Government is committed to making positive changes to reduce the time and cost to businesses resulting from onerous tax compliance obligations. The closely held company taxation issues review was completed with this broad objective in mind.

68. The objectives against which the options for change have been assessed, and which support this wider Government commitment are:

i. **Overall efficiency**: To support the overall economic efficiency of the tax system, the options should, to the extent possible, reduce distortions resulting from the tax treatment to ensure that taxpayers' decisions are not tax driven.

ii. **Fairness and neutrality:** To support fairness in the tax system, the options should, to the extent possible, seek to treat similar taxpayers or similar circumstances in a similar way. This can include ensuring that the rules are more robust so that a specific tax treatment, such as LTCs which help fairness and neutrality at the margin, cannot be used far more broadly by those that should be taxed under the ordinary company rules.

iii. **Efficiency of compliance and administration**: Compliance costs for taxpayers and administrative costs for Inland Revenue should be minimised as far as possible. The various closely held company tax rules, in particular the LTC rules, should be clear and simple to understand and apply.

69. The optimum options should:

- not lead to tax driven outcomes;
- minimise compliance costs for closely held companies;
- reduce the risk to the tax base through the use of LTCs in unintended ways; and
- provide certainty for taxpayers using the rules.

70. When assessing the options officials have also been mindful of the fiscal implications stemming from the proposals

71. The options discussed below have been developed in response to concerns raised with officials, by submitters during the review or in prior consultation with CAANZ, on the workability or appropriateness of the rules or in response to concerns uncovered by officials in completing the review.

## REGULATORY IMPACT ANALYSIS

72. The options assessed in this RIS are grouped under the three key themes. Each option has been assessed against the stated objectives, and our conclusions are indicated in the tables below. Full details of the analysis of the advantages and disadvantages of all of the options are set out in Appendix 1.

73. For each option the analysis has weighed the likelihood of achieving the stated desired outcome, against the implications for taxpayers, focussing on the following groups:

- implications for taxpayers who have structures in place based on the current rules (this would including consideration of the compliance costs that may arise due to having to restructure as well as any tax consequences which may arise due to the change);
- implications for taxpayers looking to rely on the rules in the future (the analysis here focussed on the effect of the change on compliance costs and certainty in the rules); and
- taxpayers more generally (in terms of any implications which may arise from not proceeding with the proposals; for example the effect of not protecting the integrity of the LTC rules or allowing reputational risks).

74. To minimise any negative effects for the first group, several transitional and/or grandparenting rules are recommended to either ease the transition into the new rules or protect taxpayers who have structures in place based on the current rules.

75. Our analysis has also been informed by the comments received from submissions on the officials' issues paper. The expected outcomes of each option has been considered and contrasted against the status quo (i.e. the current tax law that applies).

76. Generally the analysis has focussed on the economic, fiscal and compliance impacts of each of the options. Officials do not expect any of the options that are discussed or recommended to have social, environmental or cultural impacts and no additional analysis of these effects has been included.

77. Fiscal implications arising from the proposals have been provided, when these have been costed. Some options would have fiscal implications, but these are unable to be costed (due to for example unquantifiable behaviour changes).

78. Some of the recommended options will give rise to some additional compliance and administrative costs (as noted in the options analysis in Appendix 1). The precise cost for companies and their shareholders, resulting from both the recommended changes to the eligibility rules or, alternatively, as a result of a choice to transition to another business model, will depend on their chosen model.

79. However we note the LTC regime is elective, so business owners have a choice to move into a business form which does not have the same tax features and limitations. Various factors may influence this decision, such as the desire to use tax losses personally versus the familiarity with the corporate structure and the advantages of limited liability, which make full and accurate analysis of behavioural changes impossible.

***Rules which impose unnecessary compliance costs***

*Deduction limitation rule*

80. Options to address concerns around the complexity and targeting of the rule that restricts a look-through owner's ability to claim LTC deductions in excess of the money they have invested in the business, are listed below:

| **Options:** | **Recommendations** | **Analysis against objectives** |
|---|---|---|
| Option 1: Repeal the rule – entirely. | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency of costs:* Meets objective. |
| Option 2: Repeal the rule except for LTCs operating in partnership or joint venture with other LTCs, and make some technical clarifications to the rule for those still covered by it. | Recommended. | *Overall efficiency:* Meets objective.<br>*Fairness/neutrality:* Meets objective.<br>*Efficiency in costs:* Meets objective for the most part. |
| Option 3: Maintain the rule but make some technical clarifications to the rule. | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Partly meets objective.<br>*Efficiency in costs:* Partly meets objective. |

| | | |
|---|---|---|
| Option 4: Maintain the status quo. | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* Does not meet objective. |

81. If the rule is repealed, as recommended under option 2 above, there is a question around the treatment of previously restricted deductions. Options for how the deductions will be released are discussed below:

| **Options:** | **Recommendations** | **Analysis against objectives** |
|---|---|---|
| Option 1: Repeal the rule in part (refer option 2 above) and release previously restricted deductions in one lump at a particular point. | Recommended. | *Overall efficiency:* No impact.<br>*Fairness/neutrality:* Mostly meets objective.<br>*Efficiency in costs:* Meets objective. |
| Option 2: Repeal the rule in part (refer option 2 above) and require restatement of prior period returns on the basis that the rule had not existed. | Not recommended. | *Overall efficiency:* No impact.<br>*Fairness/neutrality:* Meets objective.<br>*Efficiency in costs:* Does not meet objective. |
| Option 3: Repeal the rule in part (refer option 2 above) and gradually release previously restricted deductions over three years. | Not recommended. | *Overall efficiency:* No impact.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* Does not meet objective. |

*RWT on dividends between companies*

82. Options to address concerns around the initial over-taxation of fully-imputed dividends paid to corporate shareholders, as well as to minimise the unnecessary compliance costs arising from the RWT obligations which apply are:

| **Options:** | **Recommendations** | **Analysis against objectives** |
|---|---|---|
| Option 1: The obligation to account for RWT on all fully-imputed dividends paid between companies should be removed. | Not recommended. | *Overall efficiency:* Partly meets objective.<br>*Fairness/neutrality:* Partly meets objective.<br>*Efficiency in costs:* Partly meets objective. |
| Option 2: The obligation to account for RWT on all fully-imputed dividends paid between companies should be optional. | Recommended. | *Overall efficiency:* Meets objective.<br>*Fairness/neutrality:* Meets objective.<br>*Efficiency in costs:* Meets objective. |
| Option 3: The obligation to account for RWT on all fully-imputed dividends paid between companies should be maintained (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* Does not meet objective. |

*RWT on concurrent cash and non-cash dividends*

83. Options to address concerns around the over-taxation of cash and non-cash dividends paid concurrently, as well as the unnecessary compliance costs arising from the RWT obligations which apply are:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: A taxpayer should be able to opt to treat cash and non-cash dividends paid concurrently as a single dividend, when the cash dividend is sufficient to cover the RWT obligations for both dividends. | Recommended. | *Overall efficiency:* Meets objective.<br>*Fairness/neutrality:* Meets objective.<br>*Efficiency in costs:* Meets objective |
| Option 2: A taxpayer should not be able to opt to treat cash and non-cash dividends paid concurrently as a single dividend, with the two dividends remaining separate for the purposes of the RWT obligations (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* Does not meet objective. |

***Rules which restrict commercial practice***

*LTC restriction on share classes*

84. Options to address the concern that the restriction applying to LTC shares unduly restricts commercial practice are:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: LTCs should have the option of having more than one share class. | Not recommended. | *Overall efficiency:* Partly meets objective.<br>*Fairness/neutrality:* Partly meets objective.<br>*Efficiency in costs:* Does not meet objective. |
| Option 2: A LTC should be able to have more than one class of shares provided all shares still have uniform entitlements to distributions from the LTC (i.e. differentiate on voting rights only). | Recommended. | *Overall efficiency:* Meets objective.<br>*Fairness/neutrality:* Mostly meets objective.<br>*Efficiency in costs:* Meets objective. |
| Option 3: LTCs should continue to be restricted to having just one share class (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* No impact. |

*Tainted capital gains*

85. Options to address the concerns that the tainted capital gains rule has overreach and unduly restricts commercial practice are:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: Repeal the rule. | Not recommended. | *Overall efficiency:* Meets objective, as poses tax avoidance risk.<br>*Fairness/neutrality:* Partly meets objective, to extent that rule has over-reach.<br>*Efficiency in costs:* Partly met – simplifies rules but the additional tax avoidance risk may require extra Inland Revenue enforcement. |

| | | |
|---|---|---|
| Option 2: Restrict the rules to apply only to the wholly-owned group context. | Not recommended. | *Overall efficiency:* Mostly meets objective.<br>*Fairness/neutrality:* Mostly meets objective.<br>*Efficiency in costs:* Mostly meets objective. |
| Option 3: Restrict the rules to apply only to the wholly owned group context and to sales of assets where less than 15% of the asset has been sold to a third party (i.e. 85% of the asset is held indirectly by the original owners). | Recommended. | *Overall efficiency:* Meets objective.<br>*Fairness/neutrality:* Meets objective.<br>*Efficiency in costs:* Meets objective on balance between costs to taxpayers and Inland Revenue. |
| Option 4: Do not repeal the rule (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* Does not meet objective. |

