

**BILL COMMENTARY**

**Taxation (Annual Rates for 2023–  
24, Multinational Tax, and Remedial  
Matters) Bill**

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Minister of Revenue

### FIRST PUBLISHED

May 2023 by Policy and Regulatory Stewardship, Inland Revenue, PO Box 2198, Wellington 6140.

Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill – commentary on the Bill

ISBN 978-1-98-857353-3 (Online)

The document is available at <https://www.taxpolicy/publications/2023/2023-commentary-multinational-tax-bill>



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# Annual rates for 2023–24

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## Annual setting of income tax rates

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### *Clause 3*

### **Summary of proposed amendment**

The Bill sets the annual income tax rates that would apply for the 2023–24 tax year. The annual rates to be confirmed are the same as those for the 2022–23 tax year.

### **Effective date**

The proposed amendment would be effective for the 2023–24 tax year.

### **Key features**

The proposed annual income tax rates for the 2023–24 tax year would be set at the rates specified in schedule 1 of the Income Tax Act 2007.



# **OECD Pillar Two: global minimum tax**

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## Overview

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In October 2021, in response to the challenges posed by the increasing globalisation and digitalisation of the world economy, over 130 countries in the Organisation for Economic Co-operation and Development (OECD) sponsored Inclusive Framework (IF), including New Zealand, endorsed a Two-Pillar solution to reform the international income tax framework for large multinational enterprises:

- **Pillar One** aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest and most profitable multinational enterprises (MNEs) around the world. It is intended that Pillar One will replace unilateral digital services taxes.
- **Pillar Two** aims to limit the 'race to the bottom' for large MNEs, where countries compete to attract mobile income (for example, interest, dividends and royalties) through offering low tax rates and tax incentives. It is also known as the global minimum tax.

The Global Anti-Base Erosion (GloBE) rules are the main component of Pillar Two. The rules are designed so that MNEs with annual revenues above €750 million pay a minimum 15% effective tax rate on their mobile income in every country where that income is earned.

The GloBE rules are intended to apply to every in-scope MNE in the world, no matter where it has its headquarters, operations or sales. The design of the rules means this intention can be achieved even if many, or indeed most, countries do not adopt the rules, provided a critical mass of countries implement the GloBE rules (that is, enough adopt the rules that domestic MNEs cannot escape the tax by earning income only in countries that do not adopt them). The rules do this by allowing countries that adopt them to tax mobile income arising in other countries if that income is not subject to a 15% effective tax rate. This creates an incentive for countries to adopt the rules or increase their taxes on mobile income.

The Bill gives legislative effect in New Zealand to the GloBE rules. The proposals in this Bill were subject to public consultation in May 2022. The term used in the Bill to describe New Zealand's GloBE rules is the 'Applied GloBE rules', and the term used in the Bill for tax imposed under New Zealand's Applied GloBE rules is the 'Multinational Top-Up Tax'.

The Applied GloBE rules consist of an Income Inclusion Rule (IIR) and an Undertaxed Profits Rule (UTPR). Together they will ensure that if a critical mass of other countries adopt the GloBE rules, such that New Zealand MNEs will need to comply with and pay GloBE tax whether New Zealand adopts the rules or not:

- New Zealand will not lose GloBE tax revenue it is entitled to collect to other countries if it enacts the rules, and

- administration and compliance costs for in-scope New Zealand MNEs and the Government will be reduced.

The application date for the Applied GloBE rules will be set by Order in Council once the Government determines that a critical mass of countries has adopted the GloBE rules. Such adoption seems very likely, though is not certain. This application date will not be earlier than 1 January 2024 for the IIR and 1 January 2025 for the UTPR.

### Abbreviations

**BEPS** Base Erosion and Profit Shifting

**CE** Constituent Entity

**DIIR** Domestic Income Inclusion Rule

**DTA** Deferred tax asset

**DTL** Deferred tax liability

**ETR** Effective Tax Rate

**GloBE** Global Anti-Base Erosion

**IF** Inclusive Framework

**IFRS** International Financial Reporting Standards

**IIR** Income Inclusion Rule

**IPE** Intermediate Parent Entity

**JV** Joint Venture

**LTCE** Low-Taxed Constituent Entity

**MNE** Multinational Enterprise

**OECD** Organisation for Economic Co-operation and Development

**PE** Permanent Establishment

**POPE** Partially Owned Parent Entity

**QDMTT** Qualified Domestic Minimum Top-up Tax

**UPE** Ultimate Parent Entity

**UTPR** Undertaxed Profits Rule

## Glossary

**Applied GloBE rules:** The GloBE rules as introduced in New Zealand.

**Constituent Entity:** a member of an in-scope MNE group.

**GloBE rules:** Two interlocking rules (IIR and UTPR) that together form the primary mechanism of Pillar Two.

**Model Rules:** A 10-chapter document setting out model legislation for governments to base domestic legislation on to enact the GloBE rules.

**Multinational Top-Up Tax:** Top-up tax imposed under the Applied GloBE rules.

**Pillar Two:** One half of a 2-pillar solution formulated by the OECD-sponsored Inclusive Framework to address tax challenges arising from the digitalisation of the economy.

## Applied GloBE Rules

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*Clauses 6, 7, 21, 44, 45, 48, 51 to 54, 59(4), (5), (11) and (12), 63 and 77, and schedule 1*

### Summary of proposed amendments

The proposed Applied GloBE rules give legislative effect in New Zealand to the Organisation for Economic Co-operation and Development (OECD) Pillar Two Global Anti-Base Erosion (GloBE) rules and deal with consequential amendments as they relate to the interaction between the GloBE rules and New Zealand tax law.

Whether an MNE has obligations for Applied GloBE rules filing and (potentially) paying Multinational Top-Up Tax is determined by applying the OECD published Model Rules<sup>1</sup> as modified by schedule 25B to the Income Tax Act 2007 (ITA), the Commentary,<sup>2</sup> and the Agreed Administrative Guidance,<sup>3</sup> which define what type of MNEs are in scope and what are the operative rules. The OECD, through the Inclusive Framework, will continue to publish Agreed Administrative Guidance, which will become part of New Zealand law.

The proposed Applied GloBE rules have implications for both MNEs headquartered inside New Zealand and those outside New Zealand.

For an MNE **headquartered in New Zealand**, or with a constituent entity (including a branch) located in New Zealand, the proposed Applied GloBE rules require the MNE to:

- **Determine whether it is in scope for the GloBE rules**, i.e. if it has an international presence and over €750 million in consolidated revenues in any two of the preceding four years (see proposed section HP 1(1) of the ITA and Chapter 1 of the Model Rules).
- **Determine whether any de minimis or safe harbour applies** in each country where it operates (see Chapters 5 and 8 of the Model Rules and the OECD document “Safe Harbours and Penalty Relief” for the transitional safe harbours that apply to fiscal years ending on or before 30 June 2028).
- **Calculate its effective tax rate (ETR)** in each country where it operates and a safe harbour does not apply (see Chapters 3 to 7 and 9 of the Model Rules).

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<sup>1</sup> OECD (2021), Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two), available at [www.oecd.org](http://www.oecd.org)

<sup>2</sup> OECD (2022), Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two), First Edition, available at [www.oecd.org](http://www.oecd.org)

<sup>3</sup> OECD (2023), Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), available at [www.oecd.org](http://www.oecd.org)

- **Calculate mobile income** by calculating the GloBE income in each country and reducing it by the substance-based income exclusion (SBIE). The SBIE is a carve-out based on tangible assets and payroll costs in a country (see Chapter 5 of the Model Rules).
- **Calculate the top-up tax** if the ETR in a country is less than 15%. The top-up tax will bring the ETR on the MNE's mobile income in that country up to 15% (see Chapter 5 of the Model Rules).
- **Pay Multinational Top-Up Tax to Inland Revenue for:**
  - Foreign operations under the **Income Inclusion Rule (IIR)**,<sup>4</sup> which applies when a New Zealand MNE earns the undertaxed income in another country (see Chapter 2 of the Model Rules).
  - New Zealand operations under the **Domestic Income Inclusion Rule (DIIR)**, which applies when a New Zealand-headquartered MNE has undertaxed mobile income in New Zealand (see proposed schedule 25B of the ITA and Chapter 2 of the Model Rules).

**MNEs headquartered outside New Zealand** could also be subject to a Multinational Top-Up Tax liability if they have an intermediate parent located in New Zealand or a liability under the **Undertaxed Profits Rule (UTPR)**<sup>5</sup> (see proposed schedule 25B of the ITA and Chapter 2 of the Model Rules).

The Bill includes consequential amendments to deal with how the GloBE rules would interact with New Zealand tax law. These amendments propose that:

- the Applied GloBE rules would apply, notwithstanding the terms of a tax treaty, unless those terms expressly refer to the GloBE rules (see proposed section BH 1(4C))
- imputation credits would not be available for top-up taxes paid under the IIR and UTPR but would be available for taxes paid under the New Zealand Domestic Income Inclusion Rule (DIIR) (see proposed sections OB 7BB and OP 11BA), and
- foreign tax credits would be available under subparts LJ and LK for top-up taxes paid under a foreign **Qualified Domestic Minimum Top-Up Tax (QDMTT)** but not for top-up taxes paid under an IIR or UTPR (see proposed section LJ 3).

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<sup>4</sup> The IIR applies on a top-down basis, giving the ultimate parent entity country, or an intermediate parent entity country, the right to collect GloBE top-up tax for underlying foreign operations, unless the tax is collected in the foreign country under a Qualified Domestic Minimum Top-Up Tax.

<sup>5</sup> The UTPR is a back-up rule that applies when no parent is subject to the IIR. It allocates top-up tax to countries in proportion to the group's payroll costs and tangible asset values in each country that adopts the GloBE rules. This ensures that if the country where an MNE has its headquarters does not implement GloBE rules, the MNE will still have to pay top-up tax.

## Background

The GloBE rules were developed by all IF member jurisdictions and agreed and approved by consensus. They were released in December 2021 as the Model Rules and provide a template that jurisdictions can translate into domestic law.

The release of the Model Rules was followed by the release of detailed commentary (the Commentary) to the rules in March 2022 and the first tranche of Agreed Administrative Guidance in February 2023. In some instances, the Commentary and Agreed Administrative Guidance modify provisions in the Model Rules. Further tranches of agreed administrative guidance will be periodically issued by the IF to supplement the Commentary by providing additional guidance on the interpretation and operationalisation of the Model Rules (including safe harbours). The further tranches of agreed administrative guidance may also effectively modify the Model Rules.

If a country adopts the GloBE rules, it must adopt the Model Rules, Commentary and Agreed Administrative Guidance. Where a country's legislation departs from the Model Rules, there is a risk its GloBE rules will not be "qualifying", and other participating jurisdictions will continue to apply GloBE top-up tax to the country's in-scope MNEs under the UTPR. To mitigate this risk in New Zealand, the GloBE rules will be incorporated into New Zealand legislation by reference to the Model Rules, Commentary and Agreed Administrative Guidance. In the limited areas where the rules need to be adapted, for example, to reflect concepts in New Zealand law like imputation credits and foreign tax credits, the adaptation will respect the intended outcomes agreed in the IF.

## Key features

The key features of the proposed Applied GloBE tax rules include:

- Incorporating the Model Rules, Commentary and Agreed Administrative Guidance developed by the OECD-sponsored Inclusive Framework into the ITA. This is done by reference to the rules, rather than by repeating or translating them in New Zealand law.
- Changes to the ITA necessary to support the interpretation and implementation of the GloBE rules in New Zealand.
- Consequential changes to the ITA necessary to ensure the Applied GloBE rules are "qualifying".
- A regulation-making power enabling the Governor-General to make Orders in Council providing for the GloBE rules to come into effect in New Zealand and to make regulations providing for the cancellation, reversal, or non-application of the Commentary or Agreed Administrative Guidance (including future tranches of agreed administrative guidance).

## Effective date

The proposed regulation-making power would take effect on the day after the date the Bill receives the Royal assent.

The application date for the Applied GloBE rules would be set by Order in Council once the Government determines that a critical mass of countries has adopted the GloBE rules. This would not be earlier than 1 January 2024 for the IIR and 1 January 2025 for the UTPR.

## Detailed analysis

The proposals in the Bill would affect:

- New Zealand-headquartered MNEs and their constituent entities (including branches) with over €750 million in global consolidated revenues, and
- Foreign-headquartered MNEs with over €750 million in global consolidated revenues that have New Zealand operations or a New Zealand intermediate parent entity if a top-up tax is due to New Zealand under the UTPR or IIR in accordance with the GloBE rules.

### Multinational Top-Up Tax will be an ancillary tax

Proposed section BF 1(b) provides that Multinational Top-Up Tax will be an “ancillary tax”, not income tax. As such, a separate administrative regime is proposed to deal with Multinational Top-Up Tax (see [Item: “Amendments to the Tax Administration Act 1994”](#) below for further detail). This also means it will not fall in scope of the provisional tax regime.

### Multinational Top-Up Tax will override our double tax agreements

The OECD has stated that the IIR and UTPR are both compatible with OECD model-based tax treaties, such as New Zealand’s. To avoid any uncertainty on this point, proposed section BH 1(4) provides that the GloBE rules adopted by New Zealand will apply notwithstanding the terms of a tax treaty, unless those terms expressly refer to the GloBE rules.

### Multinational Top-Up Tax will be payable by in-scope MNE

Proposed section HP 1 is the charging provision for the Multinational Top-Up Tax. Proposed section HP 2 provides that top-up tax would be payable 20 months after the end of the first fiscal year in which the MNE becomes in-scope of the New Zealand rules. Thereafter, top-up tax will be payable 16 months after the end of an MNE’s fiscal year.

## The Applied GloBE rules

Proposed sections HP 3 and HP 5 provide for the application of the GloBE rules in New Zealand (i.e., the Applied GloBE rules) by reference to the OECD Model Rules, Commentary and Agreed Administrative Guidance. Section HP 3 is modified by schedule 25B. The Applied GloBE rules are treated as applying at a time consistently with the most recent commentary and guidance on the interpretation or administration of the GloBE rules published by the OECD before the start of the fiscal year in which the time falls.

The Model Rules (Article 8.3.1) provide that the tax administration of an implementing jurisdiction shall, subject to any requirements of domestic law, apply the GloBE rules in accordance with any Agreed Administrative Guidance. This provision has been removed in schedule 25B to the ITA because proposed section HP 3 requires the Model Rules to be applied consistently with the Commentary and the Agreed Administrative Guidance.

Consequently, where there is an inconsistency between the Model Rules and the Commentary or Agreed Administrative Guidance, it is the Commentary and Agreed Administrative Guidance that take precedence. For example, the Model Rules provide that Article 7.4.1 only applies to investment entities. The Commentary provides that Article 7.4.1 applies to investment entities and insurance investment entities. The correct outcome is that Article 7.4.1 applies to investment entities and insurance investment entities.

Proposed section 226G of the Tax Administration Act 1994 provides that the Governor-General, by Order in Council made on the recommendation of the Minister of Revenue, shall make regulations providing for the cancellation, reversal, or non-application of a change to the Commentary or the Agreed Administrative Guidance (including future tranches). Although it is unlikely that this power will be used, it makes explicit the power of the New Zealand Parliament in the future to reject, in whole or in part, changes to the rules occurring at the level of the OECD.

## The Model Rules

This Guidance Material item provides an overview of the Model Rules and how they would be implemented in New Zealand. Further detail on the Model Rules, Commentary and Agreed Administrative Guidance is available at the OECD website.<sup>6</sup>

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<sup>6</sup> <https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm>

## Chapter 1: Scope

This Chapter discusses which types of entities are in scope for the Model Rules. The GloBE rules apply to MNEs that have consolidated annual revenues of at least €750 million in at least two of the last four fiscal years. The fiscal year is the period covered by the MNE group's consolidated financial statements.

Special rules exist to address situations when:

- an MNE does not prepare consolidated financial statements
- an MNE does not have four years of consolidated financial statements
- one of the four preceding fiscal years is for a period other than 12 months, or
- an MNE has undergone a merger or demerger.

### MNE groups

The Ultimate Parent Entity (UPE) of an MNE group is the entity that owns – directly or indirectly – a controlling interest in any other entity but is not controlled – directly or indirectly – by another entity. The UPE is important because the IIR is applied at the UPE level in the first instance (if the UPE's jurisdiction has a qualified IIR), and the UPE's consolidated financial statements determine what entities are within the group.

An 'MNE group' is a group with at least one entity or permanent establishment (PE) that is not located in the jurisdiction of the UPE. Regardless of size, a group that is located entirely within one jurisdiction with no offshore subsidiaries or PEs is therefore outside the scope of the GloBE rules. A member of an MNE group is referred to as a 'Constituent Entity' of the group.

### Excluded entities

The following entities are excluded from the GloBE rules:

- Governmental entities.
- International organisations.
- Non-profit organisations.
- Pension funds.
- Investment funds that are UPEs.
- Real estate investment vehicles that are UPEs.

An entity owned by an excluded entity can also qualify as an excluded entity if it meets certain criteria relating to its ownership, assets and income.

## Chapters 2-5: Key operative rules

The GloBE rules apply a minimum tax on the excess profits in each jurisdiction that are taxed below the minimum 15% rate. The key operative rules cover the steps required to determine whether top-up tax is payable and where this would be paid.

The first step is to determine the profit in a jurisdiction. This is calculated by simply adding together the GloBE income and GloBE losses of all the Constituent Entities in the jurisdiction.

If the result is positive, the Effective Tax Rate (ETR) will need to be calculated for that jurisdiction. The only exceptions to this are when the jurisdiction qualifies for a GloBE safe harbour (in Chapter 8 of the Model Rules) or the de minimis exclusion (in Article 5.5 of the Model Rules). The latter will be when the average GloBE revenue (that is, gross income before expenses) and GloBE income (that is, net income) in the jurisdiction for the current and two prior years are below €10 million and €1 million respectively.

### The Effective Tax Rate

This section explains the different components of the ETR calculation in Chapters 3 to 5 of the Model Rules. It sets out the main features of the rules and notes special rules that apply in particular circumstances.

The ETR for a jurisdiction is the total tax divided by the total profit in that jurisdiction. There are detailed rules prescribing what taxes can be included in this calculation, which are referred to as 'covered taxes', and how to calculate the profit in the jurisdiction, which is referred to as 'GloBE income'.

In-scope MNEs must calculate their ETRs for each jurisdiction annually. Calculating the ETR for a jurisdiction broadly involves four steps:

- First, the MNE must identify its constituent entities in the jurisdiction. The Model Rules set out how to work out which jurisdiction an entity is located in.
- Second, the MNE must work out the 'GloBE income' or profit of each constituent entity in the jurisdiction. This starts with an entity's accounting profit. Adjustments are then made to the accounting profit to reflect the agreed GloBE base. Some adjustments are mandatory, while others are elective. There are also rules for allocating profit between jurisdictions.
- Third, the MNE must determine the covered taxes of the constituent entities in the jurisdiction. This requires consideration of the types of taxes that count as 'covered taxes' and which year those taxes are allocated to. The starting point for calculating covered taxes is the accounting current tax expense. Adjustments are then made to the current tax expense, including an adjustment based on deferred tax, to address timing differences between accounting and tax. There are also rules for allocating covered taxes between jurisdictions.

- Lastly, the ETR is derived by aggregating covered taxes and GloBE income and losses of the constituent entities in a jurisdiction. The total taxes are divided by the total net GloBE income to get the ETR for the jurisdiction.

These steps are discussed in more detail below.

#### *Step 1: Identify the constituent entities in a jurisdiction*

The GloBE rules calculate the ETR for a jurisdiction as a whole. This ensures that an MNE with a high ETR in a jurisdiction does not become liable for a top-up tax because of an isolated low-tax entity whose low level of taxation could be a function of its relationship with other entities in the jurisdiction.

Chapter 10 of the Model Rules determines where an entity is located. Most constituent entities will be located in the jurisdiction where they are tax resident. Where a constituent entity is not tax resident in a jurisdiction, it will be located in the jurisdiction where it was created, for example, where it was incorporated.

Specific rules locate tax transparent entities, like partnerships and permanent establishments (PEs), for the ETR calculations and charging provisions.

#### *Step 2: Calculate the GloBE income for each constituent entity*

The starting point is the entity's financial accounting profit. This is then subject to adjustments that IF countries agreed are desirable to reconcile the most important and common differences between accounting and tax definitions of profit. These adjustments are intended to bring the GloBE base more into line with a measure of taxable profit so that the ETR provides a reasonable measure of the level of effective taxation in that jurisdiction.

There are also rules to appropriately allocate certain types of income between jurisdictions.

#### Accounting profit

The calculation of a constituent entity's GloBE income starts from its financial accounting income. The general rule is that this income should be calculated according to the accounting standard of its UPE and therefore reflects the amount that feeds into the UPE's consolidated financial statements before consolidation adjustments.

This is subject to a requirement that the UPE prepares its accounts under an acceptable accounting standard, or that it adjusts any material differences in its accounting treatment of an item that could result in the MNE obtaining an unfair competitive advantage when compared with the IFRS treatment. NZ IFRS is an acceptable accounting standard for the GloBE rules.

The Model Rules recognise there are situations when it may not be practicable to accurately calculate the entity's accounting profit under the UPE's accounting standard.

### Adjustments to accounting profit

Once the MNE has computed the financial accounting income of the constituent entity, the next step is to make the mandatory adjustments.

These adjustments generally reflect significant differences between accounting and tax measures of profit that do not reverse out over time. Separate rules address timing differences in the recognition of income and expenses for accounting and tax, which are covered further below.

Certain elective adjustments are also available to the MNE group. These include an election to offset a net realised gain on local tangible assets against a net realised loss on local tangible assets in the four preceding years and spread any remaining net realised gain equally over the current year and four preceding years.

The election to spread back a net realised gain on local tangible assets should be useful in a jurisdiction, such as New Zealand, that does not tax some capital gains (though gains on sales of shares in companies more than 10 percent owned are already excluded from the GloBE base). The election will allow untaxed gains to be matched against prior year untaxed losses. It will also allow tax to be imposed at greater than the 15% rate in the spread-back years to reduce or eliminate any GloBE liability that would otherwise arise from the untaxed gain.

### Special rule for incentive tax credits

A special rule prescribes the treatment of government incentives delivered as credits via the tax system. This rule is intended to apply to incentives to engage in certain activities, such as research and development.

When an incentive tax credit is designed so that it must be paid in cash or cash equivalents within four years, it can be treated as GloBE income for the GloBE rules instead of as a reduction to covered taxes.

New Zealand's research and development tax credit is designed so that it must be partially refunded within four years. The portion that must be refunded within four years is the amount calculated under section LA 5(4B)(a) of the ITA and referred to as the 'maximum limit of the person's refundability cap' for the year in which the associated research and development expenditure is incurred. Officials' view is that under the Model Rules this amount can be treated as GloBE income and any remaining credit must be treated as a reduction to covered taxes (even if it gives rise to a tax reduction or other benefit within the four-year period).

The mandatory adjustments and remaining elective adjustments are described in Chapter 3 of the Model Rules.

### Special rules for acquisitions and disposals

Articles 6.2 and 6.3 of the Model Rules provide special rules for calculating GloBE income (and covered taxes) when a constituent entity joins or leaves a group and when there are transfers of assets or liabilities.

### Special rules for Ultimate Parent Entities that are subject to a tax neutrality regime

There are also special rules in Chapter 7 of the Model Rules for calculating the GloBE income of a UPE that is subject to a tax neutrality regime, that is, a regime that achieves a single level of taxation on business income.

Article 7.2 applies to a UPE that is subject to a deductible distribution tax regime. This Article will be relevant to a New Zealand co-operative UPE. It allows such a UPE to reduce its GloBE income (but not below zero) by the amount that is distributed as a deductible dividend within 12 months of the end of a fiscal year if the dividend recipient is:

- subject to tax on the dividend at a nominal rate that equals or exceeds 15% within 12 months of the end of the group's fiscal year
- a natural person who is a tax resident in the UPE country, or has a fixed establishment in the UPE country, and holds an ownership interest in the UPE of 5 percent or less, or
- resident in the UPE country and is a governmental entity, international organisation, non-profit organisation or pension fund that is not a pension services entity.

### Allocating income between jurisdictions

The GloBE rules are designed to ensure that MNEs pay tax at a rate of 15% on their profits in each jurisdiction (after taking into account a substance-based carve-out). This means tax imposed at a high rate on profits in one jurisdiction cannot be used to credit low-taxed profits in another jurisdiction. Consequently, allocating profits appropriately between jurisdictions is integral to the GloBE rules.

The Model Rules achieve this through:

- valuing cross-border intragroup transactions in accordance with the arm's length principle, when this is different to the transfer price used for accounting
- requiring financial accounting profits to be allocated between a PE and its head office entity based on the attribution of income and expenses to the PE for tax purposes (special allocation rules apply to PEs of entities subject to a worldwide tax system, such as New Zealand's), and
- allocating the income of a tax transparent constituent entity (when not attributable to a PE) to its owners to the extent the owners also treat the entity as tax transparent (that is, tax the income) or are not members of the MNE group.

### *Step 3: Determine the taxes paid by constituent entities*

#### Covered taxes

Covered taxes are generally limited to taxes on net income in the Model Rules. This limitation reflects that the GloBE rules are intended to ensure a minimum level of tax is paid on the profit in each jurisdiction. It follows taxes should only be included in covered taxes when they are levied on a measure of income.