*Options for taxing shareholder salaries*

86. Options to address the concerns that the PAYE and provisional tax rules do not provide sufficient flexibility for shareholder employees whose earnings are irregular are:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: Shareholder employees should be able to choose between a mix of PAYE and provisional tax on their salaries, and the choice of method is unrestricted period to period. | Not recommended. | *Overall efficiency:* Partly meets objective.<br>*Fairness/neutrality:* Partly meets objective.<br>*Efficiency in costs:* Partly meets objective but poses tax avoidance risk which may raise costs of Inland Revenue enforcement action. |
| Option 2: Shareholder employees should be able to choose between a mix of PAYE and provisional tax on their salaries, and the choice of method is restricted period to period to prevent flip-flopping between methods in succeeding periods. | Recommended. | *Overall efficiency:* Meets objective.<br>*Fairness/neutrality:* Meets objective<br>*Efficiency in costs:* Meets objective, balances benefits to taxpayers and costs to Inland Revenue. |
| Option 3: Shareholder salaries should be subject to either PAYE or provisional tax, but not both (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* Does not meet objective. |

***Rules which fail to achieve their intended policy objectives***

*LTC eligibility criteria*

87. Options to address the concern that for LTCs owned by trusts the fact that the current eligibility criteria focus only on distributions of beneficiary income when counting look-through owners is not robust enough to ensure that LTCs are not more widely held than intended are:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: Extend the 'look-through counted owners' test to include all beneficiaries who receive any distributions (whether as beneficiary income or trustee income, corpus or capital) from LTC shareholding trusts. | Recommended. | *Overall efficiency:* Meets objective, less tax driven behaviour.<br>*Fairness/neutrality:* Meets objective, by supporting integrity of the LTC rules by helping to ensure LTCs are closely held.<br>*Efficiency in costs:* Somewhat met, requires trustees to track all distributions, but does provide greater certainty by not differentiating between distributions. |
| Option 2: Remain with status quo, and count only distributions of beneficiary income from LTC interests. | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* No impact. |

88. Options to address the concern that the current restriction around corporate ownership of LTCs is not robust enough to ensure that LTCs are not indirectly owned by corporates through trusts, are listed below:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: Trusts that own LTCs should not be allowed to have corporate beneficiaries. | Not recommended. | *Overall efficiency:* Partly meets objective.<br>*Fairness/neutrality:* Meets objective, but in practice would exclude many existing LTCs.<br>*Efficiency in costs:* Does not meet objective as may result in tax-driven restructuring. |
| Option 2: Trusts that own LTCs should be allowed to have corporate beneficiaries so long as no distributions are made to those corporate beneficiaries. | Recommended. | *Overall efficiency:* Mostly meets objective as tax-driven behaviour less likely.<br>*Fairness/neutrality:* Mostly meets objective and takes into account current structures.<br>*Efficiency in costs:* Mostly meets objective, but may raise risk of inadvertent breach. |
| Option 3: Trusts that own LTCs should be allowed to have corporate beneficiaries. | Not recommended. | *Overall efficiency:* Does not meet objective. May encourage behavioural change by corporates.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* Increased tax avoidance risk may raise costs of Inland Revenue enforcement action. |
| Option 4: Trusts that own LTCs should be allowed to have corporate beneficiaries if the total number of counted owners (including all shareholders of the corporate beneficiary) remains below 5(status quo). | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* No impact. |

89. Options to address the concern that for LTCs owned by charities (directly or indirectly through trusts) the fact that the current eligibility criteria focus only on distributions of beneficiary income when counting look-through owners is not robust enough to ensure that these LTCs are not more widely held than intended, are listed below:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: Charities are precluded from owning LTCs directly or indirectly, with no allowance for distributions akin to donations. | Not recommended. | *Overall efficiency:* Does not meet objective as will encourage tax-driven restructuring.<br>*Fairness/neutrality:* Does not meet objective. May support integrity of LTC rules but disadvantages charities through precluding genuine donations.<br>*Efficiency in costs:* Does not meet objective as costs associated with any restructuring. |
| Option 2: Charities are precluded from owning LTCs either directly or indirectly, but are allowed to make charitable distributions (capped at 10% of net LTC income received by the trust in the year). | Not recommended. | *Overall efficiency:* Partly meets objective as will be less restructuring but may discourage true donations which is inefficient.<br>*Fairness/neutrality:* Partly meets objective.<br>*Efficiency in costs:* Does not meet objective as results in compliance costs to track distributions. |
| Option 3: Charities are precluded from owning LTCs directly, but not precluded from indirectly benefiting from the LTC as either residual beneficiary of a LTC owning trust, or ordinary beneficiaries when the charity has no influence over the LTC or trust (in effect any distribution is a true gift which is freely given). | Recommended. | *Overall efficiency:* Mostly meets objective as will not lead to tax-driven restructuring and will not discourage true donations.<br>*Fairness/neutrality:* Mostly meets objective.<br>*Efficiency in costs:* Mostly meets objective. |
| Option 4: Charities should be able to own LTC interests (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective. In effect allows widely held ‘ownership’.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* No impact. |

90. Options to address the concern that for LTCs owned by Māori authorities (directly or indirectly through trusts) the fact that the current eligibility criteria focus only on distributions of beneficiary income when counting look-through owners is not robust enough to ensure that these LTCs are not widely held vehicles, are listed below:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: Māori authorities are precluded from owning LTCs directly or indirectly. | Not recommended. | *Overall efficiency:* Partly meets objective as may simply result in restructuring to other look-through vehicles given problems in using excess imputation credits from separate business subsidiaries.<br>*Fairness/neutrality:* Partly meets objective by treating corporate subsidiaries of Māori authorities equivalently to their competitors.<br>*Efficiency in costs:* Does not meet objective as may be restructuring costs. |
| Option 2: Māori authorities are precluded from owning LTCs directly or indirectly, but existing structures are grand-parented. | Recommended. | *Overall efficiency:* Partly meets objective and reduces likelihood of restructuring.<br>*Fairness/neutrality:* Partly meets objective.<br>*Efficiency in costs:* Meets objective, as limits impact on compliance costs. |

| | | |
|---|---|---|
| Option 3: Māori authorities are not precluded from owning LTCs directly or indirectly (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective as enables widely held ownership.<br>*Fairness/neutrality:* Does not meet objective. May be competition issues.<br>*Efficiency in costs:* No impact on compliance costs. |

91. Options to address the concern that LTCs are currently able to be used as conduit investment vehicles, are listed below:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: Foreign owners should not be able to own LTCs at all. | Not recommended. | *Overall efficiency:* Does not meet objective. Prevents conduit investment but restricts inbound foreign investment through a LTC.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* Does not meet objective, as would result in significant transitional costs. |
| Options 2: Foreign owners should be able to own LTCs but not earn any foreign income. | Not recommended. | *Overall efficiency:* Does not meet objective. Prevents conduit investment but precludes outbound investment through a LTC, including personal services income.<br>*Fairness/neutrality:* Does not meet objective. Foreign investment can be done directly.<br>*Efficiency in costs:* Does not meet objective, as would result in significant transitional costs. |
| Option 3: Foreign owners should be able to own LTCs, but LTCs that are foreign controlled (i.e. 50% foreign owned) should only be able to earn a limited amount of foreign income. | Recommended. | *Overall efficiency:* Meets objective, without unduly restricting foreign investment (inbound and outbound).<br>*Fairness/neutrality:* Meets objective, by supporting the integrity of the LTC rules and better targeting of restriction.<br>*Efficiency in costs:* Meets objective, as limits transitional costs to relatively few LTCs. |
| Option 4: Foreign ownership of LTCs should not be restricted and the ability to earn foreign income should not be restricted (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective given reputational concerns.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* No impact. |

*LTC entry tax*

92. Options to address the concern that the LTC entry tax is not operating as intended, are listed below:

| Options: | Recommendations | Analysis against objectives |
|---|---|---|
| Option 1: The entry tax formula should be amended to change the tax rate that applies to any income calculated by the adjustment, to the LTC shareholder's personal tax rates. | Recommended. | *Overall efficiency:* Meets objective.<br>*Fairness/neutrality:* Meets objective, by ensuring income is taxed at correct tax rates and minimising tax avoidance risk.<br>*Efficiency in costs:* Mostly meets objective. |

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|---|---|---|
| Option 2: The entry tax formula should not be amended to change the tax rate that applies to any income calculated by the adjustment (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective.<br>*Fairness/neutrality:* Does not meet objective, as does not address unfairness in current over/under taxation depending on applicable personal tax rates.<br>*Efficiency in costs:* Does not meet objective. No impact on compliance costs but may be enforcement costs. |

*Debt remission in the LTC context*

93. Options to address the concern that the interaction of the financial arrangement rules and LTC rules results in unintended debt remission income for creditor-shareholders, are listed below:

| **Options:** | **Recommendations** | **Analysis against objectives** |
|---|---|---|
| Option 1: Debt remission income should not arise for the shareholder-creditor when the debt is forgiven. | Recommended. | *Overall efficiency:* Meets objective.<br>*Fairness/neutrality:* Meets objective.<br>*Efficiency in costs:* No impact. |
| Option 2: Debt remission income should arise for the shareholder-creditor when the debt is forgiven, but they should get a bad debt deduction to offset the income. | Not recommended | *Overall efficiency:* Does not meet objective, as it may remove one distortion but it is inconsistent with the general treatment of capital losses.<br>*Fairness/neutrality:* May not meet objective.<br>*Efficiency in costs:* No impact. |
| Option 3: Debt remission income should arise for the shareholder-creditor when the debt is forgiven, and they should not get a bad debt deduction to offset the income (status quo). | Not recommended | *Overall efficiency:* No effect.<br>*Fairness/neutrality:* Does not meet objective.<br>*Efficiency in costs:* No impact. |

*QC status*

94. Options for what should be done with remaining grand-parented QCs are listed below:

| **Options:** | **Recommendations** | **Analysis against objectives** |
|---|---|---|
| Option 1: Repeal the QC regime. | Not recommended. | *Overall efficiency:* Meets objective by limiting the number of available structures, but forces re-structuring for current QCs.<br>*Fairness/neutrality:* Partly meets objective.<br>*Efficiency in costs:* Does not meet objective as raises costs for current QCs which must convert. |
| Option 2: Maintain grand-parenting but allow remaining QCs to continue (status quo). | Not recommended. | *Overall efficiency:* Does not meet objective, as allows any tax advantage to be traded.<br>*Fairness/neutrality:* Does not meet objective, as allows QCs to maintain any tax advantage.<br>*Efficiency in costs:* No impact. |

| | | |
|---|---|---|
| Option 3: Allow remaining QCs to continue but QC status would be lost on the sale of any QC shares to new owners. | Not recommended. | *Overall efficiency:* Partly meets objective, as continues any tax advantage but does remove scope for trading QCs.<br>*Fairness/neutrality:* May unfairly result in loss of QC status upon a shareholding change which is not tax-driven.<br>*Efficiency in costs:* Does not meet objective, as may lead to increased costs from unintended loss of status. |
| Option 4: Allow remaining QCs to continue but QC status would be lost if sufficient shares are sold so that there has been a change of control. | Recommended | *Overall efficiency:* Partly meets objective, as continues any tax advantage but does remove scope for trading QCs.<br>*Fairness/neutrality:* Meets objective by adequately restricting QC trading without capturing minor changes in shareholding.<br>*Efficiency in costs:* Partly does not meet objective, as will be compliance costs if choose to sell sufficient shares to lose QC status. |

## CONSULTATION

95. As part of the review process, officials held a series of meetings with a representative group from CAANZ's tax committee out of which the September 2015 issues paper, titled *Closely held company taxation issues,* was prepared.

96. Seventeen submissions were received in response to the issues paper, mainly from accounting firms plus CAANZ, the New Zealand Law Society and the Corporate Taxpayers Group.

97. Overall, the various proposed liberalisations of the current rules were strongly supported including the remedial amendments. However, some submitters thought that the proposals in the issues paper did not go far enough. Submitters were generally less supportive of the proposals to tighten the rules on who could become a LTC shareholder, designed to ensure the LTC regime was better targeted at the original intended target audience. Our expectations are that the proposed tightenings would affect relatively few LTCs.

98. The main submission points raised on the LTC eligibility criteria included general disagreement with the proposed tightening in the way that trustees and beneficiaries are counted when determining their eligibility as LTC owners, and the associated proposed preclusion of charities and Māori authorities from being LTC owners.

99. In the view of submitters, the tightening was driven by officials' concerns over situations that were unlikely, or were at the margin, but would impose additional compliance costs on a far wider group of LTCs and could increase the likelihood of inadvertent loss of LTC status.

100. Submitters agreed with the proposal to allow LTCs to have more than one class of shares and the removal, for most LTCs, of the deduction limitation rule. Submitters had mixed views on whether there should be a restriction on the use of LTCs as a conduit vehicle for international investment. Some suggested that this issue was better considered as part of the work on Base Erosion and Profit Shifting (BEPS) or that better disclosure requirements

could be used instead of the proposed threshold. There were also technical comments on the design of the threshold.

101. With regard to the proposals around the treatment of debt remission income in the LTC context, submitters were generally supportive.

102. There was mixed support for the proposed changes to the "entry tax" adjustment done at the time a company enters the LTC rules, with some submitters considering the adjustment as unduly punitive given that it requires tax to be paid with no actual distribution taking place.

103. Submitters were in agreement that QCs should be allowed to continue, but there was some debate over the merits of applying a requirement that QC status would be lost upon change of control of the company.

104. The various proposals in relation to RWT and PAYE were generally supported.

105. There was overall strong support for the proposed liberalisation of the tainted capital gains rule. We note that these submissions were on the limited liberalisation proposals recommended in the issues paper. Officials therefore expect that the wider proposal, as recommended under this RIS, will have even wider support.

106. We have taken these comments into consideration in our design of the policy details as discussed in this RIS.

## CONCLUSIONS AND RECOMMENDATIONS

107. We note that the majority of the proposals recommended below were suggested in the officials' issues paper, which contains additional background on the issues and the proposed solutions.

108. Where the proposals have been modified as a result of the submissions received in response to the issues paper, additional comments have been provided to outline officials' additional considerations.

### *Rules which impose unnecessary compliance costs*

*Deduction limitation rule*

109. Officials recommend that, except for LTCs that are in partnership or joint ventures, the LTC deduction limitation rule should be removed and previously restricted deductions be released in the 2017/18 year.

110. The removal of the deduction limitation rule is in response to general concern that the rule was not operating correctly, resulted in unnecessary compliance costs for very little effect and was overall unnecessary. This was generally supported by submitters. Instead reliance would be placed on other rules in the Income Tax Act, to preclude excessive deductions, including extending the anti-avoidance rule for partnerships of LTCs.

*RWT on dividends between companies*

111. Officials recommend the withholding of RWT by a company on a fully imputed dividend paid to another company should be made optional. This proposal reflects the fact

that the obligation to withhold RWT on a fully-imputed dividend paid to another company gives rise to unnecessary compliance costs and over-taxation of the dividend.

112. The proposal recommends that the obligation to withhold should be optional in this circumstance. This optionality reflects the fact that for some taxpayers (particularly widely held taxpayers) a requirement to not withhold RWT on fully-imputed dividends may actually raise compliance costs, as they will need to first establish which shareholders are corporates and which are not and also to differentiate between these two groups within their systems.

*RWT on concurrent cash and non-cash dividends*

113. The proposal recommends that where cash and non-cash dividends are paid contemporaneously they may be regarded as one dividend with respect to the obligation to withhold RWT, so long as the cash component is sufficient to allow for the payment of the RWT on both. This would address the current potential over-taxation of these dividends, and was supported by submitters.

***Rules which restrict commercial practice***

*LTC restriction on share classes*

114. Officials recommend that LTC shares be allowed to have more than one class, provided that all shares have uniform entitlements to all distributions. This will allow for legitimate commercial structuring or generational planning without compromising on the simplicity of the income and expenditure attribution. Submitters were widely supportive of this proposal.

*Tainted capital gains*

115. With regard to the tainted capital gains rule, officials have recommended that the rule's application be restricted to circumstances where indirectly the shareholders of the original owners still own at least 85% of the asset that gave rise to the tainted capital profit. This proposal restricts the scope of the tainting rule significantly compared with the restriction as originally proposed. In response to strong submissions that the proposals in the issues paper did not go far enough, officials did considerable further analysis on the need for the rule.

116. The rule has not been completely repealed, as was recommended by some submitters, because officials consider that it's retention for transactions within a wholly-owned group of companies is appropriate. In particular officials are concerned that repealing the rule would allow, in a wholly-owned group, for companies to realise capital profits and distribute them to shareholders "in lieu of dividends". Officials have concerns over the ability to create "capital profits" which are not real because the asset is still owned by the same shareholder(s) who own the wholly-owned group of companies.