This means corporate income taxes will generally be covered taxes. However, when an income tax is refundable or creditable to the beneficial owner of a dividend distributed by a constituent entity (for example, by way of imputation), it will only qualify as a covered tax if the credit is provided:

- under a foreign tax credit regime by a jurisdiction other than the jurisdiction that imposed the income tax
- to a beneficial owner of the dividend that is subject to tax on the dividend, at a rate that equals or exceeds the minimum rate, in the jurisdiction that imposed the corporate income tax
- to an individual beneficial owner of the dividend who is tax resident in the jurisdiction that imposed the income tax and who is subject to tax on the dividend, or
- to a governmental entity, international organisation, resident non-profit organisation, resident pension fund, resident investment entity that is not a group entity, or a resident life insurance company to the extent the dividends are received in connection with a pension fund business and subject to tax in a similar manner as a dividend received by a pension fund.

The Model Rules refer to an income tax that is charged under a qualifying imputation system as a Qualified Imputation Tax. New Zealand's corporate income tax meets the definition of a Qualified Imputation Tax and is therefore a covered tax. Australia's corporate income tax is similarly a covered tax.

Withholding taxes and other taxes that are imposed in lieu of a corporate income tax are also covered taxes. Taxes on payroll or sales will not be counted. New Zealand's goods and services tax is not a covered tax, as it is not charged on a measure of income.

#### Calculating covered taxes for the relevant year

Having established which taxes qualify, the next step is to determine the amount of those taxes in the relevant year. The Model Rules look first to the current tax expense recorded in the financial statements to determine the amount of covered taxes that have been paid.

This amount is adjusted – for example, to exclude any tax paid in respect of income excluded from GloBE income – to exclude current tax accrued in relation to an uncertain tax position and to add any covered taxes that have been treated as an expense in the accounts.

An adjustment is also required when an amount of covered tax is refunded or credited to a group entity and the refund or credit is not treated as a reduction to the current tax expense in the financial accounts. An example of this in a New Zealand context is a tax credit for a supplementary dividend, which is typically accounted for directly in equity instead of as a reduction to the current tax expense. An adjustment would be required for GloBE purposes to reduce the current tax expense by the amount of this credit.

The remaining adjustments are described in Chapter 4 of the Model Rules.

#### Refundable tax credits

As discussed above, the treatment of incentive tax credits in the Model Rules depends on their refundability. Tax credits designed in such a way that they must be refunded within four years are referred to as Qualified Refundable Tax Credits and are treated as GloBE income. Refundable tax credits that do not satisfy this refundability requirement are referred to as Non-Qualified Refundable Tax Credits and are treated as a reduction to covered taxes.

This means an adjustment must be made to increase covered taxes when a Qualified Refundable Tax Credit is accounted for as a tax credit or to reduce covered taxes when a Non-Qualified Refundable Tax Credit is accounted for as income.

#### Timing differences

The Model Rules also include rules designed to address circumstances when the period in which profits are taxed is different to the period in which they are recognised in GloBE income. This difference typically arises from differences between when income and expenses are recognised for accounting and tax purposes. For example, capital assets are often depreciated at different rates.

Without rules to address these differences, an MNE could suffer a top-up tax because it appears to be low-taxed, when in fact the income has been taxed in a different period from the one in which it has been recognised for the ETR calculation. While this deferral can be of significant benefit if it is long term, the Model Rules have been designed generally (but not always) so that timing benefits do not give rise to the imposition of tax. At least in part, this was to avoid the need to provide refunds of GloBE tax.

The Model Rules address this issue using an approach based on deferred tax accounting. Deferred tax accounting is an accounting concept that seeks to match taxes to the period in which the income or expenses are recognised for accounting purposes. It does this by shifting the tax expense from the year the tax is paid to the years in which the income or expenditure is recognised in the financial statements.

In the Model Rules, this means the covered taxes are adjusted by the constituent entity's deferred tax income or expense in the period.

**Example 1: Timing differences**

A constituent entity accrues a current tax expense of \$10 for fiscal year 1 and a deferred tax expense of \$5 due to a temporary difference between accounting and tax. The deferred tax expense of \$5 is added to the current tax expense of \$10 to give \$15 of covered taxes for Fiscal Year 1.

The temporary difference reverses in Fiscal Year 2, resulting in an increase to the current expense for that year of \$5 and a decrease to the deferred tax expense of \$5, that is, the deferred tax liability of \$5 unwinds. The decrease in the deferred tax expense in Fiscal Year 2 offsets the increase in the current tax expense. So, if there was a current tax expense for Fiscal Year 2 of \$10, the decrease in the deferred tax expense in that year would be deducted from this to give covered taxes of \$5.

Recognising the deferred tax expense in each year effectively brings forward the \$5 of tax relating to the temporary difference to the year when the deferred tax liability is first recognised (rather than the year when the tax is actually paid).

Some modifications to an entity's deferred tax accounting used in its financial statements ensure the outcomes are appropriate for the GloBE rules.

Revaluing deferred taxes

The Model Rules require the deferred tax expense for financial reporting purposes to be valued at the lower of the minimum rate and the applicable tax rate. This ensures there is no top-up for the timing difference when the local tax rate is above the minimum rate without enabling additional upfront credits for deferred tax liabilities to shelter other exempt income in that year.

**Example 2: Revaluing deferred taxes**

A constituent entity has a temporary difference between accounting and tax of \$100 for the Fiscal Year due to immediately expensing an asset under the local tax rules where it is resident. The local tax rate is 28%. Therefore, the constituent entity recognises a deferred tax liability of \$28 for accounting purposes, which increases the deferred tax expense by \$28.

This deferred tax expense must be recast to the minimum rate for GloBE purposes ( $\$100 \text{ temporary difference} \times 15\% = \$15$ ), which means covered taxes can only be increased by \$15 due to deferred tax.

The Model Rules also exclude certain types of deferred tax movements. These include deferred tax movements for income or expenses excluded from GloBE income and deferred tax from uncertain tax positions.

### The recapture

A recapture rule applies for deferred tax liabilities (DTLs) when a DTL has not unwound within five years of the Fiscal Year in which the DTL was originally recognised.

Under this rule, the MNE group is required to recompute its ETR in the year the DTL was originally recognised. This ETR is recalculated without the DTL. If the revised ETR results in a top-up, this top-up is added to the top-up in the current year.

Some types of timing difference are exempt from the recapture rule. These include those for:

- Accelerated depreciation on tangible assets.
- Fair value accounting.
- Research and development expenses.

These timing differences do not need to be recaptured even if it takes longer than five years for the DTL to unwind.

### Losses

The timing difference rules also address tax losses. These rules are also based on deferred tax accounting, which means covered taxes are reduced (potentially to a negative number) in the year the local tax loss arises and a deferred tax asset (DTA) is recognised. Covered taxes are then increased in the year the loss is used and the DTA unwinds. This is done by taking account of the deferred tax expense accrued in the financial accounts, which could be a positive or negative figure.

#### **Example 3: Losses**

A constituent entity has a tax loss and GloBE loss of \$100 in Fiscal Year 1. The local tax rate is 15% so the constituent entity recognises a loss deferred tax asset in this year of \$15 (\$100 tax loss x 15%).

In Fiscal Year 2, the constituent entity earns \$100 of net income for local tax purposes (before tax losses brought forward) and \$100 of GloBE income. For accounting purposes, there is no current tax expense in Fiscal Year 2 because the tax loss brought forward of \$100 reduces taxable income to zero, but a deferred tax expense of \$15 is recognised because the loss deferred tax asset is written off when the tax loss is used. The deferred tax expense increases covered taxes by \$15 in Fiscal Year 2. As a result, there would be no top-up tax in Fiscal Year 2 (or Fiscal Year 1).

As the DTA is based on the tax loss available under the tax rules of the local jurisdiction, further rules ensure the appropriate relief is given.

For example, the DTA could be based on an economic loss that would also be recognised in the GloBE income or loss. These losses are recognised in the Model Rules to prevent top-up taxes being applied in a later (profit) year when the MNE has not made an economic profit over time. The loss could also be created by a timing difference between the accounts and the local tax system, in which case the accounting will recognise both a DTA and a DTL.

However, the local tax loss could also be caused by certain features of that jurisdiction's tax rules – for instance, if the jurisdiction exempted certain types of income from tax or provided tax deductions in excess of the cost incurred ('super deductions').

These local tax concessions are not intended to be recognised in the GloBE base and should ordinarily reduce the ETR when there is net GloBE income in the jurisdiction. However, without further rules, they would be incorporated in the GloBE base if they produced a local tax loss and the related DTA could be used for GloBE purposes.

Consequently, a special rule identifies the amount of loss relief that would have been available in the jurisdiction if the DTA was based on the GloBE base rather than the local tax rules. Any excess losses are deemed to be losses arising from permanent differences and give rise to an additional top-up for that year under Article 4.1.5 of the Model Rules.

This ensures that MNEs receive appropriate relief in the GloBE rules for economic losses and for those created through timing differences, while preventing excessive relief when the loss arises from a permanent difference.

#### **Example 4: Losses and permanent differences**

An MNE has one constituent entity in a jurisdiction that has a tax rate of 15%. This constituent entity has a GloBE loss for the fiscal year of \$100 but a local tax loss of \$200 because \$100 of income earned is exempt for local tax purposes. The constituent entity recognises a DTA of \$30 (\$200 tax loss x 15% tax rate) in the fiscal year.

Absent an adjustment, this DTA would increase covered taxes by \$30 for GloBE purposes (when the tax loss is used in the future), sheltering \$200 of GloBE income. This would not be appropriate because the constituent entity has only suffered an economic loss of \$100. The Model Rules address this issue by charging additional top-up tax of \$15 in the fiscal year (that is, in the year there is \$100 of exempt income for local tax purposes).

Where additional top-up tax arises under Article 4.1.5, an MNE can elect to apply the Carry-forward of Excess Negative Tax Expense administrative procedure. Under this procedure, the MNE avoids the immediate cash impost by carrying forward the Excess Negative Tax

Expenses to future periods. Further guidance on this procedure is available in the Agreed Administrative Guidance.

An election also allows an MNE to create a DTA for the GloBE rules based on the GloBE loss in the jurisdiction multiplied by the minimum rate. This may be useful for MNEs with operations in zero tax countries, where the MNE would get no benefit under a system based on deferred tax.

#### Assigning taxes to a jurisdiction

As with the rules allocating income between jurisdictions, the Model Rules contain similar rules allocating certain covered taxes. These generally seek to assign the tax to the jurisdiction to which the income is allocated so that all the taxes paid on this income are taken into account.

For example, taxes paid by a (head office) entity on the profits of its permanent establishments are assigned to the jurisdiction where the permanent establishment is located. Similarly, controlled foreign company (CFC) charges are 'pushed down' to the CFC so that the tax and income are aligned. There are similar rules to assign taxes for transparent entities, hybrid entities and reverse hybrids.

There is a limit on the extent to which CFC tax charges and taxes on hybrid entities can be pushed down when the tax is charged for passive income. In these cases, the tax can only be pushed down to achieve the minimum rate on that income. Any tax that is not pushed down is included in the covered tax calculation for the owner that was subject to the tax charge.

Withholding taxes are generally assigned to the constituent entity that recognises the income in its financial accounts rather than the entity that deducts the tax on payment. An exception exists for withholding taxes on dividends paid to other constituent entities, and this also applies to net basis taxes on dividend income. Both these taxes are assigned to the entity that paid the taxable distribution. The logic is that these taxes can be seen as an additional tax on the profit of the distributing entity.

#### *Step 4: Calculate the ETR*

Finally, the ETR for a jurisdiction is calculated by dividing the total covered taxes for a jurisdiction (the aggregate of covered taxes in Step 3 for each constituent entity) by the total GloBE income in that jurisdiction (the aggregate of the GloBE income or loss in Step 2 for each constituent entity).

#### **Example 5: The ETR calculation**

An MNE has two constituent entities in Jurisdiction A. Constituent Entity 1 has covered taxes of \$6 million and GloBE income of \$80 million for the current fiscal year, and

Constituent Entity 2 has covered taxes of \$4 million and GloBE income of \$20 million. The MNE's ETR for Jurisdiction A is 10% (covered taxes of \$10 million/GloBE income of \$100 million).

On a standalone basis, Constituent Entity 1's ETR is 7.5% (\$6 million/\$80 million) and Constituent Entity 2's ETR is 20% (\$4 million/\$20 million). Constituent Entity 1's low ETR is due to tax concessions in Jurisdiction A that apply to its business activity. The GloBE rules permit outcomes within a jurisdiction to be blended, which means Constituent Entity 2's excess taxes (that is, taxes in excess of 15%) are used to increase the ETR for Jurisdiction A.

When an MNE has GloBE income and negative covered taxes (that is, prima facie, a negative ETR), the Carry-forward of Excess Negative Tax Expense administrative procedure must be applied. Under this procedure, the MNE must carry forward the Excess Negative Tax Expenses to future periods, resulting in an ETR for the current year of 0%. Further guidance on this procedure is available in the Agreed Administrative Guidance.

#### Further special rules for calculating ETRs

Special rules exist for calculating the ETR of stateless entities, joint ventures and minority-owned constituent entities.

#### **Calculating the top-up tax**

When the ETR in a country is below the 15% minimum rate, the next step is to determine how much top-up tax is owed for each entity in the country.

To do this, MNEs must work out the top-up tax percentage, which is the difference between the minimum rate and the ETR in the jurisdiction. That top-up tax percentage is applied to the MNE's GloBE income in the jurisdiction, after deducting a substance-based income exclusion, to calculate the jurisdictional top-up tax. Finally, the jurisdictional top-up tax is allocated between the constituent entities located in the jurisdiction.

This section explains these rules for calculating the top-up tax and allocating it between low tax constituent entities. They are in Chapter 5 of the Model Rules.

#### *The steps*

There are several steps in the top-up tax calculation in the Model Rules:

- Compute the top-up tax percentage.
- Calculate the substance-based income exclusion.
- Deduct the substance-based income exclusion from the net GloBE income in the jurisdiction to determine the excess income.

- Calculate the top-up tax in the jurisdiction by:
  - multiplying the excess income by the top-up tax percentage
  - adding any additional top-up tax calculated for earlier years and for current year permanent differences when there is a GloBE loss in a jurisdiction.
- Allocate the top-up tax for the jurisdiction between the constituent entities in that jurisdiction.

These steps are explained in more detail in the remainder of this section.

#### *Compute the top-up tax percentage*

The top-up tax percentage must be calculated when the ETR is below the 15% minimum rate. It is calculated simply by subtracting the ETR from the minimum rate and represents the additional tax rate that needs to be charged on the low-taxed profits to bring the tax on those profits up to the minimum.

#### **Example 6: The top-up tax percentage**

Assume the same facts as in example 5 above. The MNE has two constituent entities in Jurisdiction A and its ETR for Jurisdiction A is 10% (covered taxes of \$10 million / GloBE income of \$100 million).

The top-up tax percentage for Jurisdiction A is calculated by subtracting the ETR of 10% from the GloBE tax rate of 15%. This results in a top-up tax percentage for Jurisdiction A of 5%.

#### *Calculate the substance-based income exclusion*

The top-up tax percentage is applied to the net GloBE income in the jurisdiction that exceeds the substance-based income exclusion. This approach ensures the substance-based income exclusion does not inappropriately increase the ETR in the jurisdiction.

The substance-based income exclusion is a formulaic carve-out that excludes a reasonable return to the level of substance in the jurisdiction from top-up tax. This is based on a percentage of the MNE's payroll costs and tangible assets in the jurisdiction, on the grounds that employment costs and tangible assets tend to be relatively immobile factors of production and are therefore reasonable proxies for substantive economic activities.

#### The percentage

The substance-based income exclusion, or "carve-out", will be 5 percent of the carrying value of the payroll costs and tangible assets in the jurisdiction. An increased amount applies in the transition period, which begins on 1 January 2023 and lasts for 10 years.

In this transition period, the carve-out for payroll costs is 10 percent in the first year, and then it is reduced by 0.2 percent per year for the next five fiscal years and 0.8 percent per year for the remaining four fiscal years. The carve-out for tangible assets is 8 percent in the first year, and then it is reduced by 0.2 percent per year for the next five fiscal years and 0.4 percent per year for the remaining four fiscal years.

#### Payroll costs

The payroll carve-out for a jurisdiction is based on payroll costs for a constituent entity located in the jurisdiction for employees and independent contractors that perform activities for the MNE in that jurisdiction.

For this purpose, independent contractors include only natural persons and may include natural persons who are employed by a staffing or employment company but whose daily activities are performed under the direction and control of the MNE. Independent contractors do not include employees of a corporate contractor providing goods or services to constituent entities in the jurisdiction.

The payroll costs include employee benefits that provide a direct personal benefit to the employee, like health insurance and pension contributions, as well as wages and salary costs. Payroll taxes and social security contributions borne by the employer are also included.

#### Tangible assets

The tangible asset carve-out is based on the average of the opening and closing carrying value (net of accumulated depreciation) of tangible assets in the financial statements. The tangible assets that qualify include property, plant and equipment, natural resources (including land not held for sale, lease or investment), as well as licences for the use of immovable property or exploitation of natural resources. The asset must be located in the jurisdiction of the constituent entity that owns it.

Assets that are leased also qualify for the lessee, which provides consistency between owned and leased assets. Where an asset is leased from another group member, the asset will only be included in the jurisdiction of the lessee.

Special rules to determine how the carve-out is allocated for permanent establishments and for transparent entities are included in Article 5.3.6 and Article 7.4.6 respectively.

**Example 7: Calculating the substance-based income exclusion**

Assume the same facts as example 6 above. Constituent Entity 1's payroll costs for activities performed in Jurisdiction A is \$30 million for the current fiscal year, and its tangible assets located in Jurisdiction A have an average accounting carrying value for the current fiscal year of \$170 million. Constituent Entity 2 has no payroll costs or tangible assets.

The substance-based income exclusion for Jurisdiction A is calculated as follows\* ((payroll costs of \$30 million x 5 percent) + (tangible assets of \$170 million x 5 percent)) = \$10 million. Therefore \$10 million would be deducted from the MNE's GloBE income for Jurisdiction A when calculating the income subject to top-up tax.

\* Assume the carve-out percentages have reduced to 5 percent in the year of the example.

*Compute the top-up tax in the jurisdiction*

The top-up tax for the jurisdiction is calculated by deducting the substance-based income exclusion from the net GloBE income in the jurisdiction and then multiplying the result by the top-up tax percentage.

**Example 8: Computing the top-up tax**

Assuming the same facts as in example 7 above, the MNE's top-up tax for Jurisdiction A for the current fiscal year equals \$4.5 million:

(net GloBE income of \$100 million – the substance-based income exclusion of \$10 million) x the top-up tax percentage of 5%

If an adjustment is made that results in a decrease to the liability for covered taxes in a prior year (for example, when a tax return is reassessed resulting in a reduction to the tax liability for a prior year), the GloBE rules require the ETR in the earlier year to be recalculated unless the decrease is less than €1 million, in which case it can be included in the current year. This includes when the recapture rule is applied to deferred tax liabilities that have not unwound within five years. When these recalculations result in an ETR falling below the minimum rate, the additional top-up tax for that year is added to the current year's top-up tax and charged in the current fiscal year.

**Example 9: Decrease in covered taxes for a prior year**

Assume the same facts as in example 8 above. Constituent Entity 2's Jurisdiction A income tax return for a prior year has been reassessed, resulting in a reduction in its local tax liability for that prior year of \$1.2 million but no change in its GloBE income for that year. The Jurisdiction A ETR and top-up tax is recalculated for this prior year resulting in additional GloBE top-up tax for the year of \$1 million.\*

This additional top-up tax of \$1 million is added to the \$4.5 million top-up tax for the current fiscal year, resulting in total top-up tax for the current fiscal year of \$5.5 million. The GloBE return for the prior fiscal year is not reassessed.

\* The reduction in the prior year local tax liability doesn't result in a Dollar-for-Dollar increase in top-up tax because of the impact of the substance-based income exclusion in the prior year.

*Allocation of a jurisdiction's top-up tax to constituent entities*

The final step in calculating the top-up tax is to allocate the jurisdictional top-up tax to the individual constituent entities in the low tax jurisdiction. This paves the way for the final step in the GloBE tax process, which is for the tax allocated to the low tax entities to then be allocated under Article 2 of the Model Rules to the entities required to pay tax under the IIR and UTPR.

This allocation between the low-taxed constituent entities is necessary to deal with situations when some of the top-up tax is charged to an entity that is not the UPE. For example, if the UPE is not subject to a qualified IIR, the top-up tax may be collected through a combination of the IIR applied at different levels of the group structure, the UTPR (as described in the next section) and the QDMTT. Allocating the top-up tax to individual constituent entities ensures the different charging rules can be coordinated.

It is also necessary because the IIR is intended to collect top-up tax from a parent entity based on its interest in a low-taxed constituent entity. This means that where a parent applying the IIR does not wholly own a low-taxed constituent entity, it will only bear the cost of its proportional share of top-up tax. Allocating top-up tax to low-taxed constituent entities is an important step in achieving this outcome.

The GloBE rules generally allocate the top-up tax for a jurisdiction between the constituent entities located in the jurisdiction based on their proportion of the jurisdictional GloBE income.

**Example 10: Allocating top-up tax to constituent entities**

Assuming the same facts as in example 9 above, the total top-up tax for Jurisdiction A for the current fiscal year of \$5.5 million is allocated to each constituent entity located in Jurisdiction A based on its proportion of the net GloBE income for Jurisdiction A.

Constituent Entity 1 is allocated \$4.4 million ((Constituent Entity 1 GloBE income of \$80 million / jurisdictional GloBE income of \$100 million) x top-up tax of \$5.5 million).

Constituent Entity 2 is allocated \$1.1 million ((Constituent Entity 2 GloBE income of \$20 million / jurisdictional GloBE income of \$100 million) x top-up tax of \$5.5 million).

Special rules deal with situations when top-up taxes are payable and there is no GloBE income in the jurisdiction, for example, when all the top-up tax for the year relates to a recalculation of the ETR from an earlier year.

**Imposition of top-up tax**

As outlined above, the IIR and the UTPR both allocate the liability to pay top-up tax on foreign constituent entities between the MNE's entities. The QDMTT (Qualified Domestic Minimum Top-up Tax) can be contrasted with the IIR and UTPR, as a QDMTT applies exclusively to domestic constituent entities.

The IIR and the UTPR are designed to work together and are also coordinated to ensure the right amount of top-up tax is collected when multiple IIRs or UTPRs are applied at the same time in different jurisdictions. Therefore, both rules start from the same top-up tax calculation explained above, which allocates top-up tax amongst constituent entities in a low tax jurisdiction.

This part of the Guidance Material sets out the ordering rules that prescribe how the QDMTT, IIR and UTPR operate together and how top-up tax is imposed on an MNE's entities. The rules are in Chapter 2 of the Model Rules.

**QDMTT**

If the country where the income is earned has enacted a QDMTT, the top-up tax will be paid first to that country.

A QDMTT is a minimum tax implemented and administered in a way that is consistent with the outcomes provided for under the GloBE Rules and Commentary such that it increases the MNE group's domestic liability on domestic excess profits to the minimum rate. The definition also prohibits the provision of benefits to the MNE group related to the GloBE rules.

Under the QDMTT, the jurisdictional top-up tax calculation is based on 100% ownership interest, irrespective of the actual ownership interests held by the parent entity of the MNE group in the constituent entities located in the QDMTT jurisdiction. In some situations, imposing the whole amount of the jurisdictional top-up tax under a QDMTT will result in a greater tax charge than the tax charge that would otherwise have been imposed under the IIR, as the IIR takes into account minority ownership interests.

A QDMTT excludes from the covered tax calculation:

- taxes paid or incurred by a constituent entity owner under a CFC tax regime allocable to a domestic constituent entity, and
- taxes paid or incurred by a main entity allocable to a permanent establishment located in the jurisdiction.

This means taxes paid under the New Zealand CFC regime or by New Zealand head offices for their permanent establishments will not be creditable against a foreign QDMTT. However, taxes paid under a foreign QDMTT will give rise to a foreign tax credit in New Zealand under subparts LJ and LK of the Income Tax Act 2007.

#### *IIR ordering rules*

The IIR takes the top-up tax calculated for a low-taxed constituent entity (LTCE) and then imposes this tax on a parent entity in the LTCE's group.

When a parent applies the IIR, the amount of top-up tax it is charged is based on the amount of top-up tax calculated for the relevant LTCE multiplied by the parent's allocable share of the LTCE's income.

The allocable share is a measure of the parent's rights to the profit of the LTCE and is calculated based on accounting principles. The test works by determining the proportion of the LTCE's GloBE income attributable to the parent (that is, after adjustment for interests held by other owners).

#### The top-down approach

There will often be MNE structures where more than one group entity has an interest in the LTCE. The GloBE rules establish:

- which entities in the group apply the IIR, and
- if more than one group entity applies the IIR for the same LTCE, what adjustments are made to avoid over-taxation.

#### Which entities apply the IIR

The GloBE rules include a priority order for applying the IIR.

The basic structure is a top-down approach. This means the UPE jurisdiction will usually have the first right to charge the top-up tax for low tax jurisdictions (other than the UPE jurisdiction itself, unless it is in a country that has adopted a domestic IIR).

If the UPE is not subject to a qualified IIR, intermediate parent entities located in other jurisdictions and held directly by it (second tier entities) will apply the IIR to LTCEs in other jurisdictions to the extent of their direct and indirect interest in those LTCEs.

To the extent that the above steps do not result in the imposition of the full amount of top-up tax calculated under chapter 5 of the GloBE rules, third tier intermediate parent entities may have an IIR liability, and so on. Intermediate parent entities are entities that are controlled by the UPE and have an ownership interest in the LTCE, but investment entities are excluded.

Unless the split ownership rules apply (see below), an intermediate parent entity (lower IPE) will not apply its IIR if:

- the UPE is subject to a qualified IIR,<sup>7</sup> or
- another intermediate parent entity (higher IPE) that owns, directly or indirectly, a 'controlling interest'<sup>8</sup> in the lower IPE is subject to a qualified IIR.

If the higher IPE does not have a controlling interest in the lower IPE, the lower IPE's IIR will not be switched off. As explained below, the lower IPE will charge its IIR, but the higher IPE must reduce its share of the top-up tax by the tax charged by the lower IPE.

#### Adjustments if more than one group entity applies the IIR

If more than one parent entity in a group applies the IIR for an LTCE, parent entities applying the IIR must reduce their own top-up tax liability by any top-up tax allocated to a parent entity further down the group structure. This prevents double allocation of the same top-up tax amount.

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<sup>7</sup> The exception to this is when there is a partially owned parent entity (POPE) lower down the group structure. A POPE is a parent entity where at least 20% of its shares are held by minority shareholders.

<sup>8</sup> 'Controlling interest' is defined in the GloBE rules. Broadly, the GloBE definition means an ownership interest such that the parent is required to consolidate the subsidiary's financials on a line-by-line basis in accordance with an acceptable financial accounting standard (or would have been required to, had it prepared consolidated financial statements). It does not mean an ownership interest over 50%.

**Example 11: Multiple intermediate parents**

The amount of top-up tax calculated for an MNE's low-taxed constituent entity (LTCE) is \$100. The LTCE is 100 percent directly owned by Parent B. Parent A owns 20 percent of Parent B – it does not have a controlling interest.

Both Parent A and Parent B are in jurisdictions with a qualified IIR. The UPE of the group is not in a jurisdiction with a qualified IIR.

Since Parent A does not have a controlling interest in Parent B, both parents apply the IIR. However, since Parent B's IIR will charge the full \$100 of top-up tax, Parent A's share of the top-up tax is reduced from \$20 to nil. The full amount of top-up tax is charged to Parent B under the IIR.

Exception: the split ownership rules

The split ownership rules are an exception to the IIR's general top-down approach. Under the GloBE rules, an intermediate parent entity that is more than 20 percent owned by minority investors outside the MNE group is called a partially owned parent entity (POPE). The POPE definition is satisfied even if minority investors *indirectly* own more than 20 percent of the ownership interests in the parent entity. A parent entity owned by a POPE will therefore usually also be a POPE.

POPEs have priority rights to apply the IIR, notwithstanding the general top-down approach. The reason for this is that when there are substantial minority interests, some amount of the top-up tax would not be collected at all if the IIR were only applied by parent entities higher up the ownership structure.

**Example 12: Partially owned parent entities (POPEs)**

The amount of top-up tax calculated for an MNE's LTCE is \$100. The UPE indirectly owns the LTCE through A Co. The UPE owns 60 percent of A Co, and A Co owns 100 percent of the LTCE.

Under the GloBE rules, A Co (and not the UPE) would apply the IIR and pay \$100 of top-up tax. By charging all the top-up tax to A Co, the top-up tax is effectively borne 60 percent by the UPE and 40 percent by the minority shareholders.

If this were not the case and only the UPE applied the IIR, the UPE would only be charged \$60 of the top-up tax based on its allocable share. The remaining \$40 would not be collected under either the UTPR or the IIR.

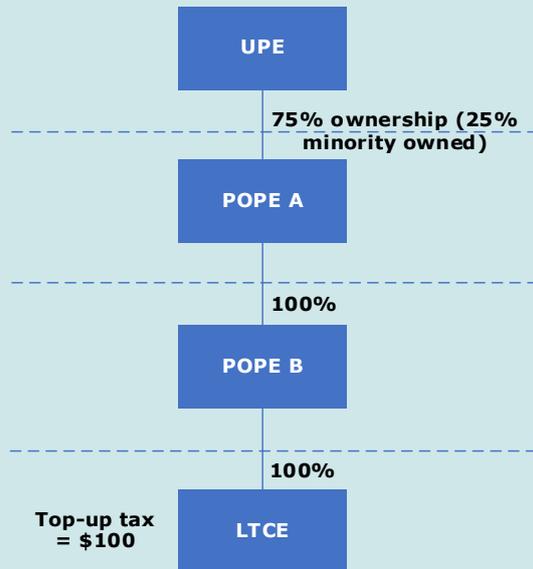
The ordering rules for POPEs require a lower-tier POPE to switch off its IIR only if it is wholly owned by a higher POPE that is subject to the IIR.

**Example 13: POPE rules and corresponding tax reductions**

The amount of top-up tax calculated for an MNE’s LTCE is \$100. The UPE indirectly owns the LTCE through a chain of POPEs. The UPE directly owns 75 percent of POPE A, with the remaining 25 percent held by minority investors outside the MNE group. POPE A directly owns POPE B (ownership percentage varies under the two examples below). POPE B directly owns 100 percent of the LTCE.

**POPE A owns 100 percent of POPE B**

If POPE B is 100 percent owned by POPE A, POPE A would apply the IIR and be charged \$100 of top-up tax. POPE B would not be required to apply the IIR.



**POPE A owns 90 percent of POPE B, with the remaining 10 percent owned by outside investors**

If POPE B is only 90 percent owned by POPE A, both POPEs would apply the IIR.

POPE B would be charged \$100 of top-up tax. POPE A would also apply the IIR, but its top-up tax liability would be reduced to zero by the amount of tax charged to POPE B.

As noted above, if a parent entity further down the group structure has applied the IIR, the liability of any parent further up the group applying the IIR must be reduced. The amount of the reduction is the top-up tax paid by the lower parent under an IIR multiplied by the higher parent’s ownership interests in the low-taxed entity held indirectly through that lower parent. So, for example, if the lower parent pays top-up tax of \$100 for a low-taxed entity

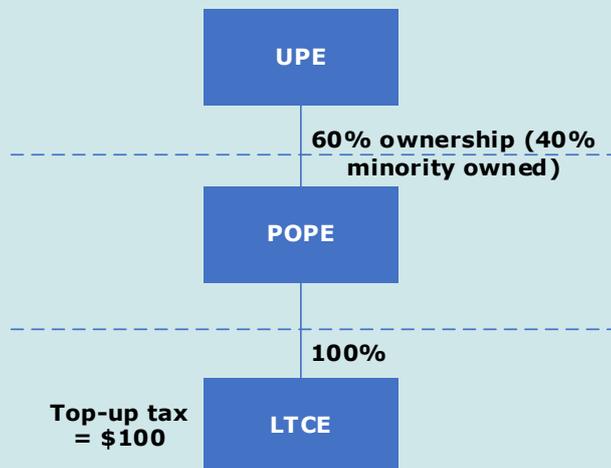
and the higher parent indirectly holds a 60 percent ownership interest in that same low-taxed entity through the lower parent, then the amount of the reduction is  $\$100 \times 60\% = \$60$ .

#### Example 14: Reduction for top-up tax charged to lower parent

The amount of top-up tax calculated for an MNE's LTCE is \$100.

##### The UPE indirectly owns the LTCE through a POPE

Assume the POPE directly owns 100 percent of the LTCE, and the UPE directly owns 60 percent of the POPE, with the remaining 40 percent held by minority investors outside the group.

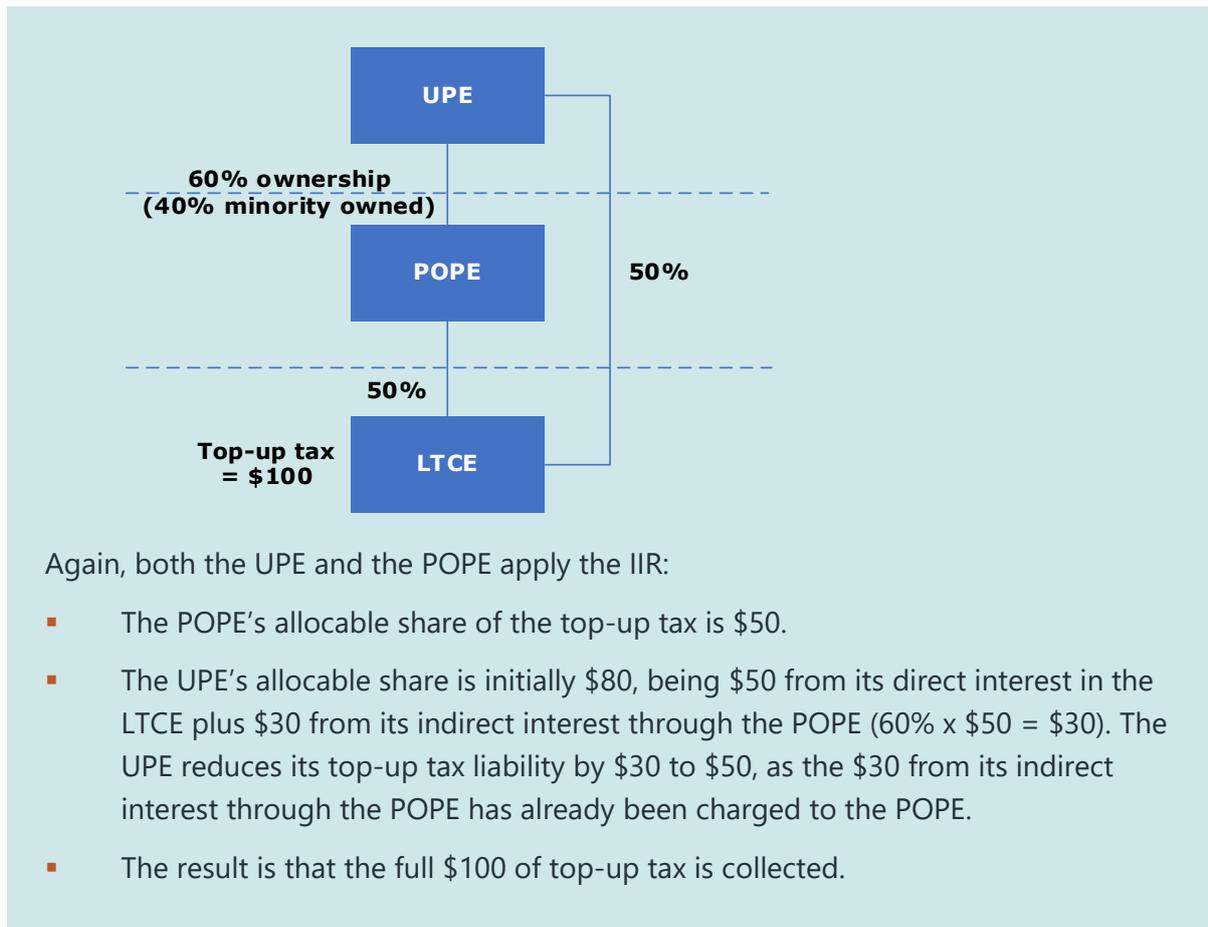


Both the UPE and the POPE apply the IIR:

- The POPE's allocable share of the top-up tax is \$100.
- The UPE's allocable share is initially \$60, but this is reduced by the top-up tax paid by the POPE multiplied by the UPE's ownership interest in the LTCE held indirectly through the POPE. This reduction equals \$60 ( $\$100 \times 60\% = \$60$ ), meaning the UPE has zero allocable share. This is appropriate because the top-up tax has already been fully charged to the POPE.

##### The UPE owns the LTCE both directly and indirectly through a POPE

Assume the POPE owns 50 percent of the LTCE, and the UPE owns the other 50 percent. As above, the UPE also directly owns 60 percent of the POPE with the remaining 40 percent held by minority investors outside the group.



### The UTPR

Like the IIR, the UTPR allocates top-up tax. The UTPR primarily functions as a backstop to the IIR.<sup>9</sup> It aims to ensure that top-up tax for an LTCE is paid even if its parent entities are located in jurisdictions without a qualified IIR. This eliminates the incentive for an MNE to headquarter in a country without an IIR.

As the UTPR is a backstop, the GloBE rules give the IIR priority over the UTPR in charging tax on low-taxed profits outside of the UPE jurisdiction. The UTPR therefore does not apply when all the interests in the LTCE are held by parent entities subject to a qualified IIR.

The UTPR applies if some of the interests in an LTCE are not held by parent entities that are subject to a qualified IIR. However, any top-up tax collected under the UTPR is reduced by the amount that is charged under an IIR. This ensures the IIR takes priority.

<sup>9</sup> It also ensures that any LTCEs in the UPE's jurisdiction are subject to top-up taxation.

**Example 15: Interaction between IIR and UTPR**

The amount of top-up tax calculated for an MNE's LTCE is \$100. The MNE's UPE indirectly owns 100 percent of the LTCE through two companies – A Co (which owns 60 percent) and B Co (which owns 40 percent). A Co is in a jurisdiction with a qualified IIR. B Co and the UPE are not.

Applying the IIR, A Co's allocable share of the top-up tax is \$60. The remaining \$40 of top-up tax is allocated to the MNE's constituent entities under the UTPR.

How the UTPR allocates top-up tax to different jurisdictions

Unlike the IIR, which allocates top-up tax to entities by allocable share or ownership, the UTPR allocates top-up tax to *jurisdictions* based on where the group's tangible assets and employees are located.

The UTPR uses an allocation key to allocate the top-up tax between the different jurisdictions in which the MNE has constituent entities. The top-up tax is only allocated to jurisdictions that have implemented a qualified UTPR (a 'UTPR jurisdiction').

The allocation is calculated at a jurisdictional level. The top-up tax is allocated based on the proportion of the tangible assets and number of employees in each UTPR jurisdiction. There are equal weights for the asset and employee factors.

**Example 16: UTPR allocation**

An MNE consists of one company in Jurisdiction P with permanent establishments in Jurisdictions A, B, C, D and E.

The value of tangible assets and number of employees owned by the MNE located in each jurisdiction are:

- Jurisdiction A: \$400 million tangible assets, 500 employees
- Jurisdiction B: \$400 million tangible assets, 300 employees
- Jurisdiction C: \$100 million tangible assets, 200 employees
- Jurisdiction D: \$100 million tangible assets, no employees
- Jurisdiction E: No tangible assets or employees.

The MNE's total value of tangible assets in all UTPR jurisdictions is \$1 billion, and the total number of employees in all UTPR jurisdictions is 1,000.

Jurisdiction P has not adopted the GloBE rules. Jurisdictions A, B, C, D and E have all adopted the GloBE rules and implemented the UTPR. The PE in Jurisdiction A is low tax, having a top-up tax amount under Article 5 of \$100,000.

The share of Jurisdiction A's top-up tax allocated to Jurisdictions A, B, C and D under the UTPR is calculated as follows:

- Jurisdiction A:  $50\% \times (400\text{m}/1\text{b}) + 50\% \times (500/1,000) = 45\%$
- Jurisdiction B:  $50\% \times (400\text{m}/1\text{b}) + 50\% \times (300/1,000) = 35\%$
- Jurisdiction C:  $50\% \times (100\text{m}/1\text{b}) + 50\% \times (200/1,000) = 15\%$
- Jurisdiction D:  $50\% \times (100\text{m}/1\text{b}) + 50\% \times 0 = 5\%$
- Jurisdiction E will not be allocated any top-up tax, even though it is a UTPR jurisdiction, as it has no tangible assets or employees.

The data for this allocation can be taken from the MNE's Country-by-Country report, provided the report is prepared in accordance with the GloBE rules' definitions for Number of Employees and Tangible Assets. This will minimise the additional compliance burdens on MNEs and improve coordination by basing the calculation on existing, readily available and objective data.

## **Chapter 6: Mergers or acquisitions**

Chapter 6 contains special rules dealing with corporate restructurings (including mergers, acquisitions, and demergers) and transfers of assets or liabilities. The chapter also addresses the application of the GloBE Rules to certain holding structures such as Joint Venture investments and Multi-Parented MNE Groups.

## **Chapter 7: Tax neutrality or existing distribution tax regimes**

There are special rules in Chapter 7 of the Model Rules for calculating the GloBE income of a UPE that is subject to a tax neutrality regime, that is, a regime that achieves a single level of taxation on business income. Article 7.1 applies to a UPE that is a flow-through entity, and Article 7.2 applies to a UPE that is subject to a deductible distribution tax regime.

## **Chapter 8: Administration**

Chapter 8 of the Model Rules sets some of the administration rules for the regime.

## The GloBE Information Return

Article 8.1 covers the GloBE Information Return (GIR), which is discussed in more detail in the [Item: "Amendments to the Tax Administration Act 1994"](#) below.

## Safe Harbours

Article 8.2 covers safe harbours. When an MNE meets the conditions of a safe harbour, the MNE's top-up tax for a jurisdiction shall be deemed to be zero for a fiscal year.

Permanent safe harbours are being developed by the IF and will be released in future tranches of the Agreed Administrative Guidance. The IF has already released a transitional safe harbour that applies during the Transitional Period (that is, from fiscal years beginning on or before 31 December 2026 but not including a fiscal year that ends after 30 June 2028).<sup>10</sup>

The transitional safe harbour is designed to provide transitional relief for MNEs in the initial years during which the GloBE rules come into effect.

The transitional Country-by-Country (CbC) Report safe harbour is designed as a short-term measure that would effectively exclude an MNE's operations in certain lower-risk jurisdictions from the scope of the GloBE rules in the initial years.

The safe harbour would allow an MNE to avoid undertaking full GloBE calculations in a jurisdiction where it can demonstrate, using a Qualified CbC Report and Qualified Financial Statement, that it meets one of the following tests.

### *De minimis test*

The de minimis test applies where the MNE group reports total revenue of less than €10 million and profit (loss) before income tax of less than €1 million in the jurisdiction in its Qualified CbC Report for the fiscal year.

A Qualified CbC Report is a CbC Report prepared and filed using Qualified Financial Statements.

Qualified Financial Statements include:

- the accounts used to prepare the consolidated financial statements of the UPE, or
- financial statements of each constituent entity, provided they are prepared in accordance with either an acceptable financial accounting standard or, in some cases, an authorised financial accounting standard.

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<sup>10</sup> OECD, 2022, Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two), available at [www.oecd.org](http://www.oecd.org)

### *Simplified ETR test*

The simplified ETR test applies where the MNE group has a simplified ETR that is equal to or greater than the transition rate in the jurisdiction for the fiscal year.

The simplified ETR is calculated by dividing the jurisdiction's simplified covered taxes by its profit (loss) before income tax as reported on the MNE group's Qualified CbC Report.

The simplified covered taxes is a jurisdiction's income tax expense as reported on the MNE group's Qualified Financial Statements, after eliminating any taxes that are not covered taxes and uncertain tax positions reported in the MNE group's Qualified CbC Report.

The transition rate is 15% for fiscal years beginning in 2023 or 2024, 16% for fiscal years beginning in 2025 and 17% for those beginning in 2026.

### *Routine profits test*

The routine profits test applies where the MNE group's profit (loss) before income tax in the jurisdiction under the CbC Report is equal to or less than the substance-based income exclusion amount for constituent entities located in that jurisdiction, as calculated under the GloBE rules.

**Note:** the routine profits test uses revenue and profit (loss) before income tax from an MNE's Qualified CbC Report, but MNEs would be required to perform a full substance-based income exclusion calculation to meet the routine profits test.

### *Rules for using the transitional safe harbour*

If an MNE group has not applied the transitional CbC Report safe harbour in a jurisdiction in a fiscal year in which the MNE group is subject to the GloBE Rules, the MNE group cannot qualify for this safe harbour for the jurisdiction in a subsequent year. This is the "once out, always out" rule.

An MNE that qualifies for the transitional CbC Report safe harbour on a jurisdictional basis is still subject to the GloBE Rules and the safe harbour does not discharge the MNE group from complying with group-wide requirements. For example, an MNE group would still need to prepare and file its GloBE Information Return during the transitional period.

Special rules apply to certain entities and groups, including UPEs subject to deductible dividend regimes.

If the conditions of the transitional CbC Report safe harbour are not met, then the general rules apply, and any potential liability to top-up tax must be computed under the ordinary GloBE Rules.

## Chapter 9: Transition

Chapter 9 of the Model Rules sets out transitional rules. Some of these rules apply to all MNEs as they address transition issues arising because the GloBE rules are new. Other transitional rules apply to entities and groups when they first come within the scope of the GloBE rules (for example, through organic growth or a merger), even if that occurs after the GloBE rules have been in place for some time.

An MNE's transition year is determined on a jurisdictional basis. For a jurisdiction, the first fiscal year that the MNE comes within the scope of the GloBE rules is a "transition year" unless the MNE qualifies for a transitional safe harbour, in which case it would be the first fiscal year in which the relevant tested jurisdiction no longer qualifies for or applies the transitional safe harbour. An MNE may therefore have different transition years for different jurisdictions.

The transitional rules described in this chapter of the Model Rules:

- Allow higher percentages to be used in calculating the substance-based income exclusion in the first 10 years of the GloBE rules.
- Allow for a longer filing deadline in an MNE's transition year.
- Address the treatment of losses and other timing differences.
- Provide temporary relief from the UTPR for MNEs in the initial phase of international activity.

### Substance-based income exclusion

As described above, the percentages used in the substance-based income exclusion are higher for the first 10 years of the GloBE rules.

### Longer filing deadline in transition year

An MNE is normally required to file its GloBE return and other notifications within 15 months after the end of its accounting period. In an MNE's transition year, this deadline is extended to 18 months.

### Losses and timing differences

Once an MNE becomes subject to the GloBE rules, it will have to calculate its ETR in each jurisdiction where it operates. Losses and accounting-tax timing differences may occur before an MNE's transition year that affect its ETR calculation in its transition year and later years.

For example, if an MNE's pre-transition year losses were not taken into account at all, the MNE could have an inappropriately low ETR in a year when those losses are used to reduce local taxable income.

To prevent this, when there are losses and other timing differences arising before a transition year, the MNE will generally be treated as though it were already subject to the GloBE rules at the time the losses or timing differences arose. This is done by taking into account existing deferred tax accounting attributes (including deferred tax assets from earlier losses) in the ETR calculation described in Chapter 5. Consistent with that treatment, the amount of deferred tax assets (DTA) recorded for the purpose of Article 9.1.1 shall be equal to the DTA accrued in the financial accounts if the tax rate used to determine the DTA is below the minimum rate. In any other case, such DTA shall be determined in accordance with the following formula:

$$\frac{\text{Deferred tax assets reflected in the financial accounts}}{\text{Applicable domestic tax rate}}$$

X Minimum Rate

The applicable domestic tax rate is the tax rate in the fiscal year preceding the transition year. More detail is available on this in the Agreed Administrative Guidance.

The treatment of losses under the GloBE rules is described on page 15 and in Chapter 5 of the Model Rules.

Deferred tax assets generated after 30 November 2021 from items that are excluded from the GloBE base must be disregarded for GloBE purposes. In addition, the GloBE tax basis in assets acquired in an intragroup transaction after 30 November 2021 must be based on historical carrying values, and related deferred tax assets and liabilities must similarly be determined based on historical carrying values. This is to prevent inappropriate tax planning transactions.

### **MNEs in the initial phase of international activity**

There is temporary relief from the UTPR for MNEs in the initial phase of international activity. An MNE is in its “initial phase of international activity” if it has constituent entities in no more than six jurisdictions and has less than €50 million of tangible assets (by book value) outside of the jurisdiction in which it has the most tangible assets (again, by book value). The relief applies on an annual basis.

Because it does not apply for the IIR, this relief is only relevant for groups that are headquartered in a country that does not have an IIR, and even then, the relief will be somewhat undercut if the group has a lower tier parent company in a country with an IIR.

The temporary relief expires after the MNE has been within the scope of the GloBE rules for five years. This five-year period is not suspended if, for example, the MNE’s revenues decline so that it falls outside the scope of the rules during those five years.

**Example 17: Five-year limit to initial phase relief**

A multinational group (NewGroup) crosses the €750 million consolidated annual revenue threshold for the first time in its fiscal year ended 31 December 2030. Its consolidated annual revenues for the following four fiscal years are as follows:

- 2031: €780 million
- 2032: €600 million
- 2033: €640 million
- 2034: €720 million

As explained above, the GloBE rules apply to MNEs that have consolidated annual revenues of at least €750 million in at least two of the last four fiscal years. The first year in which the GloBE rules apply to NewGroup is therefore 2032.

Assuming NewGroup meets the other requirements for the initial phase relief from the UTPR, it will qualify for the relief in 2032, and the last year for which it can obtain the relief is the 2036 year. It does not matter that NewGroup's annual revenues fell below the €750 million threshold from 2032 to 2034.

**Chapter 10: Definitions**

Chapter 10 of the Model Rules sets out the key definitions and the rules for determining where an entity is located for applying the key operative rules.

**Consequential amendments to the ITA****Foreign tax credit rules**

Proposed new section LJ 3 would work in conjunction with section LJ 1(1) to provide that GloBE top-up tax paid under the IIR or UTPR would not be creditable for non-GloBE income tax purposes. This is because the top-up tax is determined after taking into account income tax imposed on the income attributable to a country, whether that tax is imposed by the country itself or another country (for example, under a worldwide or CFC tax regime). Similarly, proposed new section DB 1(1)(cb) would deny a deduction for these taxes.

Foreign tax credits would be available for GloBE top-up tax paid under a QDMTT. This credit would be available against a New Zealand CFC tax liability and a head-office tax liability for a New Zealand MNE's permanent establishments.

## Imputation credits

Proposed new sections OB 7BB and OP 11BA and the proposed amendments to tables O1 and O19 provide that Multinational Top-Up Tax payable under the Applied GloBE rules would not give rise to a New Zealand imputation credit unless the top-up tax is paid under the New Zealand Domestic Income Inclusion Rule (DIIR).

This is because the Model Rules state that if the payment of GloBE top-up tax under a country's IIR or UTPR gives rise to a benefit, the IIR or UTPR will not be qualifying, and other participating countries will continue to apply top-up tax to the country's in-scope MNEs under their UTPR.