117. The intention is that the revised test would, however, enable the un-tainting of a gain on an asset that has been sold between two wholly-owned group companies when it is subsequently sold outside the group.

*Options for taxing shareholder salaries*

118. It is recommended that salaries paid to shareholder-employees be able to be bifurcated so that the base salary is subject to PAYE and the variable amount is paid out pre-tax. This proposal will allow for additional flexibility for shareholder-employees who may be unduly constrained by the current rules. In order to ensure that the ability to switch between provisional tax and the PAYE system is not used inappropriately officials recommend that a restriction on flip-flopping is introduced at the same time. The detail of how this restriction will work has not yet been resolved, but we note that interested parties will have an opportunity to provide feedback on this detail as part of the select committee submission process on the bill.

***Rules which fail to achieve their intended policy objectives***

*LTC eligibility criteria*

119. With respect to the rules which limit the type of entity that qualifies as a LTC, referred to as the eligibility criteria, broadly officials consider general tightening is necessary to ensure that the rules are appropriately targeted. The transparent tax treatment which applies to LTCs, and in particular the treatment of capital gains earned by the LTC, is a tax favourable treatment that should not be available to more widely held investment vehicles. Many investors in widely held companies are ‘passive’ in the sense that the alternative to their holding shares in the company would be a bank deposit. In such cases company tax treatment is appropriate as the company distributions are, like interest on bank deposits, taxable in the hands of the shareholders. While there may be debate over whether drawing the boundary between individual and company treatment at five owners is appropriate, data suggests that in practice most closely held businesses have one or two owners which may be because, as noted earlier, close family groups are treated as one owner under the LTC rules.

120. Officials therefore recommend proceeding with the LTC eligibility criteria proposals, with some modifications, and specifically recommend that:

- that the rules for trusts and counted owners be amended to have regard to all trust distributions but using the current 3-4 year measurement period, with a transitional phase-in period;
- that Māori authorities be excluded from owning a LTC, but that present Māori authority LTC arrangements be grand-parented;
- that charities would be excluded from being shareholders in LTCs but would be beneficiaries of trusts shares in LTCs if they have no other interests in the trust except that of being a residual beneficiary in a wind up, or as a genuine beneficiary and the distribution would be regarded as a donation if they were paid by a natural individual;
- that LTC status would be lost if more than 50 per cent of the shareholding in a LTC is held by non-residents and the LTC’s foreign income exceeds the greater of $10,000 and 20 per cent of the LTC’s gross income;

121. In response to concerns raised by submitters in relation to the proposed changes for trusts that own LTCs, we note that the proposed changes are unlikely to have great practical

effect given the ability to treat close family members as a single owner when calculating the number of counted owners.

122. It should be noted that an additional proposal for extending the time period used for calculating ownership, to reduce the likelihood of rotating beneficiaries, was included in the officials' issues paper, but is now no longer recommended. This aspect is discussed further in Appendix 3.

123. We note that the proposal to preclude charities from owning LTCs has changed from that originally proposed in the officials' issues paper. This is in response to submitters concerns that the proposal would unduly push LTCs owned by trusts with charitable beneficiaries out of the LTC regime, despite the fact that the charitable beneficial ownership is not tax driven. The reason for tightening the rules in relation to charity interests is that charities are in effect widely held entities.

124. Officials now propose that rather than precluding charities from having an interest in a LTC, distributions to charities would be precluded except where the distribution was to a charity that had no influence over the LTC or trust from which they received the distribution. In effect the distribution would meet the key requirement for being a donation that to be a true gift it has to be freely given. The mere existence of a true residual beneficiary capacity should not taint the outcome. This approach would obviate the need for a safe-harbour threshold as originally proposed.

125. Despite submissions raising concerns over the proposal to preclude Māori Authorities from owning LTCs, officials consider the proposal should proceed. As with charities, officials' primary concern around the use of LTCs by Māori Authorities is that Māori Authorities are in effect widely held entities and, therefore, not the target market for LTCs. An alternative look-through vehicle is available under the limited partnership rules, use of limited partnerships in this circumstance is more appropriate as they are designed for more widely held investments.

126. In response to submitters' concerns that the proposals to restrict foreign income for foreign controlled LTCs are targeting behaviour at the margins, officials consider the fact that there may currently be relatively little conduit activity through LTCs does not obviate the need to act now to address the reputational risk, rather than awaiting the wider BEPS work.

127. Submitters also questioned the commerciality of the applicable thresholds. The thresholds are set to reflect the likely LTC target audience. They are intended to provide flexibility for some degree of combined non-resident shareholding and foreign income and should prevent a domestic family business inadvertently falling outside the rules through an owner emigrating.

128. Overall this proposal is not expected to apply to all LTCs that derive foreign income. Officials expect that the majority of LTCs earning foreign income will be predominantly New Zealand owned and, therefore, the rule will not apply. For those LTCs that are currently used by non-residents purely as conduit investment vehicles the proposal is intended to be prohibitive.

*LTC entry tax*

129. Officials recommend the following changes to the LTC entry tax rules:

- that the income adjustment be modified so that all taxable reserves are deemed to flow through to the owners and are, therefore, taxed at the owners' personal tax rates with imputation credits attached as appropriate;
- that the income adjustment done at the time a QC becomes a LTC be modified so that the owners are taxed only to the extent they would be normally taxed on a liquidation of the QC.

130. The proposal to amend the entry tax formula, to tax the adjustment income at the shareholders' personal tax rates rather than the company rate, is necessary to ensure that the LTC rules are not used to avoid the additional (potential 5%) tax. It supports the integrity of the LTC regime, and the Income Tax Act.

131. The remedial correction to the entry tax adjustment formula for QCs that convert to LTCs is necessary in order to ensure the LTC rules treat QC income consistently with the QC rules.

*Debt remission in the LTC context*

132. With respect to the debt remission rules, officials recommend the following:

- that remission income no longer arises to a LTC owner who has lent to the LTC and subsequently has remitted the debt, with the change applying retrospectively from the commencement of the LTC rules (this approach should also apply to partners and their partnerships or limited partnerships);
- a technical change to ensure the debt remission rules apply as intended in respect of other situations with the change applying retrospectively from the commencement of the LTC rules.

133. Both of these amendments are necessary to ensure that the debt remission rules operate as intended. In response to submitters concerns, officials recommend that any taxable income that arises as a result of the retrospective application of the second point of the proposal to years before the 2017–18 tax year be recognised prospectively in the 2017–18 tax year. This will minimise the tax consequences for taxpayers who should have had remission income arise in line with the intended operation of the rules, but who took a different tax interpretation.

*QC status*

134. With respect to existing QCs officials have recommended that their QC status should continue. This recommendation is based primarily on the understanding that there are practical constraints, such as the tax rules on the disposal of a LTC interest, that act as an understandable impediment to their conversion. To force all QCs to convert into ordinary companies or LTCs, by repealing the QC rules would result in significant costs for the owners of the remaining 70,000 QCs.

135. The proposal to restrict a change in control of the existing QCs is required in order to prevent QC trading and thereby ensure that the grandparented entities do not receive a permanent tax advantage. Officials have refined this proposal, in line with submissions, to ensure that property relationship changes and shareholder deaths are ignored when measuring a change of control.

136. Further, to ease compliance, officials have recommended that the change in control test should only apply prospectively, to changes in shareholding from the date of enactment.

## IMPLEMENTATION

137. If approved, the preferred options will primarily require changes to the Income Tax Act 2007.

138. Officials recommend any legislative changes be included in the taxation bill scheduled for introduction in March 2016 and apply, unless otherwise stated, from the commencement of the 2017–18 income year.

139. When introduced into Parliament, a commentary on the bill will be released explaining the amendments and further explanation of their effect will be contained in Inland Revenue's Tax Information Bulletin, which would be released shortly after the bill receives Royal assent.

140. Inland Revenue will administer the proposed changes. Enforcement of the changes would be managed by Inland Revenue as business as usual.

## MONITORING, EVALUATION AND REVIEW

141. In general, Inland Revenue monitoring, evaluation and review of these proposals would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

142. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary would be added to the tax policy work programme, and proposals would go through the GTPP.