A payment of tax under a country's DIIR that gives rise to an imputation credit will not result in a DIIR being non-qualifying.

## Schedule to the ITA adapting the OECD Model Rules to New Zealand tax law

### New Zealand's Domestic Income Inclusion Rule (DIIR)

The GloBE rules contemplate that countries may introduce a DIIR, which would use the same tax base as the GloBE rules but would apply to domestic LTCEs on domestic untaxed profits.

Proposed Article 2.1.7 will be included in schedule 25B to introduce a New Zealand DIIR that would be imposed on New Zealand-headquartered in-scope MNEs. For these MNEs, top-up tax on undertaxed New Zealand profits would ordinarily be collected under a UTPR (including New Zealand's). The UTPR allocation mechanism (based on tangible assets and number of employees in each UTPR country) means that, in many cases, much of this tax would be allocated to New Zealand, but this would depend on the level of overseas assets and employees.

A DIIR would avoid New Zealand-headquartered MNEs having to pay any part of the GloBE top-up tax on undertaxed New Zealand income to other countries under the UTPR. There would also be no additional tax cost for these taxpayers, just a change in the country they paid the tax to.

This is unlike a QDMTT. If a New Zealand UPE has a direct subsidiary that is low taxed when there is also a minority interest, the DIIR will only apply to the portion of the low-tax profits attributable to the New Zealand MNE's ownership. Under a QDMTT, the top-up tax would need to be paid on the basis of 100% ownership.

Proposed Article 2.1.8 will also be included to provide for initial phase relief, that is, if an MNE group is headquartered in New Zealand, a DIIR would not apply to it during the initial phase under the transitional rules in Chapter 9. That is because any undertaxed New Zealand profits would not be subject to any other country's UTPR or IIR during the period.

## New Zealand's UTPR

Under New Zealand's UTPR, the GloBE calculation and any resulting tax liability would be treated as a separate tax liability independent of income tax.

For the UTPR, this charge would be capped by reference to taxable deductions and available tax losses for the fiscal year to meet the "equivalent adjustment" requirements in the Model Rules. However, it would be capped by the total deductions and available tax losses claimed by all New Zealand constituent entities. When the UTPR liability exceeds these amounts, it would be carried forward to the next fiscal year.

The UTPR top-up tax liability would be a joint and several liability of all New Zealand entities in an MNE group.

## Further information

This Guidance Material on the Model Rules has focused on providing a general overview of the OECD Model Rules. For further information and detailed guidance, the OECD has published:

- GloBE Model Rules
- Commentary to the GloBE Model Rules
- Illustrative examples
- Agreed Administrative Guidance on the GloBE rules

This information is accessible on the OECD's website at

<https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm>

## Amendments to the Tax Administration Act 1994

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*Clauses 66(2), (3) and (5), 68, 69, 70(2), 71(2), 72, and 74 to 76*

### Summary of proposed amendments

The proposed amendments to the Tax Administration Act 1994 (TAA) provide an administrative regime that deals with the Applied GloBE rules and the Multinational Top-Up Tax.

As the Multinational Top-Up Tax is an “ancillary tax” under the Income Tax Act 2007 (ITA), it does not fall within the scope of income tax. This means a specific administration regime is required, which nevertheless generally follows income tax procedures. Its features include:

- All in-scope MNEs must register with Inland Revenue within six months of the end of the first income year they are in-scope of the Applied GloBE rules.
- New Zealand-headquartered in-scope MNEs must submit a GloBE Information Return (GIR) to Inland Revenue in the prescribed electronic format. A GIR may also need to be submitted to Inland Revenue by in-scope MNEs that are headquartered in a foreign country.
- All in-scope MNEs must file an annual top-up tax return. This is a separate tax return that will state the amount of Multinational Top-Up Tax payable. The first top-up tax return would be due to Inland Revenue two months after the GIR is due (in subsequent years, this will be one month).
- In-scope MNEs must pay Multinational Top-Up Tax to the Commissioner by the due date. The due date is the same as the due date for the annual top-up tax return.

The proposed amendments also introduce new penalties for late registration and incomplete and/or late filing of the GIR.

The GloBE rules are closely linked to the Country-by-Country (CbC) Reporting rules – in particular, the same taxpayers are in scope and the GloBE transitional safe harbours rely on CbC Reports. As a result, proposed amendments would require CbC Reports to be submitted in the required electronic format, and new penalties would be introduced for incomplete and/or late filing.

This Guidance Material also provides a summary of the Transitional Safe Harbours published by the OECD in December 2022.<sup>11</sup>

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<sup>11</sup> OECD (2022), Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two), available at [www.oecd.org](http://www.oecd.org)

## Background

Chapter 8 of the Model Rules provides for a coordinated and standardised approach to reporting that is designed to reduce the compliance burden for in-scope MNEs and facilitate the effective administration of the GloBE rules. It also provides for the design of safe harbours that deem a GloBE top-up tax liability for a jurisdiction to be zero when the conditions provided under the GloBE Implementation Framework are met for the relevant fiscal year.

The Model Rules place an obligation on each constituent entity to file a GIR. The GIR will need to be provided in a global standardised format, which will be developed during 2023 as part of the GloBE Implementation Framework.

The GIR provides information on the tax calculations made by an MNE group and contains the information a tax administration needs to evaluate the correctness of a constituent entity's self-assessed GloBE tax liability and to perform an appropriate risk assessment.

A constituent entity's obligation to file a GIR will be relieved if its ultimate parent entity, or a designated filing entity in the group, files the GIR with a tax administration, and the Competent Authority in the filing jurisdiction has an agreement in effect to automatically exchange the GIR with the Competent Authority of the jurisdiction of the constituent entity.

Chapter 9 of the Model Rules provides transitional timeframes for filing the GIR. For the first year an in-scope MNE has a GIR filing obligation, its GIR will be due 18 months after the end of its fiscal year instead of 15 months.

Local tax return filing and penalty rules are left to the determination of the implementing jurisdiction. In New Zealand, the compliance regime for the GIR and the Multinational Top-Up Tax return are in the TAA.

The GloBE Implementation Framework includes the provision of safe harbours. Permanent safe harbours are still being designed. However, transitional safe harbours have been published that apply for fiscal years beginning on or before 31 December 2026 but not including a fiscal year that ends after 30 June 2028. These safe harbours provide transitional relief for MNE groups in the initial years during which the GloBE rules come into effect.

## Key features

The key features of the proposed amendments are:

- All in-scope MNEs must register with Inland Revenue within six months of the end of the first income year they are in-scope of the Applied GloBE rules.
- New Zealand-headquartered MNEs are required to submit a GIR to Inland Revenue.

- In-scope MNEs that have appointed a local designated filing entity for the group, and those that do not file a GIR in a country that has an information-sharing agreement with New Zealand, are required to submit a GIR to Inland Revenue.
- All in-scope MNEs must file an annual top-up tax return.
- Multinational Top-Up Tax must be paid to the Commissioner by the due date.
- New penalties apply for late registration and late, and/or incomplete, filing of the GIR and CbC Report.

## Detailed analysis

### Registration

Proposed new section 78H provides that MNEs would be required to notify Inland Revenue that they are within the scope of the GloBE rules. It is proposed that MNEs will be given six months from the end of the first fiscal year they are in scope of the rules to complete this registration. This process would apply to both New Zealand-headquartered MNEs and foreign MNEs with constituent entities located in New Zealand (including branches).

As part of this registration process, MNEs would inform Inland Revenue of the identity and location of the entity that would be filing the GIR. This will provide Inland Revenue with notice of where the GIR will be received from (whether that is directly or through information exchange channels) and a point of contact if the forms are not received for some reason.

If MNEs cease to be in scope of the Applied GloBE rules, they must notify the Commissioner within six months of the end of the first fiscal year that the rules do not apply.

### The GloBE information return

Proposed new section 78I of the TAA provides that a constituent entity located in New Zealand must provide to the Commissioner, in the prescribed electronic format, the information set out in Articles 8.1.4(a) to (d) of the Model Rules (that is, the GIR). This does not apply where the GIR is submitted on time by the ultimate parent entity (UPE) of the constituent entity, or a designated filing entity of the constituent entity's MNE group, to a foreign competent authority that is obliged to exchange that information with the Commissioner. However, where the UPE is located in New Zealand, the GIR must be filed locally.

Foreign-headquartered MNEs proposing to file the GIR in another country must notify the Commissioner about this.

For the first income year in which a constituent entity is required to provide a GIR, the GIR must be filed within 18 months of the end of the fiscal year. For subsequent years, the GIR must be filed 15 months after the end of the fiscal year.

The GIR must be filed in a standard template that is being developed by the OECD. Article 8.1.4 of the GloBE Model Rules lists the information to be included in the GIR but notes that this will be further specified, expanded or restricted, including through the development of simplified reporting procedures. The information required includes:

- Identification of the constituent entities, including their tax identification numbers (if they exist), the jurisdiction in which they are located, and their status under the GloBE Rules.
- Information on the overall corporate structure of the MNE group, including the controlling interests in the constituent entities held by other constituent entities.
- The information necessary to compute:
  - the Effective Tax Rate for each jurisdiction and the top-up tax of each constituent entity under Chapter 5
  - the top-up tax of a member of the Joint Venture Group under Chapter 6
  - the allocation of top-up tax under the IIR and the UTPR top-up tax amount to each jurisdiction under Chapter 2.
- A record of the elections made in accordance with the relevant provisions of the GloBE Rules.
- Other information that is agreed as part of the GloBE Implementation Framework and is necessary to carry out the administration of the GloBE Rules.

It is expected that the final GIR template will be published by the OECD before the end of 2023.

## **Change to Country-by-Country reporting process**

As part of the introduction of GloBE information reporting for Pillar Two, the CbC reporting process will be modernised by moving to electronic filing using the XML format under the proposed amendments to section 78G. This will bring New Zealand into line with other jurisdictions, which require CbC reporting electronically in extensible markup language (XML) format.

## The New Zealand Multinational Top-Up Tax return

Proposed new section 78J would require a Multinational Top-Up Tax return to be filed on an annual basis by any constituent entities located in New Zealand, whether or not they have a UTPR liability. The Multinational Top-Up Tax return would include a constituent entity's self-assessment of any top-up tax in a form prescribed by the Commissioner.

The due date for the Multinational Top-Up Tax return would be one month after the GIR due date. This would allow foreign groups to arrange filing of the Multinational Top-Up Tax return. In the first year, this would be extended to two months.

## Paying the tax

As the Multinational Top-Up Tax liability would be a separate tax type, payment of the tax would be due separately from any income tax liability of the MNE and would have its own payment date.

Payment of Multinational Top-Up Tax would be due on the same day that the Multinational Top-Up Tax return is due with Inland Revenue. Payments under the GloBE rules would not be subject to provisional tax.

The standard rules in Parts 7 (Interest) and 9 (Penalties) of the TAA would apply to GloBE payments that are paid after the due date.

### Example 18: Reporting dates

World is my Oyster Limited (WOL) is the New Zealand-resident UPE of an MNE that produces specialist oyster fishing equipment. It has operations in 15 countries and meets the requirements to be subject to the GloBE rules.

WOL has a June balance date, and the first fiscal year it will be required to report under the GloBE rules will be the year ended 30 June 2025. WOL has a New Zealand tax agent and an extension of time to file its New Zealand income tax return.

WOL's reporting and payment dates for the initial 30 June 2025 year will be as follows:

- New Zealand income tax return – due 31 March 2026.
- GloBE information return – due 31 December 2026 (18 months after balance date – normally this will be due 15 months after balance date on 30 September).
- New Zealand Multinational Top-Up Tax return and payment – due 28 February 2027 (20 months after balance date – normally this will be due 16 months after balance date on 31 October).

## Joint and several liability

Proposed new section HP 1(3) provides that constituent entities located in New Zealand would be jointly and severally liable for any Multinational Top-Up Tax payments that are charged to any one New Zealand-resident entity of the MNE group under the Applied GloBE rules.

## New penalties

The Model Rules provide that penalties or sanctions for non-compliance with the GIR be set by implementing jurisdictions. These should be commensurate with penalties or sanctions in respect of other information return filing obligations in the jurisdiction (for example, section 139AB of the TAA in New Zealand).

## Late and/or incomplete GloBE Information Return

For information to be exchanged with other tax authorities on a timely basis, it is important that Inland Revenue receives a complete GloBE Information Return (GIR) on time and in the correct format. This will give time for the information to be checked before it is provided to other jurisdictions. Documents not filed electronically in the XML format would not be treated as filed for this purpose.

Proposed new section 139ABB provides for a penalty for failing to comply with the GIR requirements under proposed new section 78I. The penalty will apply to:

- New Zealand-headquartered MNEs.
- Foreign-headquartered MNEs with operations in New Zealand that do not file a GIR in a country with which New Zealand has an exchange of information agreement.
- MNEs that do not file their GIR on time in their UPE or designated filing entity country.

The amount of the penalty would be an amount specified by the Commissioner that would not exceed \$100,000.

## Late and/or incomplete New Zealand Multinational Top-Up Tax Return

Proposed new section 139ABB also provides for a penalty if a constituent entity fails to comply with the requirement to provide an annual Multinational Top-Up Tax return to the Commissioner under proposed new section 78J. In this case, the amount of the penalty would be \$500.

## **Late and/or incomplete Country-by-Country Report**

As with the GloBE Information Return, it is important that Inland Revenue receives a complete Country-by-Country Report on time and in the correct format. The proposed amendments to section 78G of the TAA would ensure that documents not filed electronically in the XML format would not be treated as filed for this purpose.

Proposed new section 139AAB would introduce a penalty for a large multinational group with a New Zealand resident ultimate owner that fails to comply with the requirements under section 78G. The amount of the penalty would be an amount specified by the Commissioner that would not exceed \$100,000.

## **Late registration**

Under proposed new section 78H of the TAA, New Zealand-headquartered and foreign-headquartered MNEs will be required to notify Inland Revenue that they are in scope of the Applied GloBE rules within six months from the end of the first fiscal year they are in scope of the rules. If the MNE fails to comply with the requirements of proposed new section 78H of the TAA, the taxpayer would be liable to pay a penalty under proposed new section 139ABB for an amount specified by the Commissioner that would not exceed \$100,000.

## **Shortfall penalties: Unacceptable tax position**

The Inclusive Framework has agreed transitional penalty relief that reflects a common understanding amongst implementing jurisdictions in relation to shortfall penalties to provide MNEs with a “soft landing” during the initial years in which the rules are being introduced.

The common understanding on shortfall penalties means no penalties or sanctions should apply in connection with the filing of a GIR during a transition period when a tax administration considers that an MNE has taken “reasonable measures” to ensure the correct application of the Model Rules.

A tax administration may consider that an MNE has taken reasonable measures when the MNE can demonstrate it has acted in good faith to understand and comply with the relevant domestic application of the GloBE rules and the Qualified Domestic Minimum Top-Up Tax.

Inland Revenue will administer the Multinational Top-Up Tax rules on this basis.

Consequently, during the transition period, the unacceptable tax position shortfall penalty in section 141B of the TAA will not apply to Multinational Top-Up Tax. Proposed changes to section 141B would result in this shortfall penalty applying to Multinational Top-Up Tax for fiscal years starting on or after 1 January 2027. All other shortfall penalties would apply from commencement.



# Trustee tax rate

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## Overview

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The Bill proposes to increase the trustee tax rate to 39% for the 2024–25 and later income years (beginning 1 April 2024 for most trusts). It also proposes special rules to buttress that rate and help prevent over-taxing estates (which are taxed as trusts) and trusts settled for disabled people (disabled beneficiary trusts).

### Current law

Unless otherwise specified, the focus of this chapter of the Bill Commentary is on complying trusts. The annual income of a trust is taxed as it is derived, either to the trustees or to the beneficiaries of the trust. Trustees of a trust are treated as a single taxable unit and their trustee income is calculated separately from their personal income.<sup>12</sup>

### Beneficiary income

Beneficiary income is all income earned by a trust in an income year that is paid or allocated to the beneficiaries before the trust has filed its tax return.<sup>13</sup> Income does not need to be paid to a beneficiary to be beneficiary income; the income can be allocated to a beneficiary. Provided the trustees cannot change their mind about the allocation (that is, the income is vested absolutely in the beneficiary), the income is considered beneficiary income and is taxed at the beneficiary's personal tax rate unless it is subject to the minor beneficiary rule.

The minor beneficiary rule applies to beneficiary income derived by a minor (a New Zealand resident natural person under 16 years old) from property settled on a trust by a relative or legal guardian, or an associated person of the relative or legal guardian. If the total beneficiary income derived by the minor is greater than \$1,000 in an income year, the income is taxed at the trustee tax rate to prevent parents, other relatives, or guardians from splitting their income with children.<sup>14</sup>

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<sup>12</sup> Sections HC 2 and YA 5 of the Income Tax Act 2007.

<sup>13</sup> Section HC 6 of the Income Tax Act 2007.

<sup>14</sup> Sections HC 35 to HC 37 of the Income Tax Act 2007.

**Table 1: Types of beneficiary income**

Types of beneficiary income	Simplified examples
<p><b>Income distributed or paid to a beneficiary</b></p>	<p>Cash transferred to the beneficiary.</p>
<p><b>Income allocated to a beneficiary that is credited to the beneficiary's current account</b></p> <p>The income is available to be called upon at any time by the beneficiary, although in practice it is usually paid to the beneficiary at the discretion of the trustee or settlor.</p>	<p>Allocated amounts are available in a bank account for the beneficiary to draw upon at any time.</p>
<p><b>Income that is allocated to a beneficiary for them to possess at a future date or event (future possession beneficiary income)</b></p> <p>This could include where income is allocated to a beneficiary for them to possess when they reach a certain age. Provided the income will go to the beneficiary's estate if the beneficiary dies before the future date or event, the income is considered beneficiary income in the year it is derived by the trust and is taxed at the beneficiary's marginal tax rate.</p> <p>Unlike beneficiary income credited to a beneficiary's current account, future possession beneficiary income is not available to be called upon by the beneficiary until they become entitled to possess the income (either once the future date or event has occurred or when the income goes to their estate on their death).</p>	<p>Allocated amounts are held in a bank account the beneficiary cannot access until they reach the age of 21.</p>

### Trustee income

Trustee income is all taxable income derived by a trust in an income year that is not beneficiary income.<sup>15</sup> Trustee income is taxed at a flat rate of 33%. Once income has been taxed as trustee income, subsequent distributions of that income to the beneficiaries are tax free. That is, trustee income is subject to a final tax imposed in the year the income is derived by the trust.

<sup>15</sup> Section HC 7 of the Income Tax Act 2007.

## Corpus

Corpus means property settled on a trust.<sup>16</sup> Corpus is used by trustees to derive income and capital gains. Distributions of any amounts other than beneficiary income, including corpus, capital gains, or trustee income from prior years, are exempt from tax to the receiving beneficiary.<sup>17</sup>

## Social policy implications unchanged

Under existing law, distributions of beneficiary or trustee income to a beneficiary of a trust are generally considered income for social policy purposes.<sup>18</sup> As a result, if Government support is means-tested (such as the Working for Families tax credit) or is otherwise calculated by reference to a person's income (such as child support and student loan obligations), distributions of trust income can impact upon that Government support.

Beneficiary income is generally considered "income" for social policy purposes in the year the income is allocated to the beneficiary, which is the year in which that income is derived by the trust. On the other hand, trustee income is normally only taken into account once it has been distributed to the beneficiary, which could be some time after the income was first derived (and tax was paid) on the income.

The Bill does not propose to change when distributions from trusts are considered income for social policy purposes.

## Background and policy rationale

The trustee tax rate of 33% has been in place since 1989 and was intentionally chosen to align with the (then) top personal tax rate. In 2020, a new top personal tax rate of 39% for income over \$180,000 was introduced. The trustee tax rate was not increased at that time. Since the trustee tax rate is a final tax, it is possible for individuals to obtain a tax advantage by earning income through a trust, thus circumventing the 39% top personal tax rate.

## Previous rate misalignment resulted in behavioural change

From 2000 to 2010, the top personal tax rate was 39%, which was higher than the trustee tax rate. During this period, significant amounts of income were diverted into trusts and taxed as trustee income. Much of the growth of trustee income was in the form of dividends. Many

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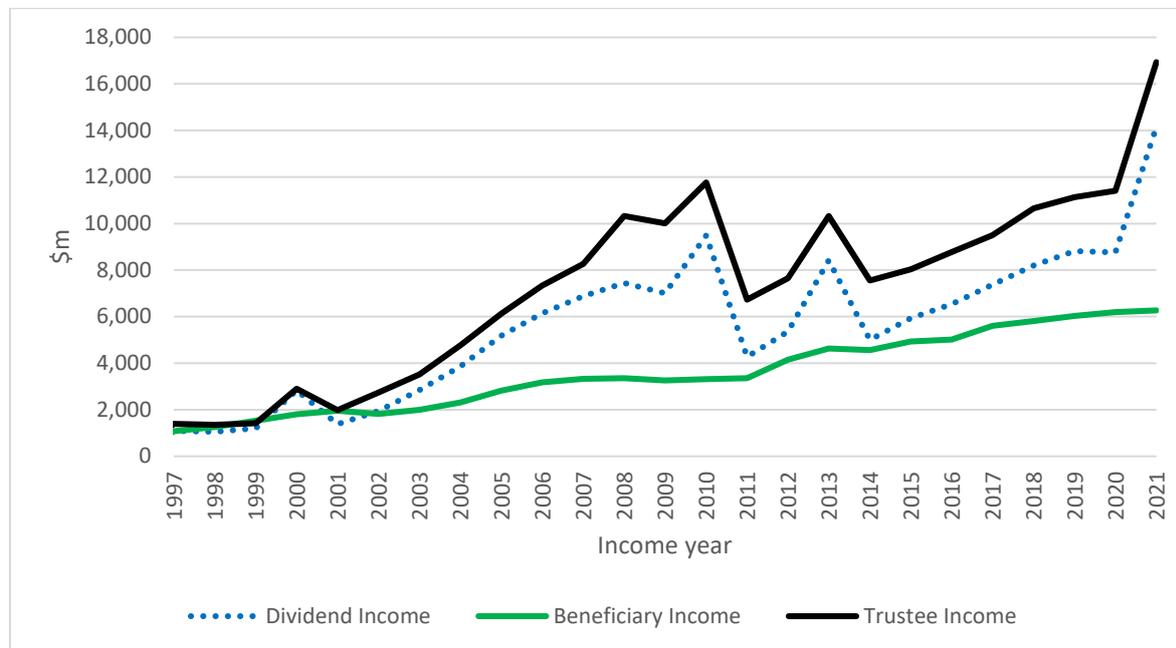
<sup>16</sup> Section HC 4 of the Income Tax Act 2007.

<sup>17</sup> Sections CW 53 and HC 20 of the Income Tax Act 2007.

<sup>18</sup> Sections MB 7 and MB 12B of the Income Tax Act 2007.

small-to-medium enterprises reorganised as companies owned by family trusts in the early 2000s to take advantage of the misalignment.

**Figure 1: Income reported on trust tax returns 1997-2021**



After the top personal tax rate was reduced to 33% in 2010, there was no longer misalignment between the trustee tax rate and the top personal tax rate. This meant there was no longer a tax advantage in passing dividends through trusts, although existing structures often remained in place. From 2022, the top personal tax rate has again been higher than the trustee tax rate. In advance of this taking effect, there were larger than usual dividend flows in the 2020–21 income year, resulting in a spike in trustee income.

**Policy rationale for addressing misalignment**

Aligning the trustee and top personal tax rates at 39% would help ensure that trusts cannot be used to circumvent the top personal tax rate. This would improve the fairness and progressivity of the tax system, protect the revenue base from erosion, and improve the Government’s ability to raise revenue.

This will also help achieve one of the Government’s long-term revenue objectives, which is to “ensure a progressive taxation system that is fair, balanced and promotes the long-term sustainability of the economy, consistent with the debt and operating balance objectives”.

## Proposals to address under-taxation

To ensure trusts cannot be used to circumvent the top 39% personal tax rate, the Bill proposes to align the trustee tax rate and top personal tax rate at 39% for the 2024–25 and later income years (beginning 1 April 2024 for most trusts). To buttress that rate, beneficiary income derived by certain companies would be taxed as trustee income. This integrity rule is targeted towards family trusts and would not affect the commercial use of trusts in large corporate groups.

## Proposals to mitigate over-taxation

In making the proposed changes, it is important to balance preventing high-income earners circumventing the top 39% tax rate with not over-taxing trusts with lower-rate beneficiaries. Trusts with lower-rate beneficiaries would be able to continue to use existing rules to mitigate over-taxation, as outlined above. The Bill also proposes targeted measures to help prevent the over-taxation of trusts in certain situations, such as deceased estates and disabled beneficiary trusts.

Current law provides for lower-rate settlors and beneficiaries to mitigate over-taxation. Income of a trust can be taxed at a beneficiary's personal tax rate if the income is paid or allocated to the beneficiary as "beneficiary income", but this may not always be feasible. To help address this, two sets of special rules are proposed:

- **Deceased estates:** When a deceased person's affairs are still being settled, an estate (which is taxed as a trust) may be unable to allocate income to beneficiaries. The proposed special rules for estates would allow income received by an estate to be taxed as though it were the deceased's income for 12 months after the deceased's date of death.
- **Disabled beneficiary trusts:** Special rules are also proposed for certain trusts settled for disabled people. These rules would allow trustee income to be taxed as though it were the disabled beneficiary's income, as beneficiary income is currently taxed, even though the income would still retain its character as trustee income.

While the rate applied to trustee income of estates or trusts settled for disabled people may differ to the rate applied to other trustee income, the income would still retain its character as trustee income.

## Increasing the trustee tax rate to 39%

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*Clause 62(1) and (4)*

### Summary of proposed amendment

The proposed amendment would increase the trustee tax rate from 33% to 39%.

### Effective date

The proposed amendment would have effect for the 2024–25 and later income years (beginning 1 April 2024 for most trusts).

### Background

Due to the trustee tax rate being lower than the top personal tax rate, and trustee income being subject to a final tax in the year it is derived (and not subject to tax when it is eventually distributed to a beneficiary, if it is), trusts can be used to shelter income from higher personal tax rates. If a trust has a 39% tax rate beneficiary (who could also be a settlor), income may be accumulated in the trust and taxed at the 33% trustee tax rate. There is then no further tax when the tax-paid trustee income is later distributed to the beneficiary.

### Detailed analysis

#### Addressing under-taxation of trustee income

Increasing the trustee tax rate to 39% to align with the top personal tax rate will ensure that trusts cannot be used to shelter income from the top personal tax rate.

#### **Example 19: Sheltering income from the 39% personal tax rate**

Amena has personal income of \$180,000 per annum and is a beneficiary of a trust.

##### 33% trustee tax rate

In the 2023–24 income year, \$50,000 has been retained in the trust as trustee income (with a tax liability of \$16,500 at the 33% trustee tax rate).

In the following year, the tax-paid trustee income (\$50,000 less \$16,500 tax = \$33,500) is distributed to Amena. This distribution is not subject to tax. That income

has only been subject to a 33% tax rate, and Amena does not need to pay the 6% difference between the 33% trustee tax rate and the 39% personal tax rate, despite earning over \$180,000. If the \$50,000 income was earned directly by Amena as personal income, the tax liability would be \$19,500.

#### 39% trustee tax rate

The amendment to increase the trustee tax rate to 39% is proposed to apply for the 2024–25 and later income years. In the 2024–25 income year, \$50,000 has again been retained in the trust as trustee income (with a tax liability of \$19,500 at the 39% trustee tax rate). Amena no longer receives a tax advantage from earning income through the trust.

## Mitigating over-taxation

As noted in the Overview section, income of a trust can be taxed at a beneficiary's personal tax rate if it is paid or allocated to a beneficiary as beneficiary income. Beneficiary income allocations may therefore be used to mitigate over-taxation that could arise from the proposed 39% trustee tax rate.

### **Example 20: Mitigating over-taxation**

Amy (an air traffic controller) and Anthony (a builder with his own company) have settled some income-generating assets on a discretionary family trust for the benefit of themselves, their children (both minors under the age of 16) and future grandchildren. Amy, Anthony and their accountant are the trustees.

#### 2024–25 income year

Anthony has personal income of \$70,000 and Amy has personal income of \$180,000. Their trust has income of \$40,000.

If the income is retained as trustee income, it will be taxed at the proposed 39% trustee tax rate. Any income allocated to their children as beneficiary income will also be taxed at 39% under the minor beneficiary rule.

However, by allocating the income to Anthony as beneficiary income, it can be taxed at his personal tax rate. This amount can be credited to Anthony's current account, available to be called upon at any time, or he can settle it on the trust if he wishes to do so.

2025–26 income year

Bary, the older of Amy and Anthony's children, has turned 16, so he is no longer a minor. Bary has no personal income. Anthony again has personal income of \$70,000, and Amy has personal income of \$180,000, while the trust has income of \$50,000.

Since Bary is no longer a minor, he is not subject to the minor beneficiary rule. Income can be allocated to Bary as beneficiary income and taxed at his personal tax rate (for example, up to \$14,000 at 10.5%, over \$14,000 and up to \$48,000 at 17.5%).

If the trustees do not want to distribute this income to Bary, it can be credited to his current account, available to be called upon at any time, or a sub-trust arrangement can be set up so that Bary's interest in a portion of the trust assets is recognised and protected.

# Beneficiary income derived by certain close companies

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*Clauses 10, 13, 17, 32, 35, 36, 39, 47 and 59(16) and (17)*

## Summary of proposed amendment

The proposed amendments would treat beneficiary income derived by certain corporate beneficiaries as trustee income for the purposes of determining the rate of tax, who pays the relevant tax, and who provides the return of income.

## Effective date

The proposed amendments would have effect for the 2024–25 and later income years (beginning 1 April 2024 for most trusts).

## Background

A company can be a beneficiary of a trust. Beneficiary income paid to a corporate beneficiary is taxed at 28%. The real beneficiary of such an allocation of income is the ultimate natural person shareholder in the company. The beneficiary income allocation should be taxed at the marginal tax rate of that person or persons. There is no reason for taxing the income earned by a trust and allocated to a company in the same way as income earned directly by the company.

If the shareholder of the corporate beneficiary is the trust that is making the allocation, the income allocation achieves nothing. The income effectively remains within the trust. The principal, or in many cases the only, effect of the allocation is to ensure that the income is taxed at 28% rather than the trustee tax rate. While a subsequent distribution of the income by the company to the trust will be taxable as a dividend (with imputation credits attached), such a distribution may never be made.

## Detailed analysis

To buttress the 39% trustee tax rate, amendments are proposed to ensure that beneficiary income derived by corporate beneficiaries is treated as trustee income for the purposes of determining the rate of tax that applies, who pays the relevant tax, and who provides the return of income, if:

- the company is a “close company” (that is, five or fewer natural persons or trustees hold more than 50% of the voting interests in the company, when treating associated persons as one person)
- the company is not a Māori authority or a tax charity<sup>19</sup>, and
- a settlor of the trust has “natural love and affection” for a direct or indirect shareholder of the company under sections YC 2 to YC 4 of the Income Tax Act 2007 (ITA).

Proposed new section HC 38 of the ITA would ensure that trustees cannot allocate beneficiary income to such companies to circumvent a 39% trustee tax rate.

### **Natural love and affection**

“Natural love and affection” is an existing concept in tax law. It is used to describe the motive of a person for an action driven not by a promise of something in return, but by the natural love and affection the person has for another. Natural love and affection is generally considered to exist between relatives, whether by blood, marriage, a non-spousal domestic relationship, or adoption. It can be present between close friends as well, although not ordinary acquaintances or colleagues.

Limiting this rule to close companies where a settlor of the trust has natural love and affection for a (direct or indirect) shareholder of the company will help ensure that the proposal is targeted towards family trusts and would not affect the commercial use of trusts in large corporate groups.

### **Mitigating over-taxation of trust income**

Taxing beneficiary income derived by certain close companies as trustee income will prevent the under-taxation that would otherwise arise if the income were taxed at the corporate tax rate. This should not give rise to over-taxation. A family trust will not make a beneficiary income allocation to a corporate beneficiary unless the company is owned by one or more of the other beneficiaries (or the trust itself). If one or more of those shareholder beneficiaries is on a lower personal tax rate, the trustees can allocate the income directly to that person as beneficiary income to mitigate over-taxation.

If the corporate beneficiary has a real need for funds, either the shareholder beneficiary, or the trust on their behalf, can invest the money in the company, either by way of debt or some form of capital contribution.

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<sup>19</sup> “Tax charity” is defined in section CW 41(5) of the ITA and includes charitable entities registered under the Charities Act 2005.

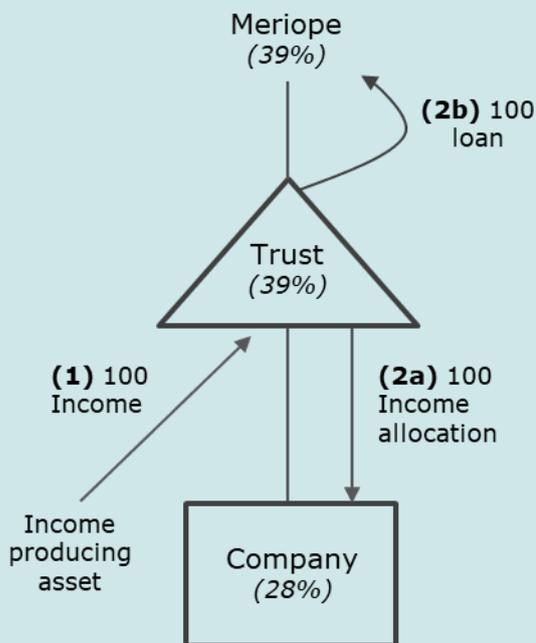
## Use of tax credits

Proposed new section LE 4B of the ITA would ensure that the trustees can use tax credits to satisfy the tax liability on beneficiary income derived by certain close companies subject to the corporate beneficiary rule in the proposed new section HC 38 of the ITA.

This treatment would mirror the existing provision in section LE 4 of the ITA for income subject to the minor beneficiary rule in sections HC 35 to 37 of the ITA.

### Example 21: Sheltering income in a corporate beneficiary

Meriope is the beneficiary of a trust. She has a personal tax rate of 39%. The trust has derived \$100 of income (this is **(1)** in the diagram).



To prevent the \$100 being taxed at the 39% rate, the trustees of the trust allocate the income to a corporate beneficiary as beneficiary income (this is **(2a)**). The income is taxed at the 28% corporate tax rate.

The trust then loans \$100 to Meriope (this is **(2b)**). The \$100 is not taxable income of Meriope.

Overall, only \$28 of tax has been paid on the income. However, \$39 of tax should have been paid, since the \$100 has actually gone to Meriope, a 39% tax rate individual (via the loan from the trust).

Under the proposed amendments, the \$100 allocated to the company would be taxed at the 39% trustee tax rate. \$39 of tax would be paid on the income.

## Deceased estates

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*Clauses 33, and 62(2) and (4)*

### Summary of proposed amendments

The proposed amendments would allow income derived by the trustee of a deceased estate within 12 months of the person's date of death to be taxed at the personal tax rate of the deceased person.

### Effective date

The proposed amendments would have effect for the 2024–25 and later income years (beginning 1 April 2024 for most trusts).

### Background

Deceased estates are taxed as trusts, which means income they derive is taxed at the trustee tax rate to the extent it is not beneficiary income.<sup>20</sup>

Income derived by some deceased estates is already over-taxed at the current 33% trustee tax rate when the deceased person (when alive) and/or the beneficiaries of the deceased estate are on lower tax rates. Any over-taxation already present at the 33% rate would be exacerbated by the proposed 39% trustee tax rate.

As noted in the Overview section, most trusts can use existing rules to pay or allocate income as beneficiary income to mitigate over-taxation. This is because beneficiary income is taxed at the beneficiary's personal tax rates. However, deceased estates cannot use beneficiary income allocations to mitigate over-taxation if the beneficiaries of the deceased estate are not yet known, which may be the case for larger or more complex deceased estates.

Trustee income of a deceased estate would not be over-taxed at the proposed 39% trustee tax rate if the deceased was on the 39% personal tax rate and/or the deceased estate's beneficiaries are on the 39% rate.

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<sup>20</sup> For more information on the taxation of estates, refer to [IS 18/01 Taxation of trusts – income tax](#) from [9.25].

## Key features

To ensure the proposed 39% trustee tax rate does not result in over-taxation for deceased estates, proposed new section HC 8B of the Income Tax Act 2007 would allow a trustee of a deceased estate to apply a modification to income derived within 12 months of the deceased person's date of death.

The Bill proposes applying the following formula in section HC 8B(2) to calculate the rate of tax that applies to trustee income subject to the modification:

$$(\text{combined tax} - \text{pre-death tax}) \div \text{post-death income}$$

**Combined tax** is the total amount of tax that would be payable for an income year, applying the personal income tax scale, if the following amounts were combined and then taxed under the personal income tax scale:

- trustee income derived by the trustees of the estate within 12 months after the deceased person's date of death, and
- the personal income that the deceased person derived before their death in that income year.

**Pre-death tax** is the amount of income tax payable in respect of the income of the deceased person in the income year. This amount would be zero in the income year following a person's death.

**Post-death income** is the total of amount of trustee income derived by the trustee of the deceased estate in the income year and within 12 months of the deceased person's date of death.

Applying the proposed formula in section HC 8B(2) means that, effectively, income derived by the trustee of a deceased estate that chooses to apply the modification would be taxed as follows:

- In the income year in which the person died, income derived by the trustee of the deceased estate would be taxed at the deceased's marginal tax rate(s).
- In the following income year, income derived by the trustee of the deceased estate within 12 months of the person's death would be taxed under the personal income tax scale.

Apart from the rate of tax, the income would remain trustee income for all other purposes and would continue to be returned by the trustee of the deceased estate as trustee income.

Any income derived by the trustee of the deceased estate after this 12-month period would be taxed at the proposed 39% trustee tax rate.

### Example 22: Trustee income of deceased estate

Petunia died on 31 December 2024. She derived employment income of \$60,000 before her death. In the two income years after Petunia's death, the trustee of her deceased estate derives the following amounts of trustee income:

- 2024–25 income year: \$30,000.
- 2025–26 income year (within 12 months of death): \$10,000.
- 2025–26 income year (more than 12 months after death): \$10,000.

The trustee decides to apply the deceased estates modification in proposed new section HC 8B (the application of the individual components of the formula is covered in more detail in the further examples below).

Income year	Trustee income	Does the modification apply?	Income tax liability
2024–25	\$30,000	Yes	\$11,020
2025–26 (within 12 months of death)	\$10,000	Yes	\$1,050
2025–26 (more than 12 months after death)	\$10,000	No	\$3,900

In the 2024–25 income year, the net outcome is the same as if the trustee income had been earned by the deceased directly while they were alive. The trustee has an income tax liability of \$11,020 for this income.

The trustee income derived in the 2025–26 income year, but within 12 months of Petunia's death, has an income tax liability of \$1,050. This is the amount of tax that would have been payable had Petunia been alive and received this income directly in the 2025–26 income year.

The remaining trustee income derived in the 2025–26 income year, but more than 12 months after Petunia's death, is taxed at the proposed 39% trustee tax rate because the modification only applies to income derived by the trustee within 12 months of Petunia's date of death. The trustee has an income tax liability of \$3,900 for this income.

## Detailed analysis

### Trustee may elect to apply the modification (section HC 8B(1))

The trustees of a deceased estate may elect to apply the modification. If they do not, trustee income would be taxed under ordinary rules at the proposed 39% trustee tax rate.

### Modification applies to trustee income derived within 12 months of death (section HC 8B(1))

The modification would only apply to trustee income derived by a trustee of a deceased estate within 12 months of the deceased person's date of death.

This helps ensure that income derived by a trustee of a deceased estate is not over-taxed while the affairs of the deceased person are being worked through, particularly when the trustee is still determining who the beneficiaries of the deceased estate are (so beneficiary income allocations cannot yet be made).

The proposed modification would apply for a limited time so that it does not incentivise trustees to retain income rather than distributing amounts to the beneficiaries of the estate.

### Modification taxes income using personal income tax rates (section HC 8B(2))

If a trustee of a deceased estate chooses to apply the modification, trustee income derived within 12 months of the deceased person's death would be taxed at the rate calculated using the formula in proposed new section HC 8B(2):

$$(\text{combined tax} - \text{pre-death tax}) \div \text{post-death income}$$

### Combined tax (section HC 8B(2) and (3)(a))

"Combined tax" is defined as the total tax calculated under schedule 1, part A, clause 1, table 1 of the Income Tax Act 2007 (ITA) (that is, applying the personal tax scale) for each dollar of taxable income derived in the income year by the deceased person or the trustee within 12 months of the person's date of death.

**Table 2: Schedule 1, part A, clause 1, table 1 of the ITA**

Row	Range of dollar in taxable income	Tax rate
1	\$0 – 14,000	0.105
2	\$14,001 – \$48,000	0.175
3	\$48,001 – \$70,000	0.300
4	\$70,001 – \$180,000	0.330
5	\$180,001 upwards	0.390

The “combined tax” is effectively the total tax that would be payable if the personal tax scale were applied to a combination of both the deceased person’s income and trustee income derived by the trustee of the deceased estate in the income year and within 12 months of the person’s date of death.

**Example 23: Combined tax (continuation of previous example)**

2024–25 income year

In the 2024–25 income year, Petunia derived \$60,000 of employment income before her death. The trustee of her deceased estate derived \$30,000 of trustee income. Applying the personal tax scale to the \$90,000 of combined income, the combined tax would be \$20,620.

Tax bracket	Tax rate	Income in bracket	Income tax
\$0 – 14,000	10.5%	\$14,000	\$1,470
\$14,001 – \$48,000	17.5%	\$34,000	\$5,950
\$48,001 – \$70,000	30%	\$22,000	\$6,600
\$70,001 – \$180,000	33%	\$20,000	\$6,600
\$180,001 upwards	39%	\$0	\$0
<b>Combined tax:</b>			<b>\$20,620</b>

2025–26 income year

In the 2025–26 income year, the trustee of Petunia’s deceased estate derived \$10,000 within 12 months of Petunia’s death. Petunia herself derived no income this year as she died in the previous income year.

Tax bracket	Tax rate	Income in bracket	Income tax
\$0 – 14,000	10.5%	\$10,000	\$1,050
\$14,001 – \$48,000	17.5%	\$0	\$0
\$48,001 – \$70,000	30%	\$0	\$0
\$70,001 – \$180,000	33%	\$0	\$0
\$180,001 upwards	39%	\$0	\$0
<b>Combined tax:</b>			<b>\$1,050</b>

**Pre-death tax (section HC 8B(2) and (3)(b))**

“Pre-death tax” is defined as the total tax calculated under schedule 1, part A, clause 1, table 1 of the ITA for each dollar of taxable income derived in the income year by the deceased person.

This is equal to the income tax liability on the deceased person’s personal income for that income year. In the income year in which the person died, this would be any amounts they derived before their death. In the income year after the person’s death, this amount would be zero.

**Example 24: Pre-death tax (continuation of previous example)**

2024–25 income year

In the 2024–25 income year, Petunia derived \$60,000 of employment income. Applying the personal tax scale, the pre-death tax would be \$11,020.

Tax bracket	Tax rate	Income in bracket	Income tax
\$0 – 14,000	10.5%	\$14,000	\$1,470
\$14,001 – \$48,000	17.5%	\$34,000	\$5,950
\$48,001 – \$70,000	30%	\$12,000	\$3,600
\$70,001 – \$180,000	33%	\$0	\$0
\$180,001 upwards	39%	\$0	\$0
<b>Pre-death tax:</b>			<b>\$11,020</b>

2025–26 income year

In the 2025–26 income year, Petunia herself derived no income because she died in the previous income year. The pre-death tax for this year is zero.

**Post-death income (section HC 8B(2) and (3)(c))**

“Post-death income” is defined to mean the total amount of trustee income derived in the income year by the trustee within 12 months after the person’s date of death.

**Example 25: Post-death income (continuation of previous example)**

In the 2024–25 income year, the trustee of Petunia’s deceased estate derived \$30,000 of trustee income.

In the 2025–26 income year, the trustee of Petunia’s deceased estate derived \$10,000 within 12 months of Petunia’s death.

The further \$10,000 derived in the 2025–26 income year, but more than 12 months after Petunia’s death, is excluded from the calculation.

## Effect of applying the formula in proposed new section HC 8B(2)

The formula in proposed new section HC 8B(2) effectively achieves the following:

- In the income year of a person's death, trustee income derived by the trustee of the deceased estate is taxed using the deceased's marginal tax rate(s), taking into account any income the person derived before their death (such as employment income).
- In the income year after a person's death, trustee income derived by the trustee of the deceased estate within 12 months of the person's death is taxed using the personal income tax scale.
- Trustee income derived by the estate more than 12 months after a person's death is taxed at the proposed 39% trustee tax rate.

### Example 26: Calculating the basic tax rate on trustee income (continuation of previous example)

The basic tax rate that applies to trustee income subject to the deceased estates modification is:

$$(\text{combined tax} - \text{pre-death tax}) \div \text{post-death income}$$

The relevant amounts for Petunia's deceased estate are:

Income year	Combined tax	Pre-death tax	Post-death income
2024–25	\$20,620	\$11,020	\$30,000
2025–26	\$1,050	\$0	\$10,000

Applying the formula, the basic tax rate in the 2024–25 income year is 32%  $((\$20,620 - \$11,020) \div \$30,000)$ .

The basic tax rate in the 2025–26 income year for trustee income derived within 12 months of Petunia's death is 10.5%  $((\$1,050 - \$0) \div \$10,000)$ .

The further \$10,000 derived in the 2025–26 income year and more than 12 months after Petunia's death is not subject to the modification. It is therefore taxed at the proposed 39% trustee tax rate.

## Disabled beneficiary trusts

*Clauses 39, 59(9), (10) and (17), and 62(2)*

### Summary of proposed amendment

The proposed amendment would allow income derived by the trustee of a trust settled for the care of a disabled person to be taxed at the disabled beneficiary's personal tax rate, provided certain criteria are met.

### Effective date

The proposed amendments would have effect for the 2024–25 and later income years (beginning 1 April 2024 for most trusts).

### Background

To ensure the proposed 39% trustee tax rate does not result in over-taxation for trusts settled for disabled people, a modification is proposed for these trusts. Special regimes for disability trusts are a common feature of overseas regimes (such as in Australia, Canada, the UK, and the US).

### Key features

To help ensure the proposed 39% trustee tax rate does not result in over-taxation, proposed new section HC 39 would enable trustee income derived by a trust settled for a disabled person (disabled beneficiary trust) to be taxed at the disabled beneficiary's personal tax rate if the trust meets certain criteria.

**Table 3: Qualifying criteria for disabled beneficiary trust**

Qualifying criteria	Further explanation
Trust must have only one beneficiary, ignoring any residual beneficiaries.	<p>The disabled beneficiary must be the only person to whom distributions can be made, unless the disabled beneficiary has died and distributions are made on the dissolution of the trust.</p> <p>The trust deed must not allow any further beneficiaries, apart from residual beneficiaries, to be added.</p>

Qualifying criteria	Further explanation
The beneficiary must be a “disabled beneficiary”.	A disabled beneficiary is a person who, for some, or all, of the income year, receives the supported living payment on the ground of restricted work capacity or had the child disability allowance paid.

Trustee income of a disabled beneficiary trust would be taxed at the disabled beneficiary’s personal tax rate. This is achieved through applying the formula in proposed new section HC 39(2):

$$(\text{combined tax} - \text{tax on beneficiary's income}) \div \text{trustee income}$$

**Combined tax** is the total amount of tax that would be payable if the trustee income were combined with the income derived by the disabled beneficiary in the income year, applying the personal income tax scale.

**Tax on beneficiary’s income** is the amount of income tax payable in respect of the income derived by the disabled beneficiary in the income year (for example, tax on the supported living payment or child disability allowance, and employment or investment income).

**Trustee income** is the total amount of trustee income derived by the trustee of the disabled beneficiary trust in the income year.

Trustee income subject to the disabled beneficiary trust modification would remain trustee income for all other purposes. This means tax paid on the income would continue to be a final tax, with no further tax payable when funds are later distributed to the disabled beneficiary (or to another person, if the disabled beneficiary dies and funds are later distributed to residual beneficiaries on the dissolution of the trust).

A trust may qualify for the disabled beneficiary trust modification in an income year, then cease to qualify for the modification in a subsequent income year (for example, because the disabled beneficiary ceases to receive the supported living payment in that year), and then requalify for the modification in a later income year.

However, if a trust ceases to qualify for the modification because further beneficiaries are added to the trust (whether in replacement of, or supplementary to, the disabled beneficiary), the trust cannot qualify for the modification again in a later income year. This is to ensure that only the disabled beneficiary can benefit from the modification. If other beneficiaries were added to the trust, they might receive distributions of tax-paid trustee income that had been taxed at the disabled beneficiary’s personal tax rate, which would be inappropriate.

**Example 27: Income taxed at disabled beneficiary’s marginal tax rate(s)**

Matilda’s only source of income is the supported living payment, which she receives on the ground of restricted work capacity. At current payment rates for a single person aged 18 years or over, Matilda receives \$21,440 of taxable income each year.

Matilda’s parents are retired and want to ensure Matilda will continue to receive a similar level of care once they have passed away. They decide to settle property on a disabled beneficiary trust for Matilda. They arrange for Matilda’s siblings, their lawyer, and their accountant to be trustees of the trust. Matilda is the only beneficiary of the trust. The trust satisfies the requirements of the disabled beneficiary trust modification for the 2024–25 income year.

The trustees of the trust derive \$50,000 of trustee income in the 2024–25 income year. Applying the formula in proposed new section HC 39(2) achieves the same net outcome as if the trustee income had been earned directly by Matilda. A 23% tax rate applies to the trustee income. This is because after taking into account the income Matilda receives because of the supported living payment, the trustee income is taxed at a combination of the 17.5%, 30% and 33% personal tax rates.

Type of income	Amount of income	Tax rate	Income tax liability
Matilda’s personal income	\$21,440	13% (combination of the 10.5% and 17.5% rates)	\$2,772
Trustee income	\$50,000	23% (combination of the 17.5%, 30% and 33% rates)	\$11,723

The application of the individual components of the formula in section HC 39(2) is covered in more detail in the further examples below.

Despite a different rate applying, the income to which the modification applies is still considered trustee income. The obligation to return and pay tax on the trustee income lies with the trustees of the trust. When the trustee income is later distributed to Matilda, no further tax will be payable.

### **Trust is wound up upon Matilda's death**

In 2040, Matilda passes away. The trust deed names Matilda's siblings as residual beneficiaries of the trust, so when the trust is dissolved upon Matilda's death, any remaining property in the trust is distributed to her siblings.

When it is dissolved, the trust has \$200,000 of trustee income that was taxed at Matilda's personal rate in previous income years. When that income is distributed to Matilda's siblings, no further tax is payable because tax paid on trustee income is a final tax. It does not matter if Matilda's siblings are on different personal tax rates.