## Appendix 1: Analysis of options

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| ***Theme*** | ***Rules which impose unnecessary compliance costs*** | | |
| **The deduction limitation rule:**<br><br>This rule restricts a look-through owner's ability to claim LTC deductions in excess of the money they have invested in the business. Is the rule necessary? | Option 1: Repeal the rule – entirely. | Completely reduces compliance costs, as the rule no longer exists. | Creates potential for avoidance of the deduction limitation rule which applies to limited partnerships, which are structural substitutes for groups of LTCs acting together.<br><br>Limited partnerships and their close substitutes are considered to be the areas of highest risk of excessive deductions.<br><br>Requires legislative changes.<br><br>Gives rise to a fiscal cost of $17m in the 2017-18 year. This is due to the fact that deductions will no longer be restricted and can be offset against owners' other income. |
| | Option 2: Repeal the rule except for LTCs operating in partnership or joint venture with other LTCs, and make some technical clarifications to the rule for those still covered by it. | Reduces the compliance costs associated with compliance for the majority of LTCs.<br><br>Supports the integrity of the deduction-limitation rule which applies to limited partnerships, which are structural substitutes for groups of LTCs acting together. | Does not remove compliance costs for the small number of LTCs which are acting together in partnership or joint venture with other LTCs. But there are close substitutes for limited partnerships which are subject to an equivalent rule.<br><br>Requires legislative changes.<br><br>Fiscal costs same as option 1. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| | Option 3: Maintain the rule but make some technical clarifications to the rule for those still covered by it. | Addresses some concerns over unintended outcomes. Though officials suspect that, it would not be possible to perfect the rule without introducing significant complexity.<br><br>Reduces some uncertainty at the margin where the technical errors applied. | Does not relieve the compliance costs as the rule would still need to be applied by all LTCs.<br><br>Requires legislative changes.<br><br>May give rise to a fiscal cost. This proposal has not been fully forecasted as the implications would depend on how the technical issues are resolved. Overall we would expect the fiscal cost to be less so than for option 2. |
| | Option 4: Maintain the status quo. | Does not give rise to a fiscal cost.<br><br>No legislative change is required. | Does not reduce compliance costs.<br><br>Would not resolve concerns over technical errors in the rule. |
| **The deduction limitation rule:**<br><br>If the rule is amended or repealed, what should happen to previously restricted deductions? | Option 1: Repeal the rule in part (refer option 2 above) and release previously restricted deductions in one lump at a particular point. | Allows for quick use of previously restricted deductions.<br><br>Avoids the compliance and administrative costs associated with re-stating past periods. | Does not address the tax impact of having deferred the deductions in the interim for the few owners (around 1%) that have suspended deductions.<br><br>Requires legislative changes.<br><br>Gives rise to a fiscal cost of $17m in the 2017-18 year. This is due to the fact that deductions will no longer be restricted and can be offset against owners' other income. |
| | Option 2: Repeal the rule in part (refer option 2 above) and require restatement of prior period returns on the basis that the rule had not existed. | Allows for the recognition of previously restricted deductions.<br><br>Addresses the tax impact of having deferred the deductions in the interim for the few owners (around 1%) that have suspended deductions. | The need to re-state past periods increases compliance and administrative costs. Overall, the increased administrative and compliance costs are unlikely to outweigh the benefits to the few owners (around 1%) that have suspended deductions. In other words, the economic costs are likely to outweigh the economic benefits.<br><br>Requires legislative changes.<br><br>Fiscal cost, as per option 1 above, except the 2017-18 cost would be spread retrospectively across past periods. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| | Option 3: Repeal the rule in part (refer option 2 above) and gradually release previously restricted deductions over three years. | Spreads the fiscal cost.<br><br>Does not create additional compliance and administrative costs incurred in re-stating past periods.<br><br>For some, may not be much different than full release in 2017/18, when there is insufficient other income to apply deductions against. | Requires legislative changes.<br><br>Minor additional compliance and administration costs relative to full release of deductions in 2017/18.<br><br>Delays utilisation of deductions that have been effectively freed-up.<br><br>Gives rise to a fiscal cost, as per option 1 above except the effect may be spread across three periods. |
| **Dividend rules: RWT on dividends between companies**<br><br>Should the RWT obligation to withhold 5% on fully-imputed dividends paid between all companies be removed? | Option 1: The obligation to account for RWT on all fully-imputed dividends paid between companies should be removed. | Eliminates the current over-taxation of dividends paid between companies.<br><br>Reduces compliance costs for some companies that pay fully-imputed dividends to other companies. | Potential increase in compliance costs for paying companies, by requiring them to:<br>• establish whether or not shareholders are corporate (which can be difficult for widely held companies); and<br>• differentiate between corporate and non-corporate recipients in their systems (i.e. in order to ensure RWT is withheld only on dividends to non-corporate).<br><br>Requires legislative changes.<br><br>Fiscal cost of $9m in first year of operation. |
| | Option 2: The obligation to account for RWT on all fully-imputed dividends paid between companies should be optional. | Alleviates the current over-taxation of dividends paid between companies.<br><br>Reduces compliance costs for all companies that choose to not account for the RWT and does not increase compliance costs for other companies who cannot or choose not to identify which shareholders are corporate. | Requires legislative changes.<br><br>Fiscal cost same as option 1. |

| Issue | Options | Benefits | Costs/Risks |
| --- | --- | --- | --- |
| | Option 3: The obligation to account for RWT on all fully-imputed dividends paid between companies should be maintained (status quo). | No fiscal implications.<br><br>Does not require paying companies to establish which shareholders are corporate and/or differentiate between corporate and non-corporate recipients.<br><br>No legislative change is required. | Does not eliminate nor alleviate the current over-taxation of dividends paid between companies.<br><br>Does not reduce compliance costs associated with the obligation to withhold RWT on fully-imputed dividends paid between companies. |
| **Dividend rules: RWT on concurrent cash and non-cash dividends**<br><br>Should a company paying cash and a non-cash dividends concurrently, be able to opt to treat the two dividends as a single dividend, for the purposes of the RWT obligations when the cash dividend is sufficient to cover the RWT due? | Option 1: A taxpayer should be able to opt to treat cash and non-cash dividends paid concurrently as a single dividend, when the cash dividend is sufficient to cover the RWT obligations for both dividends. | Addresses the concern that the current rule over-taxes the non-cash dividend (as a result of the gross up requirement) in these circumstances.<br><br>Reduces the compliance and administrative costs associated with the refund of the over-taxation.<br><br>Does not affect the RWT payment, as the RWT due on both dividends is covered in the cash dividend. | Requires legislative changes. |
| | Option 2: A taxpayer should not be able to opt to treat cash and non-cash dividends paid concurrently as a single dividend, with the two dividends remaining separate for the purposes of the RWT obligations (status quo). | No legislative change is required. | Does not address the concern that the current rule over-taxes the non-cash dividend (as a result of the gross up requirement) which may then require a refund if credit cannot be used against the tax liability on other income. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| *Theme* | *Rules which restrict commercial practice* | | |
| **LTC restriction on share classes**<br><br>Should LTCs be allowed to have more than one class of shares? | Option 1: LTCs should have the option of having more than one share class. | Allows for flexibility in succession planning and acceptable corporate structuring.<br><br>Remove the need for share class restructuring for companies that have existing share class differentiation and therefore cannot elect into the LTC regime currently. This would also remove what officials consider may be a deterrent to more grandparented QCs transitioning to LTCs. | Requires legislative changes.<br><br>Compromises on the simplicity of income/expenditure attribution from the LTC, by allowing for differentiation in share class entitlements to income/expenditure, which may lead to more compliance costs. |
| | Option 2: A LTC should be able to have more than one class of shares provided all shares still have uniform entitlements to distributions from the LTC (i.e. differentiate on voting rights only). | Allows for better flexibility in succession planning and acceptable corporate structuring, without compromising on the simplicity of income/expenditure attribution from the LTC.<br><br>Goes some way towards removing the need for share class restructuring in companies wanting to elect into the LTC regime (to the extent that the differentiation is only related to voting rights) including grandparented QCs transitioning to LTCs. | Requires legislative changes.<br><br>For companies whose classes of shares differ for more than just voting rights, this option would not be of benefit. |
| | Option 3: LTCs should continue to be restricted to having just one share class (status quo). | No legislative change is required. | Does not allow for flexibility in succession planning and acceptable corporate structuring.<br><br>Does not allow for companies that have existing share class differentiation to elect into the LTC regime, which may therefore continue to be a deterrent to more grandparented QCs transitioning to LTCs. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| **Tainted capital gains rule:**<br><br>Should the rule be repealed? | Option 1: Repeal the rule. | Removes the overreach imposed by the current rule.<br><br>Facilitates corporate restructuring. | Requires legislative changes.<br><br>Removes the protection that the current rule provides against non-market transactions (for example intra-group sales used to inflate capital profits or dividend strips to transfer cash from one company to another) and the other tax rules, which could apply, are considered to not offer sufficient alternative protection in these cases.<br><br>Freeing up corporate restructuring may encourage tax driven structuring, which is undesirable. |
| | Option 2: Restrict the rules to apply only to the wholly-owned group context. | Addresses some of the overreach imposed by the current rule.<br><br>Facilitates some corporate restructuring, (i.e. not in the wholly-owned group situation).<br><br>Preserves the protection that the current rule provides against non-market transactions (for example intra-group sales used to inflate capital profits or dividend strips to transfer cash from one company to another) which are more likely in the wholly-owned group context. | Requires legislative changes.<br><br>Freeing up corporate restructuring (outside of wholly-owned group) may still encourage tax driven structuring, which is undesirable.<br><br>Removes the protection provided by the current rule against non-market transactions outside of wholly-owned groups. |
| | Option 3: Restrict the rules to apply only to the wholly owned group context and to sales of assets where less than 15% of the asset has been sold to a third party (i.e. 85% of the asset is held by the original owners). | Addresses some of the overreach imposed by the current rule.<br><br>Facilitates some corporate restructuring, (outside of the wholly-owned group circumstance, and when asset ownership has not changed by more than 15%).<br><br>Provides scope for trading of assets between associates.<br><br>Bolsters other tax rules by providing protection against non-market transactions and payments in lieu of dividends through material third partly involvement (15%) bolsters other tax rules.<br><br>Provides certainty with the bright-line 15% threshold. | Requires legislative changes.<br><br>May still encourage tax driven structuring, which is undesirable. The requirement for a 15% change in ownership of the underlying asset provides some comfort that the price paid for the asset is genuine (i.e. limits the ability to generate inflated gains even outside of the wholly-owned group context).<br><br>The 15% threshold might be considered arbitrary. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| | Option 4: Do not repeal the rule (status quo). | No legislative change is required. | Does not address the concern that the current rule has overreach, and can taint genuine gains made on transfers to associates.<br><br>Does not address the concern that the current rule unduly restricts legitimate commercial restructuring. |
| **Options for taxing shareholder salaries:**<br><br>Should shareholder salaries for shareholder-employees who do not receive regular amounts or do not get paid in regular periods, be subject to PAYE, provisional tax or a mix of both? | Option 1: Shareholder employees should be able to choose between a mix of PAYE and provisional tax on their salaries, and the choice of method is unrestricted period to period. | Allows for flexibility in taxation approach, to reflect a shareholder-employee's individual circumstances. This can lead to reduced compliance costs for both employee and employer (by not requiring shareholder employees to structure their arrangements around the tax consequences).<br><br>Is an optional proposal, therefore, it will not result in any additional compliance costs for taxpayers who do not wish to use this option. | Would allow flip-flopping between methods from year to year which may allow manipulation of provisional tax requirements and may lead to additional compliance costs for employees and their employers. However as this is an optional proposal, this additional cost will only arise for taxpayers who choose to apply the mixed methods.<br><br>Requires legislative changes. |
| | Option 2: Shareholder employees should be able to choose between a mix of PAYE and provisional tax on their salaries, and the choice of method is restricted period to period to prevent flip-flopping between methods in succeeding periods. | Allows for flexibility in taxation approach, to reflect a shareholder-employee's individual circumstances which can lead to reduced compliance costs for both employee and employer.<br><br>Is an optional proposal, therefore, will not result in any additional compliance costs for taxpayers who do not wish to use this option.<br><br>Would prevent potential manipulation of provisional tax liabilities that might arise from flip-flopping between PAYE and provisional tax. | Changes between methods may lead to additional compliance costs as employees and their employers adjust to the change.<br><br>However as this additional cost will only arise for taxpayers who choose to apply the mixed methods.<br><br>Requires legislative changes. |
| | Option 3: Shareholder salaries should be subject to either PAYE or provisional tax, but not both (status quo). | Applying only one approach to taxation of income, can simplify compliance for the employer.<br><br>No legislative change is required. | Does not allow for flexibility in taxation approach, which can lead to additional compliance costs (by forcing shareholder employees to structure their arrangements around the tax consequences) for both employee and employer. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| *Theme* | *Rules which fail to achieve their intended policy objectives* | | |
| **LTC eligibility criteria: LTCs owned by trusts**<br><br>For LTCs owned by trusts is the integrity of the 'look-through counted owner' limitation undermined by the application of the rule to distributions of beneficiary income only? | Option 1: Extend the 'look-through counted owners' test to include all beneficiaries who receive any distributions (whether as beneficiary income or trustee income, corpus or capital) from LTC shareholding trusts. | Supports the integrity of the rules by:<br>• including all 'look-through owners' who benefit economically from the LTC ownership;<br>• recognising the fungibility of money; and<br>• preventing the streaming of certain types of income to selected beneficiaries.<br><br>Is not expected to disproportionally disadvantage current structures or induce tax driven behavioural changes because of the fact that the majority of LTCs currently have only one or two counted owners (assisted by the ability to treat close relatives as a single owner). | Potential to lead to some additional compliance costs for trustees given the need to keep accurate records of all distributions not just beneficiary income distributions.<br><br>Potentially increases risk of inadvertent breach by trustees who are not careful to count all distributions of trust income, corpus or capital. However we note that this is not a material risk for family trusts which make up a high proportion of all trusts.<br><br>This risk can also be ameliorated in the first instance by providing a transitional period.<br><br>Requires legislative changes. |
| | Option 2: Remain with status quo, and count only distributions of beneficiary income from LTC interests. | No increase in compliance costs.<br><br>No increase in risk of inadvertent breach. | Fails to recognise the reality that a person who does not receive beneficiary income can nevertheless benefit from a trust owning LTC shares.<br><br>Improves the integrity of the eligibility criteria as could effectively allow for more than 5 LTC owners.<br><br>Requires legislative changes. |
| **LTC eligibility criteria: LTCs owned by corporates**<br><br>Should trusts that own LTCs be allowed to have corporate beneficiaries, given that direct ownership of a LTC by a corporate (non-LTC) is prohibited? | Option 1: Trusts that own LTCs should not be allowed to have corporate beneficiaries. | Supports the integrity of the prohibition on corporate ownership of LTCs.<br><br>Reinforces the objective of ensuring that LTCs are not able to be widely held. | This would result in many LTCs failing the eligibility criteria, as many LTCs are owned by trusts which have corporate beneficiaries.<br><br>Would result in some restructuring, for LTCs owned by trusts with corporate beneficiaries, which may result in additional compliance costs (incurred in the restructure) and/or tax costs (incurred due to the consequences of LTC share disposal).<br><br>Requires legislative changes. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| | Option 2: Trusts that own LTCs should be allowed to have corporate beneficiaries so long as no distributions are made to those corporate beneficiaries. | Supports the integrity of the prohibition on corporate ownership of LTCs by restricting the economic benefits of LTC ownership from flowing through to corporate beneficiaries.<br><br>Does not result in restructuring of existing structures, as corporate beneficiaries in and of themselves do not cause the LTC to fail the eligibility criteria, so long as no distributions are made to those beneficiaries. | By not allowing for any distributions to corporate beneficiaries, including ones where the total number of counted owners (including all shareholders of the corporate beneficiary) is below 5, this proposal would preclude distribution to those corporates that meet the LTC requirements but who have not elected into the LTC rules. Currently such distributions are allowed.<br><br>It will result in some trusts incurring costs in restructuring to remove corporate beneficiaries and/or tax costs (incurred due to the consequences of LTC share disposal).<br><br>Requires legislative changes. |
| | Option 3: Trusts that own LTCs should be allowed to have corporate beneficiaries. | Allows for broader use of the LTC regime.<br><br>Has no effect on existing or future structures. | Undermines the policy intent that LTCs should not be widely held vehicles.<br><br>Poses a risk to the tax base by encouraging planning opportunities involving corporates.<br><br>Requires legislative changes. |
| | Option 4: Trusts that own LTCs should be allowed to have corporate beneficiaries, only if the total number of counted owners (including all shareholders of the corporate beneficiary) remains below 5(status quo). | Has no effect on existing or future structures as is current requirement.<br><br>No legislative change is required.<br><br>Partly meets objective of LTCs not being able to be widely held. | The integrity of the prohibition on corporate ownership of LTCs continues to be undermined.<br><br>Only partly meets objective of ensuring LTCs are not able to be widely held. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| **Eligibility criteria: LTCs owned by charities**<br><br>Should a charity be precluded from owning a LTC (which is ordinarily reserved for closely held businesses) either directly or indirectly (as a beneficiary of a trust) because a charity typically has a wide pool of beneficiaries? | Option 1: Charities are precluded from owning LTCs directly or indirectly. | Achieves the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries. | This may discourage donations, which is contrary to Government policy.<br><br>This would result in many LTCs failing the eligibility criteria, as many LTCs are owned by family trusts which commonly have residual charitable beneficiaries.<br><br>This could lead to increased compliance costs (incurred in the restructure) and/or tax costs (incurred due to the consequences of LTC share disposal) as taxpayers restructure to ensure LTC eligibility is maintained (for example by settling a separate LTC owning trust).<br><br>Requires legislative changes. |
| | Option 2: Charities are precluded from owning LTCs either directly or indirectly, but are allowed to make charitable distributions (capped at 10 % of net LTC income received by the trust in the year). | Assists the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries, by strengthening the rule.<br><br>Allows for some charitable donations. | The 10% threshold is arbitrary and may discourage large donations, which is contrary to Government policy.<br><br>This would result in many LTCs failing the eligibility criteria, as many LTCs are owned by family trusts which commonly have residual charitable beneficiaries which would lead to additional compliance costs (incurred in the restructure) and/or tax costs (incurred due to the consequences of LTC share disposal).<br><br>Requires legislative changes. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| | Option 3: Charities are precluded from owning LTCs directly, but not precluded from indirectly benefiting from the LTC as either residual beneficiary of a LTC owning trust, or ordinary beneficiaries when the charity has no influence over the LTC or trust (in effect any distribution is a true gift which is freely given). | Assists the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries, by strengthening the rule.<br><br>Allows for unlimited (genuine) charitable donations.<br><br>Does not force many LTCs out of the regime (by failing the eligibility criteria), by allowing residual charitable beneficiaries.<br><br>Would not necessitate extensive restructuring, (based on submissions received the majority of LTCs have only got charitable owners as beneficiaries of owning trusts). | Would result in some restructuring, for charities which own LTCs directly, which would lead to additional compliance costs.<br><br>Requires legislative changes. |
| | Option 4: Charities should be able to own LTC interests (status quo). | Allows for unlimited charitable donations.<br><br>Has no effect on existing structures.<br><br>No legislative change is required. | Does not achieve the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries.<br><br>May encourage more charities to use LTCs. |
| **Eligibility criteria: LTCs owned by Māori Authority**<br><br>Should a Māori Authority be precluded from owning a LTC (which is ordinarily reserved for closely held businesses) either directly or indirectly (as a beneficiary of a trust) because a Māori Authority typically has a wide pool of beneficiaries? | Option 1: Māori Authorities are precluded from owning LTCs directly or indirectly. | Achieves the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries.<br><br>To achieve equivalent transparent tax treatment, Māori Authorities would have to use limited partnerships, which are intended for use as widely held investment vehicles. | For Māori Authorities which currently own LTCs directly, this proposal would result in restructuring their separate business operation to either:<br>• an alternative look-through vehicle to achieve the same outcome, which may result in compliance cost; or<br>• to a standard company in which case there will be situations in which excess imputation credits cannot be readily utilised.<br><br>Requires legislative changes. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| | Option 2: Māori Authorities are precluded from owning LTCs directly or indirectly, but existing structures are grand-parented. | Achieves the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries.<br><br>Saves Māori Authorities the cost of restructuring their current LTC interests. | May provide Māori Authorities which currently own LTCs with some small advantage (through lower on-going operational costs) over Māori Authorities which do not currently own LTCs.<br><br>Requires legislative changes. |
| | Option 3: Māori Authorities are not precluded from owning LTCs directly or indirectly (status quo). | Has no effect on existing or future structures.<br><br>No legislative change is required. | Does not achieve the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries. |
| **Eligibility criteria: International aspects**<br><br>How should the use of LTCs as conduit investment vehicles (i.e. foreign investors earning foreign income through the LTC) be limited? | Option 1: Foreign owners should not be able to own LTCs at all. | Addresses the reputational risk posed by the use of LTCs as conduit investment vehicles. | Restricts inbound investment into New Zealand through LTCs entirely, not just in the conduit circumstance.<br><br>This would result in many LTCs failing the eligibility criteria, as many LTCs are in some part foreign owned, which would lead to additional compliance costs (incurred in restructuring affairs) and/or tax costs (incurred due to the consequences of LTC share disposal).<br><br>Would result in LTC status being lost where a resident becomes a non-resident for tax purposes.<br><br>Requires legislative changes. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| | Options 2: Foreign owners should be able to own LTCs but not earn any foreign income. | Addresses the reputational risk posed by the use of LTCs as conduit investment vehicles.<br><br>Best aligns with the intended use of LTCs as domestically focussed investment vehicles. | Restricts outbound investment by all LTCs, not just in the conduit circumstance.<br><br>This would result in many existing LTCs failing the test unless owners can easily dispose of foreign investments, which would lead to additional costs in restructuring affairs and/or tax costs through the disposal of LTCs shares).<br><br>Requires legislative changes. |
| | Option 3: Foreign owners should be able to own LTCs, but LTCs that are foreign controlled (i.e. 50% foreign owned) should only be able to earn a limited amount of foreign income. | Addresses the reputational risk posed by the use of LTCs as conduit investment vehicles.<br><br>Does not overly restrict inbound investment (by not restricting foreign ownership of LTCs), or outbound investment.<br><br>Ensures LTC use is better aligned with their intended use as primarily domestically focussed investment vehicles. | Introducing foreign income restrictions and foreign ownership restrictions can increase compliance costs as LTC owners need to check/ensure compliance. However we note that the application of the proposal is limited to foreign controlled LTCs, which is likely to be very few.<br><br>Requires legislative changes. |
| | Option 4: Foreign ownership of LTCs should not be restricted and the ability to earn foreign income should not be restricted (status quo). | Has no effect on existing or future structures.<br><br>Does not restrict inbound or outbound investment.<br><br>No legislative change is required. | Does not address the reputational risks posed by the use of LTCs as conduit investment vehicles. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| **LTC entry tax**<br><br>Should the entry tax formula be amended to change the tax rate that applies to any income calculated by the adjustment? | Option 1: The entry tax formula should be amended to change the tax rate that applies to any income calculated by the adjustment, to the LTC shareholder's personal tax rates. | Promotes equity by addressing the tax advantage which is currently only available to shareholders whose personal tax rate exceeds 28% (those on the 30% or 33% marginal tax rate). Equally addresses the tax disadvantage for shareholders with personal tax rates below 28%.<br><br>Creates certainty and reduces enforcement costs, by preventing the potential for avoidance of tax by cashed up companies who elect into the LTC regime and then subsequently liquidate.<br><br>Gives rise to a small fiscal gain. | Requires legislative changes. |
| | Option 2: The entry tax formula should not be amended to change the tax rate that applies to any income calculated by the adjustment (status quo). | No legislative change is required. | Does not address the potential over or under-taxation of shareholders (depending on their personal tax rates) which the current formula causes.<br><br>Does not resolve uncertainty over when a company that elects into the LTC regime and then subsequently liquidates, will be challenged on tax avoidance grounds.<br><br>Does not reduce enforcement costs associated with disputes on whether a company that elects into the LTC regime and then subsequently liquidates is guilty of tax avoidance. |
| **Debt remission in LTC context:**<br><br>When a shareholder loans money to their LTC and the debt is subsequently forgiven; should debt remission income | Option 1: Debt remission income should not arise for the shareholder-creditor when the debt is forgiven. | Addresses the current over-taxation in the hands of the owner who remitted the debt.<br><br>Is conceptually more sound than allowing the bad debt deduction, given that the deduction represents a capital loss. | Requires legislative changes. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| arise for the shareholder-creditor? | Option 2: Debt remission income should arise for the shareholder-creditor when the debt is forgiven, but they should get a bad debt deduction to offset the income. | Addresses the current over-taxation in the hands of the owner who remitted the debt, by allowing the deduction. | Requires legislative changes. In particular this changes the approach from the more general debt remission project which addresses the remission income. Any change in approach would be counter-productive and confusing.<br><br>Conceptually this proposal purports to give the shareholder-creditor a deduction for what is in reality a capital loss. Bad debt deductions are usually limited to debts held on revenue account. This proposal therefore diverges from the capital/revenue boundary in this context.<br><br>The deduction would have to be limited to the amount of remission income assigned to the shareholder-creditor as otherwise they would get recognition of the full economic loss for the debt which would not match the transfer to the other LTC owners (that is despite the fact that the other owners would be taxed on the transfer as debt remission income). |
| | Option 3: Debt remission income should arise for the shareholder-creditor when the debt is forgiven, and they should not get a bad debt deduction to offset the income (status quo). | No legislative change is required. | Does not address the current over-taxation in the hands of the owner who remitted the debt.<br><br>Does not allow a deduction for the economic loss to the shareholder-creditor. |
| ***QC Status:***<br><br>Should all grandparented QCs be repealed? | Option 1: Repeal all QCs. | Limits the number of available vehicles for closely held companies, which minimises the potential for tax driven structuring.<br><br>Addresses the concern that existing QCs may have a permanent tax advantage when compared to non-QCs. | Requires legislative changes.<br><br>Would give rise to significant compliance costs for QCs that would have to convert to either LTCs or ordinary companies. |