Any other income derived between Matilda's date of death and the date the trust is wound up is distributed to her siblings, the residual beneficiaries, as beneficiary income. This income is taxed as though it were her siblings' personal income (in accordance with existing rules regarding the taxation of beneficiary income).

## **Detailed analysis**

### **Definition of "disabled beneficiary trust" (section HC 39(4))**

The Bill proposes defining "disabled beneficiary trust" to mean a trust with one beneficiary who, during each income year for which the modification applies, meets the definition of "disabled beneficiary" (proposed section HC 39(4)(a)).

In addition, during each income year for which the modification applies, as well as all subsequent income years (regardless of whether the modification applies), the beneficiary:

- must be the only person entitled to receive distributions from the trust (unless the distributions are made when the trust is dissolved and the disabled beneficiary has died) (proposed section HC 39(4)(b)(i) and (ii)), and
- cannot be replaced, or supplemented, as the beneficiary of the trust (proposed section HC 39(4)(b)(iii)).

### **Beneficiary must be "disabled beneficiary" (section HC 39(4)(a) and (5))**

For a trust to qualify for the modification, the beneficiary of the trust would need to satisfy the definition of "disabled beneficiary" in proposed new section HC 39(5). This means the beneficiary must receive either of two Government support payments: the supported living payment on the ground of restricted work capacity, or the child disability allowance. It is

proposed that the receipt of these support payments would be used as a proxy for disability because Inland Revenue does not have the expertise to assess whether a person is disabled.

### **Supported living payment on the ground of restricted work capacity**

The supported living payment may be made to people who meet certain criteria, including disabled people. One ground for receipt of the supported living payment is “restricted work capacity”. This is essentially where a significant health condition, injury or disability is expected to impact upon a person’s ability to work for a period, or the person’s condition is terminal.

People aged under 16 cannot receive the supported living payment but may receive the child disability allowance instead.

### **Child disability allowance**

The child disability allowance is generally paid to the main carer of a child with a serious disability who is under 18 years of age. To qualify, the child must be a dependent child and must have a disability that requires constant care and attention, either permanently or for a period exceeding 12 months. The allowance is not means tested. However, it cannot be paid concurrently with the supported living payment (even though a person over 16 and under 18 could qualify for either the child disability allowance or the supported living payment).

The existing exclusion for disabled minors from the minor beneficiary rule is also tied to receipt of the child disability allowance. Basing eligibility for the proposed modification on a minor beneficiary’s receipt of the child disability allowance is therefore consistent with the existing exclusion for disabled minors from the minor beneficiary rule.

### **Support payments can be made for some, or all, of the relevant income year**

To qualify, a beneficiary would be required to have received either the supported living payment on the ground of restricted work capacity or the child disability allowance for at least part of the relevant income year. This means a trust settled for the care of a person who becomes disabled and commences receiving Government support part way through an income year could qualify for the modification for that year.

**Example 28: Beneficiary becomes disabled during income year**

Sam becomes disabled following injuries he sustains in an accident during the 2024–25 income year. After the accident, Sam’s mum (his main carer) receives the child disability allowance. Sam’s accident occurred in December 2024, and his mum starts receiving the child disability allowance soon after.

Sam’s grandparents decide to settle property on a trust for Sam so that there are extra funds available to help pay for his ongoing care. The trust meets the eligibility criteria for the modification.

Some income derived by the trust is applied for Sam’s benefit, so it is considered (and taxed as) beneficiary income. The minor beneficiary rule does not apply because Sam qualifies for the exclusion for disabled minors. Therefore, Sam’s beneficiary income is taxed at his personal tax rate. The trust’s remaining income is retained as trustee income. The trustee income is also taxed at Sam’s personal tax rate because the modification applies.

**Trust must have only one beneficiary (ignoring residual beneficiaries) (section HC 39(4))**

The modification would only apply to trusts with one beneficiary (ignoring any residual beneficiaries). Limiting this proposal to trusts with only one beneficiary minimises complexity by avoiding the need for rules regarding how trustee income should be taxed or apportioned if a trust has multiple beneficiaries.

**Further beneficiaries cannot be added (section HC 39(4)(b)(iii))**

To ensure the requirement that disabled beneficiary trusts only have one beneficiary is adhered to, further beneficiaries (except residual beneficiaries) cannot be added to the trust once the modification begins to apply to a trust.

**Example 29: Trust not eligible because further beneficiaries can be added**

Charlie and Violet settle property on a trust for their son, Danny, who has a serious disability. The child disability allowance is paid for Danny for the income year. While Danny is the sole beneficiary of the trust, the trust deed allows further beneficiaries to be added. As a result, the modification would not apply.

## **Residual beneficiaries must only be entitled to distributions after disabled beneficiary’s death (section HC 39(4)(b)(i) and (ii))**

Any other beneficiaries a disabled beneficiary trust has, or who are later added to the trust, must only be entitled to receive distributions of trust property once the disabled beneficiary has passed away.

Once a disabled beneficiary has passed away, no restrictions apply to whom the trust property can be distributed to. This means it would not matter if the residual beneficiaries were not disabled and/or were on higher personal tax rates.

### **Example 30: Trust deed only allows residual beneficiaries to be added**

Same facts as example 29, except the trust deed only allows residual beneficiaries to be added to the trust. The deed specifies that any residual beneficiaries of the trust are only to receive trust property after Danny’s death. The trust would qualify for the disability trust modification.

## **Modification taxes trustee income at the marginal rate(s) of the beneficiary (section HC 39(2) and (3))**

Proposed new section HC 39(2) provides a formula for determining the tax rate that applies to trustee income derived by the trustee of a disabled beneficiary trust.

$$(\text{combined tax} - \text{tax on beneficiary's income}) \div \text{trustee income}$$

### **Combined tax (section HC 39(2) and (3)(a))**

“Combined tax” is defined as the total tax calculated under schedule 1, part A, clause 1, table 1 of the Income Tax Act 2007 (that is, applying the personal tax scale) for each dollar of taxable income derived in the income year by the disabled beneficiary or the trustee.

**Table 4: Schedule 1, part A, clause 1, table 1 of the ITA**

Row	Range of dollar in taxable income	Tax rate
1	\$0 – 14,000	0.105
2	\$14,001 – \$48,000	0.175
3	\$48,001 – \$70,000	0.300

Row	Range of dollar in taxable income	Tax rate
4	\$70,001 – \$180,000	0.330
5	\$180,001 upwards	0.390

The “combined tax” amount is effectively the total tax that would be payable if the personal tax scale were applied to a combination of both the disabled beneficiary’s income and any income derived by the trustee in the income year.

### Example 31: Combined tax (continuation of example 27 above)

In the 2024–25 income year, Matilda derives \$21,440 of taxable income. The trustee of the disabled beneficiary trust settled for Matilda derives \$50,000 of trustee income. Applying the personal tax scale to the \$71,440 of combined income, the combined tax amount would be \$14,495.

Tax bracket	Tax rate	Income in bracket	Income tax
\$0 – 14,000	10.5%	\$14,000	\$1,470
\$14,001 – \$48,000	17.5%	\$34,000	\$5,950
\$48,001 – \$70,000	30%	\$22,000	\$6,600
\$70,001 – \$180,000	33%	\$1,440	\$475
\$180,001 upwards	39%	\$0	\$0
<b>Combined tax amount:</b>			<b>\$14,495</b>

### Tax on beneficiary’s income (section HC 39(2) and (3)(b))

“Tax on beneficiary’s income” is defined to mean the total tax calculated under schedule 1, part A, clause 1, table 1 for each dollar of taxable income derived in the income year by the disabled beneficiary. This is equal to the income tax liability on income derived by the beneficiary in the income year.

**Example 32: Tax on beneficiary's income (continuation of example 27 above)**

In the 2024–25 income year, Matilda derives \$21,440 of taxable income. Applying the personal tax scale, the tax on beneficiary's income would be \$2,772.

Tax bracket	Tax rate	Income in bracket	Income tax
\$0 – 14,000	10.5%	\$14,000	\$1,470
\$14,001 – \$48,000	17.5%	\$7,440	\$1,302
\$48,001 – \$70,000	30%	\$0	\$0
\$70,001 – \$180,000	33%	\$0	\$0
\$180,001 upwards	39%	\$0	\$0
<b>Tax on beneficiary's income:</b>			<b>\$2,772</b>

**Trustee income (section HC 39(2) and (3)(c))**

"Trustee income" is defined to mean the total amount of trustee income derived in the income year by the trustee.

**Example 33: Trustee income (continuation of example 27 above)**

In the 2024–25 income year, the trustee of Matilda's disabled beneficiary trust derives \$50,000 of trustee income.

**Effect of applying the formula**

The formula in proposed new section HC 39(2) effectively ensures that trustee income derived by the trustee of a disabled beneficiary trust is taxed at the personal tax rate of the beneficiary, taking into account the beneficiary's income. It does this by determining the basic rate of tax to apply to the trustee income.

**Example 34: Calculating the basic tax rate on trustee income (continuation of example 27 above)**

The formula in proposed new section HC 39(2) for calculating the basic tax rate on trustee income subject to the disabled beneficiary trust modification is:

$$(\text{combined tax} - \text{tax on beneficiary's income}) \div \text{trustee income}$$

The relevant amounts for Matilda's disabled beneficiary trust are:

Combined tax	Tax on beneficiary's income	Trustee income
\$14,495	\$2,772	\$50,000

Applying the formula, the basic tax rate is 23%  $((\$14,495 - \$2,772) \div \$50,000)$ .

## Corpus and settlements on other trusts

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### Clause 31

### Summary of proposed amendment

The proposed amendment would clarify that amounts paid as beneficiary income and then settled on a new trust on the beneficiary's behalf are included in the corpus of the new trust.

### Effective date

The proposed amendment would have effect for the 2024–25 and later income years (beginning 1 April 2024 for most trusts).

### Background

“Corpus” for a trust means the settlement value of property settled on the trust, subject to certain exclusions.<sup>21</sup> Distributions of amounts of corpus to beneficiaries of the trust are exempt from tax.<sup>22</sup>

A settlement by a trustee of a trust (Trust A) on another trust (Trust B) is excluded from corpus of Trust B to the extent to which, if it were distributed to a New Zealand-resident beneficiary of Trust A, it would be beneficiary income or a taxable distribution to that beneficiary.<sup>23</sup> This rule is intended to ensure that trustees cannot avoid paying tax on distributions of amounts accumulated in trusts simply by settling those amounts on other trusts and then distributing them as tax-free corpus.

### Detailed analysis

Trustees can make resettlements on behalf of beneficiaries. This involves:

- a payment made by the trustee to the beneficiary for the purposes of the definitions of “beneficiary income”<sup>24</sup> and “distribution”<sup>25</sup>, and

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<sup>21</sup> Section HC 4 of the Income Tax Act 2007.

<sup>22</sup> Sections CW 53 and HC 20 of the Income Tax Act 2007.

<sup>23</sup> Section HC 4(3) of the Income Tax Act 2007.

<sup>24</sup> Section HC 6 of the Income Tax Act 2007.

<sup>25</sup> Section HC 14 of the Income Tax Act 2007.

- a settlement by (trustees on behalf of) the beneficiary on the new trust.

The proposed amendment clarifies the definition of corpus to ensure that such settlements are not excluded from corpus of the new trust. These settlements have not been made to avoid paying tax. The proposed amendment ensures that such settlements are not subject to tax twice – first as beneficiary income (or a taxable distribution), then when the settlement is distributed to the beneficiary.



# **Taxation of backdated lump sum payments**

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## Taxation of backdated lump sum payments

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*Clauses 57, 59(15) and (19), and 62(3) and (5)*

### Summary of proposed amendment

The proposed amendments provide alternative tax treatment for two types of backdated lump sum payments: backdated Accident Compensation Corporation (ACC) payments and backdated Ministry of Social Development (MSD) entitlements.

### Effective date

The proposed amendments would have effect for payments made on or after 1 April 2024.

### Background

A lump sum backdated payment to a person of their ACC or MSD entitlements could result in that person having to pay a higher amount of tax. This is because, for most individual taxpayers, income is taxed in the year it is received. This can be seen as unfair when the person was entitled to receive the payment in earlier years.

Receipt of the lump sum can artificially push people into a higher tax bracket for a single year. This compounds the disadvantage suffered by the affected person who, in addition to having had a delay in receiving their entitlement, also receives a smaller net amount than if the amount had been paid over multiple years (that is, when it should have been paid).

A fairness issue arises when all the following occur:

- the amount is significant enough to move the taxpayer into a higher tax bracket
- if spread over the relevant tax years, the taxpayer would have had a lower tax liability in relation to that amount
- a backdated (or remedial) lump sum payment (BLSP) is made relating to two or more tax years, and
- the delay or error has been caused by an action or inaction by the Crown.

This issue has been raised repeatedly over several years for ACC and MSD payments in complaints to the Commissioner of Inland Revenue, Ministerial correspondence, media articles and Select Committee submissions.

## ACC compensation payments

Each year, ACC pays around 1,200 backdated compensation or reimbursement payments averaging around \$48,000 each. In some cases, whether a person is entitled to ACC compensation may be the subject of dispute or delay in awarding compensation and making payment to the person.

### Example 35: Taxation of Scotty's ACC payment

Montgomery Scott (Scotty) was a forklift operator for one of the major ports in New Zealand. In 2019, he was involved in a workplace accident that saw him suffer long-term damage to his leg.

For a time, Scotty received weekly compensation under the Accident Compensation Act 2001 for loss of earnings. However, ACC stopped paying him weekly compensation in 2019 when it considered he was able to return to paid employment. Scotty disputed this decision, but it took some years to resolve this dispute as several investigations needed to be completed before final eligibility was established.

In 2023, Scotty was awarded a payment of \$50,000 per year. This was paid in a lump sum of \$200,000 in March 2023. If Scotty had received this amount in the relevant years, his tax liability for the payments would have been as follows:

	2020	2021	2022	2023	Total
Income	\$50,000	\$50,000	\$50,000	\$50,000	\$200,000
Tax liability	\$8,020	\$8,020	\$8,020	\$8,020	\$32,080

However, for tax purposes the payment is only taxed on receipt of the full amount in 2023. This will result in income in the 2023 year of \$200,000, and a tax liability for Scotty of **\$58,120**.

The difference between the two treatments is an additional tax liability for Scotty of **\$26,040**.

## MSD backdated entitlements

Backdated payments of MSD entitlements may also give rise to an increased tax liability if they are paid in a subsequent tax year. BLSPs are paid by MSD, for example, when there has been a past system error, or when incorrect or incomplete information was provided at the time of an assessment. They tend to be for smaller amounts (under \$1,000) than ACC BLSPs.

MSD BLSPs are paid “net of tax” (with tax already deducted). MSD determine how much the recipient is entitled to in their hand and then gross up that amount for the tax payable. MSD calculate the tax to withhold as if the payments had been made on time (by reference to previous years).

Since Inland Revenue taxes the BLSP in the year of receipt, this may result in a higher amount of tax payable for the recipient. For some recipients of MSD entitlements, a tax write-off is available for the difference in tax (between what was deducted and the tax owing). However, for those who receive Working for Families or those who are no longer on a benefit, this tax difference is payable.

### **Example 36: Taxation of Sammy’s backdated MSD entitlement**

Sammy worked as a shepherd on a high-country farm in North Canterbury. In 2013, Sammy had to stop work after suffering extreme dizziness and fatigue over a prolonged period. Sammy was originally diagnosed with depression and was granted a sickness benefit when they left work.

Years later, Sammy applied for a supported-living payment (also known as an invalid benefit) but their claim was denied. After years of trying to treat their illness, in 2022 they were diagnosed with a rare genetic condition. Following this new information, MSD granted Sammy the supported living payment and Sammy appealed to have this backdated to 2013.

Sammy was awarded \$10,000 in backdated benefits and \$2,000 in ex-gratia payments for their pain and suffering.

When calculating the tax owed on the payment, MSD wants to ensure that Sammy will get \$10,000 by adding an extra amount (grossing up the payment) to account for Sammy’s tax liability. To do that, MSD work out the amount of the tax payable on the payments as if those payments had been taxed in the correct year, which works out to be \$2,500.<sup>26</sup> MSD pays Sammy \$12,500 gross and withholds and pays PAYE of \$2,500 to Inland Revenue. Sammy receives \$10,000 in the hand.

However, when information about the payment comes through into Sammy’s annual income tax calculation at Inland Revenue, additional tax is owing on the BLSP. This is because it is taxed in the year of receipt and not as MSD has calculated the tax liability. This has flow-on effects to their social policy obligations.

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<sup>26</sup> This amount of tax deducted is for illustrative purposes.

## Key features

The proposed amendments would introduce the following alternative tax treatments for backdated ACC payments and backdated MSD entitlements:

- ACC: the BLSP would be taxed at the recipient's average tax rate for the four years prior to the year they receive the payment.
- MSD: the tax deducted by MSD from the BLSP would be assumed as the final amount of tax owed.

The proposed tax treatment for each payment differs due to the way in which tax is calculated by MSD and ACC.

## Detailed analysis

### ACC compensation payments

Proposed new section RD 20B of the Income Tax Act 2007 (ITA) provides the method to calculate an alternative tax rate for ACC BLSPs (a multi-year compensation payment). A multi-year compensation payment is defined as an accident compensation earnings-related payment consisting of a lump sum and relating to more than one income year for a person.

Under proposed section RD 20B(3), the tax rate that would apply to a multi-year compensation payment would be:

- a. 10.5% if the average basic tax rate is less than 10.5% and paragraph c. does not apply, or
- b. the average basic tax rate if neither of paragraph a. or c. apply, or
- c. the person's basic tax rate for the income year they receive the payment if that basic tax rate is less than the average basic tax rate.

### Paragraph (a) - minimum tax rate

Paragraph (a) in proposed new section RD 20B(3) introduces a minimum tax rate of 10.5% to recognise the tax required to be withheld from the payment if the payment was the person's only income.

### **Paragraph (b) – average basic tax rate**

Proposed new section RD 20B(4) provides a formula to calculate the average basic tax rate for a person over the previous four years, based on the income information Inland Revenue holds. This formula is as follows:

$$0.25 \times (\text{basic rate 1} + \text{basic rate 2} + \text{basic rate 3} + \text{basic rate 4})$$

Basic rate 1 to basic rate 4 are defined in proposed section RD 20B(5), and they effectively mean the person's basic tax rate calculated under schedule 1, Part A, clause 1 of the ITA for each of the four income years in the averaging period.

### **Paragraph (c) – basic tax rate**

The proposed section also introduces a 'lower of' test to prevent recipients from being worse off under the alternative tax treatment compared to the status quo. This means that if the recipient has had a higher tax rate in the four years before receipt of the BLSP but has a lower tax rate in the year the BLSP is paid, the person's basic tax rate for the current year would apply.

### **Payment by ACC**

Under current information sharing provisions, ACC would be able to request the recipient's correct tax rate before the BLSP is made and then apply that as the withholding rate on the payment. This would mean no additional amount of tax should be payable for the BLSP (assuming the recipient's circumstances do not change).

The rate determined under proposed section RD 20B would apply to the BLSP separately from the rate applied to the person's other income in the year they receive the payment.

#### **Example 37: Taxation of Scotty's ACC payment in 2024 (continuation of example 35 above)**

If Scotty was paid his payment on or after 1 April 2024, the proposed tax treatment would apply.

*If Scotty had no other income – minimum tax rate*

Assume that while disputing the claim with ACC, Scotty was able to live mainly on his savings and with support from his partner.

Before ACC pays his BLSP, ACC contacts Inland Revenue for Scotty's average basic tax rate over the previous four years. Since the calculation ignores the BLSP, Scotty's

average tax rate for each year was 0%. However, applying the proposed provision, paragraph (a) would apply, so that the minimum tax rate would be 10.5%.

ACC would be able to apply this rate to Scotty's payment (\$200,000 x 10.5%) and his tax liability would be **\$21,000**. If Scotty continued to earn no income in the year of payment of the BLSP, no additional tax would be owing.

*If Scotty was earning other income*

Assume that while disputing the claim with ACC, Scotty was able to find a part-time office job.

Before ACC pays his BLSP, ACC contacts Inland Revenue for Scotty's average basic tax rate over the previous four years. His income and average basic tax rate, excluding the BLSP, for each year is as follows:

	2020	2021	2022	2023
Income	\$18,000	\$21,000	\$26,000	\$30,000
Basic tax rate <sup>27</sup>	12%	12.8%	13.7%	14.2%

Using the formula, Scotty's average basic tax rate for the previous four years would be:

$$0.25 \times (12 \text{ (BTR 1)} + 12.8 \text{ (BTR 2)} + 13.7 \text{ (BTR 3)} + 14.2 \text{ (BTR 4)}) = 13.175\%$$

Therefore, instead of Scotty's BLSP being included in his annual tax return for 2024, it would be taxed separately at his average basic tax rate.

ACC can apply the average tax rate to the BLSP (\$200,000 x 13.175%) and withhold the tax before making the payment to Scotty. Scotty's tax liability on the BLSP would be **\$26,350**.

Assuming Scotty has \$30,000 income from his part-time office job in 2024, he will continue to pay tax at the applicable rate on that income. However, no additional tax will be owed for the BLSP.

Without the alternative tax treatment, Scotty's BLSP would have been included in his taxable income for 2024 (\$30,000 + 200,000). Under ordinary treatment, his tax liability would have been **\$69,820**.<sup>28</sup>

<sup>27</sup> This is calculated by dividing tax paid by taxable income x 100.

<sup>28</sup> This calculation assumes the marginal tax rates are unchanged in the 2024-25 income year from the 2022-23 income year.

## Payments of backdated MSD entitlements

Proposed new section RD 20C provides the method to calculate an alternative tax rate for backdated payments of MSD entitlements (a multi-year benefit payment). A multi-year benefit payment is defined as a main benefit consisting of a lump sum that relates to more than one income year.

For these purposes, a main benefit is as defined in paragraph (a) of the definition of “main benefit” in schedule 2 of the Social Security Act 2018, namely:

- jobseeker support
- sole parent support
- a supported living payment on the ground of restricted work capacity, total blindness, or caring for another person
- a youth payment
- a young parent payment, or
- an emergency benefit.

The proposed formula for calculating the tax rate on the BLSP would effectively treat the tax deducted by MSD before paying the person as the correct amount of tax owed. This means there would be no further tax payable and the BLSP would be ignored for the person’s income tax liability.

The BLSP would still be considered for social policy entitlements because these entitlements are, generally, calculated with reference to cash in hand.

### **Example 38: Taxation of Sammy’s MSD payment in 2024 (continuation of example 36 above)**

If Sammy was paid their BLSP after 1 April 2024, the proposed alternative tax treatment would apply. This would mean that once MSD calculated the tax owing, this would be the final amount of tax payable on the BLSP.

The tax rate on Sammy’s payment would be calculated as follows:

$$\text{\$2,500 (tax deduction)} \div (\text{\$10,000 (received amount)} + \text{\$2,500 (tax deduction)}) = 0.2$$

The calculated rate of 20% should equal the amount deducted, meaning no extra tax would be owing on the payment.

Sammy has a small student loan, so when the income information is passed through to Inland Revenue, a small amount is owing for their student loan repayment. This would be the only extra amount owing to Inland Revenue from Sammy.

# Other policy items

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# Payment of KiwiSaver contribution to PPL recipients

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## Clause 85

### Summary of proposed amendment

Under the proposed amendment, the government would pay a three percent KiwiSaver contribution on amounts of Paid Parental Leave (PPL) received by KiwiSaver members, provided the recipient also paid a three percent KiwiSaver employee contribution.

### Effective date

The proposed amendments would take effect on 1 July 2024.

### Key features

- From 1 July 2024, the Government would pay a three percent KiwiSaver contribution to eligible PPL recipients.
- To be eligible, PPL recipients would also need to contribute three percent of their PPL payments to their KiwiSaver accounts.

### Background

The financial position of women at retirement is typically less secure than men. Although women tend to live longer than men, the average KiwiSaver balances of men are 20 percent higher than those of women. The reasons for this are varied and include overrepresentation in lower paid roles, lower rates of labour force participation, and time spent out of the workforce to raise children or care for family members.

Paid Parental Leave (PPL) is a payment made to qualifying individuals and is intended to make up for lost income when a person takes time out of the workforce to have a baby. For the period 1 July 2022 – 30 June 2023, PPL payments will match a person's weekly income up to a maximum of \$661.12 per week before tax.

Under the proposed amendment, the government would pay a three percent KiwiSaver contribution on amounts of PPL received by KiwiSaver members where the PPL recipient also paid a corresponding three percent KiwiSaver employee contribution into their KiwiSaver account. This would help to increase the KiwiSaver balances of PPL recipients, many of whom are women.

## Taxation rollover relief

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*Clauses 18, 22, 26, 27, 30, and 59(3) and (13)*

### Summary of proposed amendments

The Bill proposes to provide temporary tax relief in response to the January and February 2023 North Island flooding events. This relief would enable the profits and depreciation recovery income arising when insurance or compensation proceeds are received for business assets destroyed by the North Island flooding events to be deferred provided the assets are replaced. Similar temporary, time-limited relief was provided for assets destroyed by the Canterbury and Hurunui-Kaikōura earthquakes.

The Bill also includes several minor associated amendments to the Income Tax Act 2007 (ITA), particularly the depreciation rules. Similar amendments were included as part of the earthquake tax relief packages.

### Effective date

The proposed amendments would be effective for the 2022–23 and later income years, ceasing in the 2027–28 income year.