| Issue | Options | Benefits | Costs/Risks |
|---|---|---|---|
| | Option 2: Maintain grandparenting but allow remaining QCs to continue (status quo). | No legislative change is required.<br><br>Does not impose additional compliance costs by forcing conversion of current QCs. | Does not address the concern that existing QCs may have a permanent tax advantage when compared to non-QCs.<br><br>Allows for trading of QCs which undermines Parliament's intention to grandparent the regime. |
| | Option 3: Allow remaining QCs to continue but QC status would be lost on the sale of any QC shares to new owners. | Limits the life of the QC regime to the business span of existing QCs.<br><br>Prohibits any trading of QCs which supports Parliament's intention to grandparent the regime.<br><br>Eliminates the potential for tax driven structuring with respect to existing QCs.<br><br>Addresses the concern that existing QCs may have a permanent tax advantage when compared to non-QCs, by making the tax advantage available only to existing QC owners.<br><br>Does not impose additional compliance costs by forcing conversion of current QCs. | Requires legislative changes.<br><br>Does not allow for any commercial restructuring (which may not necessarily be tax driven).<br><br>Increases risk that a QC may inadvertently lose status upon the 'transfer' of a single share.<br><br>Should exclude share transfers as a result of a relationship property settlement or death of a shareholder. |
| | Option 4: Allow remaining QCs to continue but QC status would be lost if sufficient shares are sold so that there has been a change of control. | Prohibits any trading of QCs which supports Parliament's intention to grandparent the regime.<br><br>Minimises the potential for tax driven structuring with respect to existing QCs, while allowing for some commercial restructuring (which may not necessarily be tax driven).<br><br>Addresses the concern that existing QCs may have a permanent tax advantage when compared to non-QCs, by making the tax advantage available primarily to existing QC owners.<br><br>Does not create a risk of inadvertent loss of QC status, as it requires a significant change.<br><br>Does not impose additional compliance costs by forcing conversion of current QCs. | Requires legislative changes.<br><br>Should exclude share transfers as a result of a relationship property settlement or death of a shareholder. |