### Background

Normally, the receipt of insurance proceeds for a destroyed business asset gives rise to either depreciation recovery income on a depreciable asset, or income on a revenue account asset. The resulting upfront tax liability means that a business seriously impacted by a North Island flooding event will have less cash available to pay for the replacement assets needed to recommence business. In many cases, it would also mean a windfall revenue gain to the Government from the events.

While these taxable gains would normally have arisen if the assets were sold, the unexpected nature of the flooding destruction is a very different circumstance, and the resulting tax liability is unexpected. This issue was recognised in relation to the assets destroyed by the Canterbury and Hurunui-Kaikōura earthquakes and rollover relief was provided.

Rollover relief defers the recognition of the depreciation recovery income or income on a revenue account asset, provided there is a commitment to rebuild or replace the destroyed assets.

As part of the earthquake provisions, several associated amendments were made to clarify the timing around the deductibility of expenditure and recognition of income for the

damaged assets. The Bill contains similar proposed technical amendments as part of the flood tax relief package.

For more detail and examples on the Canterbury legislation, see *Tax Information Bulletin* Volume 24, No 10, December 2012.

## Key features

The Bill contains a set of proposed amendments to the ITA as part of providing rollover relief for assets “destroyed” because of the January/February North Island flooding events. These amendments:

- provide rollover relief for both revenue account assets and depreciable assets that are destroyed or uneconomic to repair
- clarify that on-going expenses or losses can continue to be deducted when a business activity is so disrupted by a flooding event that there is no longer a sufficient nexus between the expenses and the income-earning activity
- align the tax treatment of depreciable assets that are uneconomic to repair with the treatment of depreciable assets that have been “irreparably damaged” or are “useless for earning income” for tax purposes
- limit the recovery income that arises under the tax rules when insurance proceeds have been received for a damaged asset that is repairable to the amount of depreciation deductions previously claimed for the asset
- provide optional matching rules to smooth the timing of income and deductions/disposal losses when insurance proceeds have been received for flood affected (depreciable) assets
- clarify that a depreciation deduction may be claimed on depreciable property when access to the property is temporarily restricted because of a flooding event, and
- provide an optional adjustment rule for measuring group assets for the purposes of the thin-capitalisation rules.

## Detailed analysis

The Bill proposes to insert new sections CZ 25C, DZ 20B, EZ 23BE, EZ 83 to EZ 87, and FZ 7B to the ITA. These provisions are based on the previous earthquake provisions. A key exception is that the proposed provisions do not include a requirement that replacement land and buildings be located in the same region in New Zealand.

## Key rollover provisions

The key provisions are in proposed new section CZ 25C, which provides the option of rollover relief for profits arising because of an insurance or compensation pay-out on revenue account property destroyed by a North Island flooding event, and proposed new section EZ 23BE, which provides a similar relief option for depreciable property.

In both cases, the rollover option requires the destroyed<sup>29</sup> asset to be replaced. If it is not replaced by the end of the 2027–28 income year, then the rollover relief would cease in that year. If the business ceases operations or acquires the replacement asset in an income year before the 2027–28 income year, the rollover relief would cease in that earlier income year.

The cost of the replacement asset for tax purposes is reduced to reflect the deferred income in the year the asset is replaced, or partially replaced if the replacement expenditure is incurred gradually.

As rollover relief is optional, the taxpayer would need to elect to use the option and notify the Commissioner of their election. This must be done by the date their return of income is required to be filed for each income year that they elect to use rollover relief. Certain information is required as part of the notification. Its purpose is to ensure that the taxpayer turns their mind each year to deciding whether they still intend to replace the asset.

### Example 39

A taxpayer's revenue account building located in the Hawke's Bay is destroyed by a North Island flooding event. The building originally cost \$1.5 million. The replacement insurance proceeds are \$3 million, and the replacement building is completed on 15 June 2026. In the absence of rollover relief, the building owner will have taxable income of \$1.5 million (under section CG 6). Proposed section CZ 25C would allow the owner to defer that income tax liability by allocating an amount of \$1.5 million to the replacement building.

As a result of negotiations between the building owner and the insurance company, the insurance proceeds can be reasonably estimated on 30 September 2023.

In the tax return for the tax year ending on 31 March 2024, the building owner files an election to defer the \$1.5 million of income pending replacement of the building. Provided the taxpayer continues to elect to defer the income, it remains suspended for the tax years ending on 31 March 2025 and 31 March 2026.

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<sup>29</sup> The asset has to be irreparably damaged/useless for income-earning purposes.

As the replacement building is completed on 15 June 2026, the tax return for the tax year ending 31 March 2027 will include the new building at a cost of \$1.5 million (being the \$3 million cost of the new building less the \$1.5 million rollover relief).

A notice will have to be filed with the tax return for the year ended 31 March 2027 advising that the deferred income has been rolled into the tax base for the replacement asset. The taxpayer must also give notice that the amount of unallocated suspended income has been reduced by \$1.5 million to \$0.

When the replacement asset is eventually sold, the difference between the \$1.5 million cost and the sales proceeds will be taxable, provided the building is sold for more than \$1.5 million.

#### **Example 40**

Plant and equipment (not previously depreciated under the pool method) destroyed by a North Island flooding event had a cost of \$1 million. On the day of the flood, the plant and equipment had an adjusted tax book value of \$700,000. The owner receives an insurance pay-out of \$1 million. The net depreciation recovered is, therefore, \$300,000, and this becomes the suspended recovery income. The replacement assets are acquired over two years at a cost of \$400,000 per year. In year three, the owner decides to acquire no more replacement assets.

Under proposed section EZ 23BE, the \$300,000 suspended recovery income is allocated as follows:

Year 1 ( $\$400,000 \times \$300,000$ ) /  $\$1,000,000 = \$120,000$ )

Year 2 ( $\$400,000 \times \$300,000$ ) /  $\$1,000,000 = \$120,000$ )

The cost of the replacement plant and machinery is reduced in total by \$240,000.

The remaining suspended recovery income balance of \$60,000 (representing the portion of assets not replaced) is taxed in the year the taxpayer decides to make no further investment in replacement property.

### **Deductibility of expenses when no income-earning activity**

Proposed new section DZ 20B addresses the situation where some taxpayers are no longer able to deduct their on-going expenses or losses relating to their income-earning activity. For example, when land is not physically accessible due to silt, resulting in the business activity being so disrupted by the flooding event that there is no longer a sufficient nexus between the expenses and the income-earning activity.

The proposed new section provides certainty on the deductibility of expenses or losses for affected taxpayers who intend to continue their income-earning activities. To qualify, the person must:

- have an income-earning activity in the “affected area” immediately before the flooding event, and
- in the current year, during the period of interruption, have incurred expenditure or loss in meeting an obligation relating to the income-earning activity and that interruption expenditure does not meet the requirements of the general deductibility permission in section DA 1, but would have done so but for the interruption, and
- resume the income-earning activity in an income year before the 2028–29 income year.

If all these conditions are met, the person is allowed to deduct the expenditure in the year their income earning is resumed.

### **Damaged depreciation property that is uneconomic to repair**

The tax depreciation rules do not provide an appropriate outcome when an asset has been damaged by a North Island flooding event and the insurer or comparable qualified assessor considers it to be uneconomic to repair, even though the asset may be technically repairable. This is because the tax rules distinguish between assets that are repairable and those that are irreparably damaged or rendered useless for earning income. Assets that are uneconomic to repair are generally included in the former category. The consequence is that a taxpayer may face a significant unexpected tax liability when an insurance amount is received.

To help overcome this problem, proposed new section EZ 83 would provide for a deemed disposal and reacquisition of assets that are damaged by a January/February North Island flooding event and are uneconomic to repair. This would better align their depreciation treatment with those of assets that have been irreparably damaged by a flooding event. Rollover relief would then be available for those assets.

The asset would be deemed to be reacquired for nil consideration on the same day as the deemed disposal (which would be for the amount of insurance), meaning that the post-flooding event repairs would be capitalised rather than being treated as deductible expenditure.

### Example 41

A building has a cost of \$5 million, accumulated depreciation deductions of \$4 million, and an adjusted tax value of \$1 million. It is damaged by a North Island flooding event and the insurance company decides it has an obligation under the insurance policy to replace it at a cost of \$10 million because it is no longer fit for purpose and is uneconomic to repair. The damaged building is retained by the insured party and put to another, less productive, use.

Proposed new section EZ 83 could be applied in these circumstances. Therefore, the building would be treated as being disposed of for \$10 million and reacquired for nil consideration on the date of the flooding event that caused the asset to be uneconomic to repair. As the building would be treated as having been disposed of, the owner of the asset could apply the matching rule in proposed new section EZ 86 to smooth the timing of income calculated under existing section EE 48. Under section EE 48, the result will be:

Original cost	\$5,000,000
Depreciation deductions	\$4,000,000
Adjusted tax value	\$1,000,000
Amount for disposal (consideration)	\$10,000,000
Depreciation recovery income	\$4,000,000
Capital gain	\$5,000,000

Rollover relief (under proposed new section EZ 23BE) would be available to the building owner for the \$4 million of depreciation recovery income.

### Cap on depreciation recovery income

Section EE 52 of the ITA treats as taxable any insurance proceeds in excess of an asset's adjusted tax value and expenditure on repairing the asset. As a result, the tax rules may end up taxing more than the amount of earlier depreciation deductions allowed for the asset. In the context of the North Island flooding events, this means that some taxpayers may face significant unanticipated income tax liabilities in relation to damaged (but repairable) assets.

Accordingly, proposed new section EZ 84 would limit depreciation recovery income to the amount of depreciation deductions previously taken when insurance proceeds are received for a repairable depreciable asset damaged by a January/February North Island flooding event.

**Example 42**

A building costing \$5 million is damaged by a flooding event but is repairable. The building has an adjusted tax value of \$1 million, with depreciation deductions of \$4 million taken. Insurance proceeds of \$7 million are received, with \$1 million of the proceeds being spent on repairing the asset. Proposed section EZ 83 would not apply because the asset is not uneconomic to repair. Under section EE 52, the depreciation recovery income would be \$5 million. However, proposed section EZ 84 would cap the amount of depreciation recovery income at \$4 million. The remaining \$1 million would be treated as a capital gain.

**Property that is available for use**

For an item of property to be depreciated for tax purposes, it must be used in a business or be available for use. However, it is not clear how this rule should be applied when access to depreciable property is temporarily restricted by a January/February North Island flooding event. Proposed new section EZ 85 would address this issue by treating the item as being available for use during the period of restricted access, provided it was available for use immediately before the restriction was imposed. Depreciation could therefore be claimed.

**Optional timing rule when damage results in a disposal**

Proposed new section EZ 86 would provide an optional rule to smooth the timing of income and deductions when insurance proceeds have been received for depreciable property that has been irreparably damaged or rendered useless for earning income because of a January/February North Island flooding event. The proposed timing rule would also apply to depreciable assets that are uneconomic to repair and to which proposed new section EZ 83 would apply.

The optional rule would apply to individual items of depreciable property, in line with the general approach under the depreciation rules.

The proposed section provides that any income or deductions are recognised at the earlier of:

- the first income year in which
  - the insurance receipt is, or has been, derived or able to be reasonably estimated, and
  - the cost of disposing of the item is, or has been, incurred or able to be reasonably estimated, and

- the consideration from the disposal of the item is, or has been, derived or able to be reasonably estimated, or
- the 2027–28 income year.

Whether insurance proceeds and other amounts can be reasonably estimated is essentially a question of fact, which will depend on the individual circumstances of each case. However, it is envisaged that some form of documentation would be required, for example, a written quote from an insurer.

Proposed new section EZ 86 would override the normal depreciation timing rules. The section could also be applied to assets depreciated in a pool. A person who opts to use the matching rule would be required to use it for all their items of depreciable property that meet the criteria for applying the rule. This is to prevent taxpayers “cherry-picking” the assets to which they apply the rule.

A taxpayer’s election to use the matching rule would be reflected in the tax position they take in their return of income for each tax year – no prior notice of election would be required.

#### **Example 43**

Equipment originally costing \$10,000 is irreparably damaged by a North Island flooding event. The asset’s tax book value is \$7,000, with \$3,000 of accumulated depreciation deductions. The disposal costs are reasonably estimated in 2022–23 to be \$1,000. The insurance proceeds received for the asset are reasonably estimated in 2023–24 as being \$9,000. The equipment has a scrap value of \$100, which is reasonably estimated in 2022–23.

Applying the proposed matching rule, any income or deductions would be recognised in the 2023–24 income year, as this is when all the insurance proceeds, disposal costs and disposal proceeds can be reasonably estimated. Accordingly, in the 2023–24 income year, section EE 48 would apply to determine the amount of depreciation recovery income or depreciation loss.

### **Optional timing rule when damage does not result in a disposal**

Proposed new section EZ 87 would introduce an optional rule to smooth the timing of income and deductions when insurance proceeds have been received for a depreciable asset that has been damaged in a January/February North Island flooding event, but the asset is repairable. The rule is broadly similar to proposed new section EZ 86 in design, except in this case, the asset is economically repairable.

Again, the owner would need to choose to apply the timing rule to all their depreciable assets that meet the requirements.

The timing rule provides that any income or deductions would be recognised at the earlier of:

- the first income year in which
  - the insurance receipt is, or has been, derived or able to be reasonably estimated, and
  - the cost of repairing the asset is, or has been, incurred or able to be reasonably estimated; or
- the 2027–28 income year.

Proposed new section EZ 87 would override the timing rules in existing sections CG 4, EE 22 and EE 52 of the ITA. The section would also be applicable to assets depreciated in a pool.

#### **Example 44**

Machinery originally costing \$100,000 is damaged by a flooding event. The asset's adjusted tax value is \$60,000, with \$40,000 of accumulated depreciation deductions. The insurance proceeds are estimated in 2022–23 as being \$110,000. Repair costs are estimated in 2023–24 to be \$20,000, and \$10,000 is actually incurred in each of 2023–24 and 2024–25.

Applying the matching rule, any income or deductions would be recognised in the 2023–24 income year, as this is when the insurance proceeds and total repair costs can reasonably be estimated. Accordingly, in the 2023–24 income year, existing sections CG 4 and EE 52 would apply.

The repair costs are deductible under the general deductibility rules.

Section CG 4 would treat \$20,000 of the insurance proceeds as taxable, as this is the amount of insurance proceeds that recovers deductible expenditure.

Section EE 52 would apply to the insurance proceeds as follows:

$$\text{Adjusted tax value of } \$60,000 \text{ less } (\$110,000 - \$20,000) = (\$30,000)$$

Accordingly, the adjusted tax value would be reduced to nil and depreciation recovery income under section EE 52 would be \$30,000.

## Optional adjustment to assets under thin-cap rules

Proposed new section FZ 7B would provide an optional adjustment to how group assets are measured for the purposes of the thin-capitalisation rules. The adjustment would mitigate a timing problem that arises because insurance proceeds may be recognised for tax purposes at a later date than the damage caused by a North Island flooding event.

The thin-capitalisation rules are based on accounting measures of assets. For accounting purposes, damaged assets are immediately impaired or derecognised. In contrast, insurance proceeds cannot be recognised until they are reasonably expected.

Proposed new section FZ 7B is designed to mitigate this timing difference by allowing certain taxpayers to carry back known insurance proceeds to the date on which an asset was impaired or derecognised as a result of damage caused by a flooding event. The amount that can be carried back would be limited to the lesser of the amount of damage or the related insurance proceeds.

Without this option, a business may be temporarily disadvantaged in terms of how much debt they can carry on their balance sheet under the thin-capitalisation rules, resulting in reduced interest deductions.

A person who chooses to use this option would be required to notify the Commissioner and provide certain information.

## Definition of flooding events and affected area

The recently enacted Severe Weather Emergency Recovery Legislation Act 2023 defines a series of weather events that occurred over January-February 2023 as "severe weather events". It is proposed to replace the definition of "North Island flooding events" in section YA 1 of the ITA with a new definition to align it with the "severe weather events" definition. The proposed new definition of "North Island flooding events" provides that it means flooding and other damage that occurred in an affected area caused by any of the following weather events:

- Cyclone Hale, which crossed the North Island of New Zealand during the period commencing on 8 January 2023 and ending on 12 January 2023.
- The heavy rainfall commencing on 26 January 2023 and ending on 3 February 2023 in the Northland, Auckland, Waikato, and Bay of Plenty regions.
- Cyclone Gabrielle, which crossed the North Island of New Zealand during the period commencing on 12 February 2023 and ending on 16 February 2023.

The proposed new definition of “affected area” would mean any of the following regions or districts:

- The regions of Northland, Auckland, Waikato, Bay of Plenty, Gisborne, and Hawke’s Bay.
- The districts of Tararua, Masterton, Carterton, South Wairarapa, Manawatū, and Rangitikei.

The Severe Weather Emergency Recovery Legislation Act 2023 extended the affected area to include the Manawatū and Rangitikei districts.

This widened definition would be used for the taxation rollover relief provisions to provide regulatory consistency.

The definition is intended to also cover an affected area where subsequent events exacerbate the damage caused by one or more of the above flooding events in that area. An example of such a subsequent event would be the Mangawhai floods.

## Schedule 32 – Overseas donee status

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### Clause 64

### Summary of proposed amendment

The proposed amendments would add six organisations to, and remove seven organisations from, the list of donee organisations in schedule 32 of the Income Tax Act 2007.

### Effective date

The proposed amendments to add organisations would take effect on 1 April 2023. The additions of Ekal Vidyalaya Foundation of New Zealand and Make My Name Count NZ Charitable Trust would end on 31 March 2028.

The proposed amendments to remove organisations would take effect on the day after the Bill receives the Royal assent.

### Background

Individual taxpayer donors to organisations listed in schedule 32 are entitled to a tax credit of 33 $\frac{1}{3}$  percent of the monetary amount donated, up to the amount of their taxable income. Companies and Māori authorities may claim a deduction for donations up to the level of their net income. Charities that apply funds towards purposes that are mostly outside New Zealand must be listed in schedule 32 before donors become eligible for these tax benefits.

### Detailed analysis

#### Additions to schedule 32

##### Butterfly Trust

Butterfly Trust works primarily in Vanuatu. It supports indigenous initiatives in health and education throughout the archipelago. It was established in 2008 and works with local and central government agencies in Vanuatu to improve health and education outcomes.

##### Develop Together

Develop Together leads various humanitarian aid and development projects primarily in Bangladesh, India, Papua New Guinea, and Samoa. The projects focus on education and

literacy, economic development, healthcare, human rights and gender equality, and environmental care.

### **Ekal Vidyalaya Foundation of New Zealand**

Ekal Vidyalaya Foundation of New Zealand raises funds to support Ekal Vidyalaya Foundation of India (India), an organisation that works to bring literacy, digital literacy, health services, and skills training to remote rural villages in India. Using in-country networks in India and Nepal, the main activity is to run one-teacher schools (known as Ekal Vidyalayas) that provide free education to children in over 80,000 remote rural villages.

### **The Limapela Foundation**

The Limapela Foundation works primarily in Zambia. It provides education and support to children and teenagers in poorer communities. The Foundation runs two schools in Zambia, which support over 700 pupils in education and development. It also provides outreach and medical funds for struggling children in local areas. The Foundation aims to build up vulnerable communities through long-lasting support in education and self-sufficiency.

### **Pasifika Safe Shelter Trust**

Pasifika Safe Shelter Trust was established to collect non-perishable food and material items to distribute to people in the Pacific region as they live through the effects of a natural disaster. Most recently, they collected farming equipment and tractors to be sent to Tonga. This was to assist in rebuilding the agricultural industry following damage caused to food production by the volcanic eruption and subsequent tsunami.

### **The Make My Name Count NZ Charitable Trust**

The Make My Name Count NZ Charitable Trust (MMNC) primarily focuses on providing the basics of life for, currently, 172 orphaned children at the Orphanage of Hope in Uganda, a nationally recognised orphanage and charity. Within the same community in which the orphanage operates, MMNC also provides development aid by creating community facilities and providing financial support for local businesses and farmers.

## **Organisations to be removed from schedule 32**

The following organisations are being removed from schedule 32 from the day after the date the Bill receives the Royal assent. The charities listed below have either ceased their activities and/or been wound up.

- Akha Rescue Ministry Charitable Trust
- Astha Childrens Home (Nepal/New Zealand)
- Bangladesh Flood Appeal Trust
- Nelson Mandela Trust (New Zealand)
- Operation Hope (Aid Ship to Africa)
- The Bouganville Library Trust, and
- The Mutima Charitable Trust

# Extending the tax exemption for non-resident offshore oil rig and seismic vessel operators

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## Clause 16

### Summary of proposed amendment

The proposed amendment would extend the temporary exemption for non-resident offshore oil rig and seismic vessel operators to 31 December 2029.

### Effective date

The proposed amendment would take effect on 1 January 2025.

### Background

Income derived by non-resident companies from operating offshore oil rigs and seismic vessels is covered by an exemption in section CW 57 of the Income Tax Act 2007. These rigs and vessels are used to drill for oil and gas and gather data on potential oil and gas finds. There is a worldwide market in rigs and seismic vessels. No New Zealand company owns offshore rigs or seismic vessels, so any company wishing to explore in New Zealand waters needs to use a rig or seismic vessel provided by a non-resident owner.

Section CW 57 was introduced to deal with a problem created by our double tax agreements (DTAs). New Zealand generally taxes non-residents on income that has a source in New Zealand. However, our DTAs provide that non-residents are only taxable on their New Zealand-sourced business profits if they have a "permanent establishment" in New Zealand. Many of our DTAs (such as the New Zealand-United States DTA) have a specific rule providing that a non-resident enterprise involved in exploring for natural resources only has a permanent establishment in New Zealand if they are present for a particular period, often 183 days in a year. Once a non-resident has a permanent establishment in New Zealand, they are taxed on all their New Zealand business profits starting from day one.

The issue caused by this DTA provision was that seismic vessels and rigs used in petroleum exploration were leaving New Zealand waters before the 183-day period had expired to ensure they would not be subject to New Zealand tax. This meant that, in some cases, a rig would leave and a different rig would be mobilised to complete the exploration programme. This "churning" of rigs increased the cost for companies engaged in exploration and had the potential to delay exploration drilling and any subsequent discovery of oil or gas.

A temporary five-year exemption from tax on the income of non-resident offshore oil rig and seismic vessel operators was introduced in 2004. This exemption was previously rolled over for a further five years in 2009, 2014 and 2019, and it will expire on 31 December 2024 if it is not further extended. The proposed amendment would extend the exemption for a further five years to 31 December 2029.



# Remedial items

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## Correcting extra pay inaccuracy on termination

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### Clause 56

### Summary of proposed amendment

Section RD 17 of the Income Tax Act 2007 can result in the inaccurate taxation of extra pay received when employment is terminated.

The proposed amendment would seek to reduce the inaccuracies by replacing the annualisation of the amount of PAYE income payments received in the four weeks preceding the date of the extra pay with the annualisation of the amount received in the last preceding two paid pay periods (that is, the last two pay periods for which payment was received).

### Effective date

The proposed amendments would take effect on 1 April 2024.

### Background

Section RD 17 governs the taxation of extra pay when it is received with other PAYE income payments. The amount of tax for the extra pay is currently based on:

- the amount of the extra pay, and
- the annualised value of all PAYE income payments made to the employee in the four-week period that ends on the date of the payment of the extra pay.

However, this approach can understate or overstate the rate of taxation in the case of an employee termination. This is because the final payment received by the employee on termination is not representative of a typical PAYE cycle. Therefore, including that payment in the amount that is annualised can lead to a reduced or inflated annual figure for the employee. If, as a result, the amount of tax is understated or overstated, the taxpayer will have a liability or receive a refund, respectively, at the end of the tax year.

The proposed amendment seeks to reduce the number of these inaccuracies by removing the reference to the prior four-week period. Instead, the amount of PAYE income payments received by an employee in the last two paid pay periods preceding the employee's final PAYE income payment would be annualised. That is, the employee's final PAYE income payment would not be included in the amount that was annualised, but rather the PAYE

income payments received by the employee in the last two pay periods for which payment was made by the employer would be annualised instead.

#### Example 45: Last two pay periods for which payment made

Ben owns Ben's Bakery, a busy boutique sandwich shop in Wellington. One day, his long-time employee, Kelvin, advises Ben that he will be leaving to work at a rival store. Ben realises he will have to pay Kelvin the amount of \$2,000 in extra pay on the termination of Kelvin's employment on 3 June.

Kelvin is paid weekly, and his hours can vary from one week to the next. Fortunately, Ben has the recent salary information below:

Period end	Status	PAYE income payments
6 May	At work	\$600.00
13 May	At work	\$500.00
20 May	Unpaid leave	\$0.00
27 May	At work	\$550.00

To determine the amount of tax that applies to the extra pay, Ben knows he must annualise the two most recent periods for which payment was made.

Ben sees that payment was made in connection with the pay periods ended 27 May and 13 May. He ignores the period ended 20 May because no payment was made for that period as Kelvin was on unpaid leave. He performs the annualisation calculation as follows:

- Step 1: Ben adds together the amounts received for the pay periods ended 27 May and 13 May ( $\$550 + \$500 = \$1,050$ ).
- Step 2: Because the sum of the two pay periods represents two weeks' PAYE income payments, he divides the number of weeks in the year (52) by two to determine the number of fortnights in the year, for a total of 26 fortnights.
- Step 3: Ben annualises the amount of Kelvin's PAYE by multiplying the number of fortnights in the year by the amount determined in Step 1 ( $\$1,050 \times 26$ ) for a total of \$27,000.
- Step 4: Finally, Ben adds the amount of extra pay to the amount determined in Step 3 ( $\$27,000 + \$2,000$ ) for a total of \$29,000.

Having completed this calculation, Ben then proceeds to apply the appropriate marginal tax rate (based on the total of \$29,000) to the amount of the extra pay as required by section RD 17 and pays the resulting amount to Kelvin the following week, on 3 June.