## Appendix 2: Analysis of remedial issues identified for amendment

| Keyword | Issue | Proposal | Comments | Nature of proposal |
|---|---|---|---|---|
| QCs and LTC entry tax | The QC rules allow for tax free distribution of capital gains and other un-imputed earnings, which are treated as exempt dividends when distributed to QC shareholders. The entry tax formula will apply to tax all un-imputed retained earnings except eligible capital profits, which for QCs which elect into the LTC rules means that tax is incorrectly overcharged to the extent that the earnings are not eligible capital profits. | Officials recommend that the adjustment formula is amended to ensure that QCs electing into the LTC regime do not get overtaxed. This would mean that reserves that are would be untaxed if distributed prior to conversion, are untaxed on conversion under the entry formula. | This technical error may be discouraging some QCs from converting to LTCs. Fixing this error may therefore result in more QCs converting to LTCs. | Technical |
| Asset value upon LTC entry | There is technical doubt about which asset values to use (cost/market value/something else) when a company elects into the LTC regime. | Officials recommend that the law be clarified so that the tax book value of assets and liabilities of a company that elects into the LTC regime are the opening tax book values for the LTC. This amendment should be made retrospective to the commencement of the LTC regime (that is, from the commencement of the 2011–12 tax year). | The policy intent is that the company's tax book values roll over into the LTC, and the LTC election tax is calculated on this basis. Officials are not aware of any taxpayer that has not used tax book values. However, this is not made clear in the legislation. | Remedial |
| Backdated dividends and shareholder current accounts | There is a concessionary rule which enables dividends to be paid to shareholders to clear their overdrawn current accounts with their dividends being regarded as being paid on the 1st day of an income year so long as the dividend is fully tax paid (that is RWT does not need to be deducted). However, due to the company tax rate being decreased, all dividends incur at least 5%RWT and the concessional backdating cannot apply. | Officials recommend that the rule is amended to allow dividends that are fully imputed (to 28%) to qualify for back dating to the 1st day of the income year, for shareholder current account purposes. | Anecdotally, taxpayers appear to observing this rule in the breech when the dividend is fully imputed. | Remedial |

| Keyword | Issue | Proposal | Comments | Nature of proposal |
|---|---|---|---|---|
| Debt remission upon exit from LTC regime or liquidation | When a LTC elects out of the regime or enters liquidation, the LTC is deemed to have disposed of all of its financial arrangements at market value and there should be debt remission income on any unpaid third party debt. The LTC legislation that governs LTCs liquidating or exiting the LTC regime (treated as a deemed liquidation) is not sufficiently clear and in insolvency situations where the remission of third party debt is likely to happen, some LTC owners are not returning the debt remission income as was contemplated. | Officials recommend that a retrospective amendment is made to ensure that the debt remission income rules apply as intended. This would mean that remission income should arise for LTC owners when they either liquidate or elect to take their company out of the LTC rules. | This is a technical change, as remission income was always intended to arise. The issue is around the market value of any impaired third party loans at the time of disposal, with some practitioners arguing that the market value of a loan, distressed or not, is the present value of its future cash flows without considering its distressed impairment. This approach ignores the risk associated with the loan.<br><br>Ensuring, that the debt remission rules work as intended is particularly important if, as recommended the deduction limitation rule is largely removed.<br><br>This proposal is expected to be fiscally positive. The retrospective application of the rule may mean that taxpayers who did not apply the rule as intended may have tax due on amounts remitted from the 2011-12 onwards. To ease compliance and to limit the adverse tax consequences for these taxpayers (for example exposure to UOMI, penalties and the need to restate prior periods), officials have recommended that any income arising as a result of the retrospective application of this remedial will be included in the 2018-19 income year. | Remedial |

## Appendix 3: Analysis of issues not progressed

| Proposal | Origin | Decision | Comments |
|---|---|---|---|
| Companies should be able to distribute capital gains tax free during the course of business, not just on liquidation. | Raised by submitters | Proposal to be considered for inclusion in the tax policy work programme. | Officials consider that the wider policy issue of capital gain distributions outside of the LTC and QC context is complex and cannot be looked at purely in isolation as part of the closely held companies review. Further work on this issue would be better handled through the standard tax policy work programme process at some future date. |
| Close companies should be able to elect out of RWT obligations on dividends and interest, subject to director's guarantee | Discussed by officials in the *Closely held company taxation* issues paper | Proposal to be considered as part of *Making Tax Simpler.* | This proposal would give rise to significant fiscal costs resulting from the deferral of tax from one period to the next. Officials consider that this proposal would best be considered in the wider context of the work being undertaken to streamline business tax processes, as discussed in the Government discussion document titled Making Tax Simpler A Green Paper (released in March 2015). |
| Extend the measurement period when counting beneficiaries who receive LTC income distributions from a trust that owns a LTC | Discussed by officials in the Closely held company taxation issues paper | Proposal should not be progressed. | This was one of two proposals recommended in the issues paper with regard to counting beneficiaries for the purposes of determining the number of LTC owners. Officials were concerned that the current 3-4 year measurement period provided the potential to 'rotate' beneficiaries so as to undermine the 5 or fewer look-through counted owner limitation and suggested extending the measurement period to 6 years, in line with general record keeping requirements. Submissions were concerned that this extension would create undue compliance costs. In response, officials recommend keeping this aspect under review to see if churning proves to be an issue in practice and if need be the matter could be addressed by an anti-avoidance rule. |
| LTC elections should not be able to be revoked by a single shareholder, and the Commissioner should have more discretion to apply late or incomplete LTC elections retrospectively. | Raised by submitters | Proposals should not be progressed. | Officials consider that given all look-through owners are personally responsible for the tax on the company's business profits, it would not be appropriate to change the rules to restrict an owner's ability to elect out of the regime. The risk of an unintended revocation is addressed both by shareholders having the ability to structure agreements to provide additional protections, as well as by the Commissioner's discretionary power to disregard a revocation notice in circumstances where the owner who made the revocation is subsequently bought out. Further, as all look-through owners are personally responsible for the tax on the company's business profits, officials consider that it would not be appropriate for the Commissioner's current discretionary power to accept late elections and apply them retrospectively, to be extended in the way suggested by the submission. |

| Proposal | Origin | Decision | Comments |
|---|---|---|---|
| The definition of close company, which refers to companies with five or fewer natural person shareholders, should be clarified to address the concern that at present the definition allegedly excludes companies owned by trusts, which is a common structure for many of New Zealand's small businesses. | Raised by submitters | Proposals should be considered for inclusion in the tax policy work programme as a separately project. | Given the time required to adequately consider the extensive use of the definition in different contexts throughout the legislation, officials have recommended that this issue should be progressed as a separate project. In the meanwhile Inland Revenue is considering issuing further guidance on point. |
| The extent of LTC transparency should be clarified. | Raised by submitters | Further consideration deferred for the time being. | There is case law on the treatment of partners in partnerships which could assist in the interpretation of the LTC rules which have been modelled on the partnership tax provisions. However, this will not assist for a LTC with a single shareholder. Officials agree that LTC transparency should be an area for further consideration, but consider the issue a low priority given that the key issue, debt remission income, is being addressed. |