# Allowing death information to be shared with KiwiSaver scheme providers

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## Clause 86

### Summary of proposed amendment

The proposed amendments would allow the Commissioner of Inland Revenue to communicate information about deceased KiwiSaver members' estates to KiwiSaver providers.

### Effective date

The proposed amendment would take effect on 1 April 2024.

### Background

The accounts of deceased KiwiSaver members can become dormant, no longer receiving contributions while still incurring KiwiSaver provider fees.

In some cases, the scheme provider may not learn of the member's death or know the contact details of the deceased member's estate. In other circumstances, the executors or administrators may be unaware the deceased's KiwiSaver account exists. In either case, the member's account will not be distributed to the member's intended heirs.

Under current legislative settings, Inland Revenue is unable to offer KiwiSaver providers any information about the executors or administrators of the deceased member's estate.

The proposed amendment to section 220B of the KiwiSaver Act 2006 would allow the Commissioner to provide KiwiSaver providers with information relating to the administration of a deceased member's estate. This would assist them in contacting the executors or administrators of the deceased member's estate.

## Charitable entities and RWT-exempt status

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### *Clause 67*

### **Summary of proposed amendment**

The proposed amendment would ensure that all charities registered under the Charities Act 2005 are automatically exempt from RWT for the duration of their registration.

### **Effective date**

The proposed amendment would take effect on 1 April 2020.

### **Background**

Since 1 April 2020, section 32E(1A) of the Tax Administration Act 1994 has provided automatic RWT-exempt status for charitable trusts registered under the Charities Act 2005. This was a simplification change intended to reduce unnecessary compliance costs for registered charities.

However, the Charities Act 2005 registers "charitable entities", not just charitable trusts. The proposed amendment will align the legislation with existing practice and ensure that all entities (for example, companies) registered under the Charities Act 2005 automatically have RWT-exempt status for the duration of their registration.

## Gift-exempt bodies

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### Clause 66(4)

### Summary of proposed amendment

The proposed amendment would extend the definition of a “gift-exempt body” in section 3(1) of the Tax Administration Act 1994 (TAA) to include all charities registered under the Charities Act 2005 and all persons eligible to apply for RWT-exempt status under section 32E(2)(k) or (l) of the TAA.

### Effective date

The proposed amendment would take effect on the day after the date the Bill receives the Royal assent.

### Background

Sections 18K, 32 and 58 of the TAA are integrity provisions relating to “gift-exempt bodies”. They provide for a gift-exempt body to keep records, and provide returns, showing the sources and application of donations. Additionally, they allow the Commissioner to notify the Minister of Revenue if he believes the funds of a gift-exempt body are being applied for a purpose that is not charitable, benevolent, philanthropic, or cultural.

A “gift-exempt body” is defined in section 3(1) of the TAA as any overseas donee organisation listed in schedule 32 of the Income Tax Act 2007 (ITA) or any person who has RWT-exempt status following an application made under section 32E(2)(k) or (l) of the TAA.<sup>30</sup>

Thus, the definition of a “gift-exempt body” is currently limited to persons that *apply* for RWT-exempt status. Since charitable trusts registered under the Charities Act 2005 are automatically provided with an RWT-exemption without having to apply, they are unintentionally excluded from the gift-exempt body definition under current law. The proposed amendment to section 32E(1A) of the TAA (discussed in [Item: “Charitable entities and RWT-exempt status”](#) above) would also extend this automatic RWT-exempt status to all charities registered under the Charities Act 2005. Therefore, the current proposed

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<sup>30</sup> A person can apply for RWT-exempt status under section 32E(2)(k) or (l) of the TAA if they derive exempt income under sections CW 38(2), CW 38B(2), CW 39(2), CW 40 to CW 52, and CW 64 of the ITA or if they are a non-profit organisation to which section DV 8 of the ITA applies. Examples include public and local authorities, local and regional promotion bodies, charities registered under the Charities Act, friendly societies, amateur sporting bodies and community trusts.

amendment would ensure that all charities registered under the Charities Act 2005 are included within the definition of a “gift-exempt body” so that they are subject to the integrity provisions relating to the source and application of donated funds.

In addition, entities that derive exempt income (or can access the statutory \$1,000 deduction for not-for-profit organisations in section DV 8 of the ITA) are not subject to the integrity provisions relating to the source and application of donated funds unless they apply for RWT-exempt status. The proposed amendment would also ensure that those exempt entities and not-for-profit organisations eligible to apply for RWT-exempt status under section 32E(k) or (l) of the TAA are included within the definition of a “gift-exempt body”, and therefore subject to the integrity rules, regardless of whether they have applied for RWT-exempt status.

## Charities: deregistration tax

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### *Clause 46*

### **Summary of proposed amendment**

The proposed amendment would ensure that when an entity is deregistered under the Charities Act 2005 and does not re-register within one year, certain net assets will be subject to income tax if they are not disposed of or transferred to another registered charity.

### **Effective date**

The proposed amendment would take effect on the date of introduction of the Bill.

### **Background**

Most charities registered under the Charities Act 2005 receive tax benefits, including an income tax exemption. In 2014, new rules were introduced to impose income tax on the value of the net assets of charities that have been deregistered under the Charities Act 2005. These rules were designed to be a disincentive to transfer net assets out of the charitable base once they are settled there. The imposition of tax also ensured deregistered charities are held to account for the assets and income they built up while they enjoyed the benefit of the tax concessions.

Section HR 12 of the Income Tax Act 2007 provides that one year after the day an entity is removed from the Charities Register (or one year after the day on which that entity exhausts all disputes and appeals in relation to its charitable status, whichever is the latter), certain net assets are included as income of that entity and subject to income tax.

Adjustments are made to carve out assets that meet certain criteria, which reduces the net assets balance subject to tax. A carve-out exists for assets that, within the one-year period mentioned above, are disposed of or transferred for charitable purposes or in accordance with the entity's rules contained on the Charities Register.

This carve-out does not require assets to be disposed of or transferred to another registered charity. In practice, the breadth of this carve-out means assets may be transferred to entities that are not subject to regulatory oversight under the Charities Act 2005. With no regulatory oversight, the funds and their accumulated tax benefits may be used for non-charitable purposes or charitable purposes that do not benefit New Zealanders. The policy intent of the rules can therefore be undermined.

The proposed amendment would ensure that the rules more effectively keep assets in the sector and that there is no deferral benefit from the application of the rules. Net assets transferred by a deregistered charity to another entity are only carved out from the deregistration tax rules if the receiving entity is a charity registered under the Charities Act 2005. Assets transferred by a deregistered charity to an entity that is not a registered charity would be subject to the deregistration tax rules.

**Example 46: Transfer of assets to a charitable trust**

Grey Warbler Group is a charity registered under the Charities Act 2005. The charity voluntarily deregisters on 30 March 2025 because it no longer wishes to publicly report on its financial activities. Following deregistration, the Group decides to transfer all the assets it built up while enjoying tax concessions to Kōwhai Charitable Trust, a trust registered under the Charitable Trusts Act 1957 but not registered under the Charities Act 2005.

Trusts registered under the Charitable Trusts Act 1957 are not subject to the same obligations as charities registered under the Charities Act 2005. Kōwhai Charitable Trust is not required to publicly report on its financial activities, and it cannot access the same tax concessions as Grey Warbler Group.

Under the current rules, Grey Warbler Group would not be liable for deregistration tax on assets transferred to Kōwhai Charitable Trust. Therefore, the Kōwhai Charitable Trust would be able to access the benefit of accumulated tax concessions, even though it would not qualify for those tax concessions itself.

The proposed amendment would ensure that the assets transferred by Grey Warbler Group to Kōwhai Charitable Trust would be subject to the deregistration tax. This is more likely to encourage Grey Warbler Group to choose to distribute its assets to another registered charity. However, if Grey Warbler Group does transfer its assets to Kōwhai Charitable Trust, it will not be able to transfer the benefits of tax-exempt status that were conferred on those assets.

**Example 47: Transfer of assets overseas**

Kingfisher Charitable Trust is a charity registered under the Charities Act 2005. The founders decide to deregister the charity from the Charities Register on 30 June 2024 and plan to wind up the trust. On deregistration, the trust has assets of \$1.5m and no liabilities.

The deregistration tax calculation is determined one year after a charity is deregistered. Before 30 June 2025, the trust transfers assets worth \$500,000 to Albatross Association, another charity registered under the Charities Act 2005. The trust transfers the remaining \$1m assets to Stingray Charitable Trust, a charity established in the Cayman Islands.

Under the current rules, the Kingfisher Charitable Trust would have no deregistration tax liability as all its assets have been transferred to entities with charitable purposes within one year of deregistration.

The proposed amendment would ensure that the \$1m assets transferred out of the New Zealand charitable sector to Stingray Charitable Trust in the Cayman Islands would be subject to the deregistration tax. The Kingfisher Charitable Trust will not be able to transfer the benefits of tax-exempt status that were conferred on those assets to an overseas charity where there is no oversight by New Zealand regulators and no entitlement to New Zealand tax concessions.

#### **Example 48: Transfer of assets received from a Treaty of Waitangi settlement claim**

Kākāriki Charitable Trust is a charity registered under the Charities Act 2005. The Trust was established to administer assets received from the Crown from a Treaty of Waitangi settlement claim.

Kākāriki Charitable Trust deregisters from the Charities Register on 1 January 2024 and transfers all its assets to Whio Incorporated, a company that is not registered under the Charities Act.

Under existing rules, the deregistration tax does not apply to assets received from a Treaty of Waitangi settlement claim. The proposed amendment would not change this treatment.

## Charitable trust definition

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*Clauses 34, 37, 38, 40, 59(7) and 60*

### Summary of proposed amendments

The proposed amendments would simplify the legislation by repealing the definition of a “charitable trust” in the trust rules and replacing references to a “charitable trust” with a “trust that is a tax charity”.

### Effective date

The proposed amendments would take effect on the day after the date the Bill receives the Royal assent.

### Background

Section HC 13 of the Income Tax Act 2007 (ITA) provides that, in the trust rules, a trust is a “charitable trust” in an income year if:

- all income derived or accumulated by the trust in that, or any earlier, year is held for charitable purposes, and
- any income derived by the trustee in the income year is exempt income under either section CW 41(1) (Charities: non-business income) or CW 42(1) (Charities: business income) of the ITA.

This definition is used to ensure that such trusts are excluded from rules relating to settlors’ liability to income tax (sections HC 29 and HD 12 of the ITA). It also ensures that settlors and trustees of such trusts are not associated persons (section YB 8 of the ITA).

The section HC 13 definition is inconsistent with the ordinary meaning of “charitable trust”, as not all charitable trusts registered under the Charitable Trusts Act 1957 are eligible to derive exempt income under either section CW 41 or CW 42 of the ITA. A trust must be a “tax charity”, as defined in section CW 41(5), to derive exempt income under section CW 41(1) or CW 42(1) of the ITA.

The proposed amendments would repeal the definition of a “charitable trust” in sections HC 13 and YA 1 of the ITA and replace any reference in the ITA to a “charitable trust” with a reference to a “trust that is a tax charity”.

These changes would simplify the legislation by using a consistent definition throughout for these trusts.

## Double tax agreement source rule

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### *Clause 61*

### **Summary of proposed amendment**

The proposed amendment would ensure that the double tax agreement (DTA) source rule in section YD 4(17D) of the Income Tax Act 2007 does not apply to technical service fees or certain payments connected to a permanent establishment in a third state.

### **Effective date**

The proposed amendments would be effective for income years commencing on or after 1 July 2018.

### **Background**

New Zealand taxes income on the basis of both residence and source. While New Zealand residents are generally taxed on their worldwide income, non-residents are only taxed on New Zealand-sourced income. In broad terms, income is treated as having a source in New Zealand when its connection with New Zealand is strong enough for New Zealand to exert taxing rights over that income. However, the point when a connection will be “strong enough” is not always clear and may involve judgement calls that appear arbitrary.

The DTA source rule in section YD 4(17D) deems an item of income to have a source in New Zealand if New Zealand has a right to tax that income under a DTA. There are several exceptions to the DTA source rule.

Before the introduction of section YD 4(17D), an item of income would only have a source in New Zealand if it was included in a specific domestic source rule.

The rule was introduced with other anti-Base Erosion and Profit Shifting (BEPS) measures to reduce risks of double non-taxation. It applies for income years beginning on or after 1 July 2018.

The problem with the DTA source rule is that it can deem income to be sourced in New Zealand in unintended circumstances where the income’s connection with New Zealand is tenuous, and where New Zealand did not anticipate collecting tax on that income. Where officials have identified such overreaches, amendments have been made to ensure those amounts are not caught by the DTA source rule (for example, income falling under sections YD 4(15) to (17)).

The proposed amendments would similarly address the following two cases of overreach resulting from the DTA source rule:

- fees for technical services provided by a non-resident and performed outside New Zealand, and
- certain payments made to another contracting State but connected to a permanent establishment (PE) in a third State.

## Detailed analysis

### Technical services fees

Income from personal services is usually treated as sourced in New Zealand under section YD 4(3) or (4) if the service is performed in New Zealand.

Under the DTA source rule, fees for technical services provided by a non-resident to a New Zealand customer (payer) can be deemed to be sourced in New Zealand even if the services are performed overseas. However, it is unusual for personal services income to be treated as sourced in New Zealand when the services are neither performed in New Zealand nor connected to a New Zealand PE.

This result occurs under New Zealand's DTAs with India, Fiji and Malaysia only because of a special "fees for technical services" provision in those DTAs. Such a provision does not exist in New Zealand's negotiating model and is not in our other DTAs.

Further, it is difficult for taxpayers to understand and comply with the law, and for Inland Revenue to enforce the rules, when different source rules apply depending on which DTA applies. This may also disincentivise taxpayers from acquiring services from providers in particular countries, and so distort their economic decision-making.

The proposed amendment would therefore exclude technical services fees from the DTA source rule.

### Certain payments connected to a third State PE

As DTAs are bilateral in nature, issues can arise when arrangements involve three States.

A technical issue arises when a New Zealand resident pays interest and royalties for its PE in a third State to a recipient in the other DTA country.

New Zealand's domestic source rules exclude payments made, or borrowed funds used, in connection with or for the purposes of a business carried on through a fixed establishment outside NZ (see sections YD 4(9)(a) and YD 4(11)(b)(i)). This ensures the payment does not

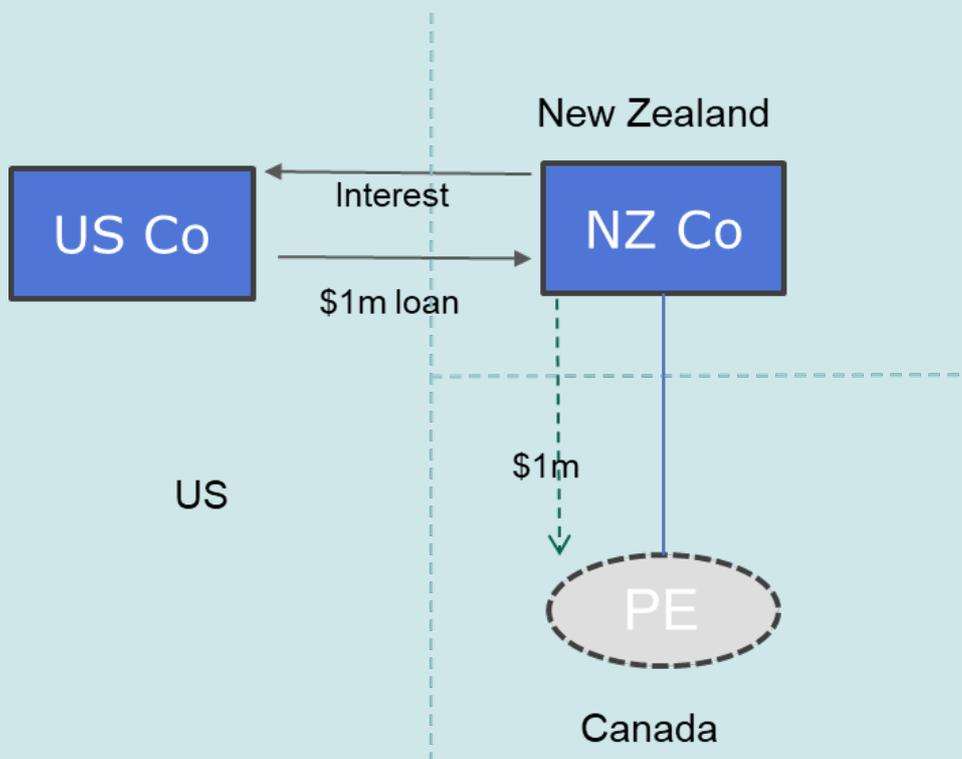
have a New Zealand source when it is connected with a PE in another State. However, the DTA source rule inadvertently overrides these domestic source rule exclusions. This can result in the same income being sourced and taxed in both New Zealand and in the PE State.

The DTA between New Zealand and the recipient's State creates a source in New Zealand but does not provide relief when that income is connected to a PE in a third State.

The below example illustrates the overreach in this scenario.

**Example 49: Overtaxation of income connected to a PE in a third State**

In this example, a New Zealand company borrows \$1m from a US company to fund its PE activity in Canada. The New Zealand company pays interest to the US company on the \$1m loan.



Under the New Zealand/US DTA,<sup>31</sup> interest is deemed to have a source in the payer's State (in this case New Zealand), even when it is connected to a PE in a third State.

As a result, the interest payment will be treated as sourced in both New Zealand (under the DTA source rule) and likely Canada (under Canadian tax law) and taxable on that basis. It will also be taxable in the US on the residence basis, with relief provided to the US under the New Zealand/US DTA.

<sup>31</sup> And most of our other DTAs, with the exception of our DTA with Australia.

If the PE had been located in the US, this issue would not arise as the New Zealand/US DTA would provide tax relief and treat the income as sourced in the US instead of in New Zealand. This is because the DTA addresses the scenario when there is a PE in a contracting State but not when the PE is in a third State.

If not for the DTA source rule, New Zealand's domestic rules would not treat the interest as being sourced in New Zealand, since it relates to a fixed establishment outside New Zealand (a fixed establishment being similar to a PE). This would prevent the interest having a deemed source in both New Zealand and Canada, the PE State.

The proposed amendment would exclude interest and royalties connected to a PE outside New Zealand from the DTA source rule.

# Transitional residents holding domestic financial arrangements

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## *Clauses 23 and 24*

### **Summary of proposed amendments**

The proposed amendments would create a deemed acquisition of financial arrangements with a New Zealand source held by a non-resident when they become a New Zealand transitional resident and therefore become subject to the financial arrangements rules.

### **Effective date**

The proposed amendments would be effective for financial arrangements if a base price adjustment is required to be completed after the date on which the Bill receives the Royal assent.

### **Background**

The financial arrangements rules spread income and expenditure over the term of an arrangement and require a base price adjustment when the arrangement matures. However, the financial arrangements rules do not apply to non-residents (section EW 9(2) of the Income Tax Act 2007). To ensure the base price adjustment only includes gains and losses when the person is a New Zealand resident, there is a deemed acquisition of the arrangement when the person becomes a New Zealand resident. This deemed acquisition is currently provided for in sections EW 37 and EW 41.

This deemed acquisition was amended in 2006 to include the transitional residence rules. The transitional residence rules were intended to encourage immigration to New Zealand by allowing qualifying residents to exclude their offshore assets from the New Zealand tax base for the first four years. The consequence of these rules is that, when a financial arrangement does not have a New Zealand source, a person will only have a deemed acquisition of the arrangement once the person's transitional residence period expires rather than when they became a New Zealand resident.

However, the changes made for the transitional residence rules did not consider that immigrating transitional residents may hold financial arrangements with a New Zealand source. Such arrangements are always subject to New Zealand tax, even when held by a non-resident – however, they are not taxed under the financial arrangements rules unless they are held by a New Zealand resident, so accrued gains and losses are not included.

The deemed acquisition rules do not currently cover a person who becomes a transitional resident while holding New Zealand-sourced financial arrangements. Although the person is taxed correctly during the life of that arrangement, the base price adjustment incorrectly includes gains and losses in the period before the person became a New Zealand resident.

This issue particularly arises for certain immigrants who are required to hold New Zealand assets (such as New Zealand government bonds) to meet their visa requirements and acquire these before moving to New Zealand.

The proposed amendments are intended to correct this issue.

## Key features

The proposed amendments would add an additional paragraph to each of sections EW 37(1) and EW 41(1). This paragraph will create a deemed acquisition of a New Zealand-sourced financial arrangement if that arrangement was held by a non-resident when they become a transitional resident. This deemed acquisition will only affect the tax position of the person once that arrangement matures by excluding from the base price adjustment any accrued gains and losses that arose before the person became a transitional resident.

## Detailed analysis

It is proposed to add the same paragraph to each of sections EW 37(1) and EW 41(1). These sections have the equivalent effect, except that section EW 37 applies to accrued obligations (eg, borrowing from another person so there is an obligation to make payment) and section EW 41 applies to accrued entitlements (eg, lending to another person so there is an entitlement to receive repayment).

Proposed new paragraph (ab) will apply when the following three requirements are met:

- The person becomes party to the arrangement after 1 April 2008. This date is chosen to align with the start of the Income Tax Act 2007.
- The person becomes a transitional resident after becoming a party to the arrangement. This ensures the deemed acquisition applies to arrangements held when the person becomes a transitional resident.
- The person must calculate and allocate income or expenditure under the arrangement for an income year under the financial arrangements rules.

The third requirement, in subparagraph (ab)(iii), is the most important and intentionally applies similar language to that in existing section EW 9(1), which covers the application of the financial arrangements rules to residents. This requirement is designed to ensure that financial arrangements with a New Zealand source are only captured once a non-resident

becomes a resident (including a transitional resident). It will not apply to a foreign-sourced financial arrangement held by a person becoming a transitional resident. This is because such an arrangement is treated, under section HR 8, as if the transitional resident were non-resident, in which case section EW 9(1) does not apply.

Foreign-sourced arrangements of a person becoming a transitional resident have been excluded from the proposed amendments as these already have a deemed acquisition under section EW 37(1)(d) or EW 41(1)(d) once the person ceases to be a transitional resident.

Likewise, arrangements of a person becoming a New Zealand resident who is not a transitional resident are excluded from the proposed amendment whether those arrangements are New Zealand or foreign sourced, as these already have a deemed acquisition under section EW 37(1)(b) or EW 41(1)(b).

# 10% income interest test for access to the attributable FIF income method

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## Clause 25

### Summary of proposed amendment

The proposed amendment to the foreign investment fund (FIF) rules would expand access to the attributable FIF income (AFI) method in periods where a person acquires or disposes of a FIF interest. The relevant period for the 10% income interest test would be changed to the period of ownership within the accounting period, rather than the entire accounting period.

### Effective date

The proposed amendment would take effect on 1 July 2011.

### Background

Several different methods are potentially available to a person to calculate the FIF income or loss from their FIF interests. To use the AFI method a person is currently required to have an income interest in the FIF of 10% or more in the accounting period. Where there are variations in the income interest during the accounting period, a weighted average calculation is performed.

However, this rule does not work as intended. An acquisition or disposal may result in an income interest below 10% for the entire accounting period (based on a weighted averaged calculation) even if the actual interest held during the period of ownership is 10% or more. As a result, a taxpayer may not be able to access the AFI method for that period and may have to apply a less favourable FIF calculation method instead.

The proposed amendment would change the relevant period for application of the 10% income interest test to be the period of ownership within the accounting period, rather than the entire accounting period.

## Provisional tax – prior year residual income tax

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### *Clause 55*

### **Summary of proposed amendment**

The proposed amendment would restore the reference to the year preceding the prior year in section RC 5(6) to ensure that provision works as intended.

### **Effective date**

The proposed amendment would take effect on 1 April 2008.

### **Background**

There are special rules in the Income Tax Act 2007 (ITA) that deal with a situation where a taxpayer calculates their provisional tax liability with reference to the prior year and a reassessment of that prior year is subsequently made that changes that instalment amount after they have paid it.

However, section RC 5(6) is currently limited to situations where the prior year (current year (CY) – 1) is reassessed. This creates an issue where a taxpayer is using the year preceding the prior year (CY – 2) to calculate their provisional tax liability and that year is subject to a reassessment. In that case, the taxpayer may be exposed to use of money interest and penalties where they have no knowledge of the actual liability.

The treatment of the CY – 2 year is inconsistent with the treatment of the CY – 1 year and the policy intent. There is no policy reason why the two years (CY – 1 and CY – 2) should be treated differently. It appears this was a drafting error at the time the ITA was rewritten.

The proposed amendment would restore the wording of section RC 5(6) before the rewrite of the ITA.

## PIE remedial amendments

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### *Clauses 5 and 43*

### **Summary of proposed amendments**

The proposed amendments would clarify the wording in several provisions that deal with the calculation of investor tax liabilities for investments in portfolio investment entities (PIEs).

### **Effective date**

The proposed amendments would take effect on the day after the date the Bill receives the Royal assent.

### **Key features**

The proposed amendments would ensure the legislation works as intended by re-linking several provisions to other amended provisions and by correcting several outdated references.

In particular:

- Section HM 60(4) of the Income Tax Act 2007 (ITA) would be reworded to reflect the relationship between sections CX 56 and HM 60.
- The reference to section 28B of the Tax Administration Act 1994 in section HM 60(1) of the ITA would be removed. Section HM 60(1) deals with the notified investor rate. Section 28B deals with the tax file number.
- Section BC 7(5) of the ITA would be amended to refer to “natural person investors who are resident in New Zealand” to be consistent with section HM 36B.

## Resident withholding tax and custodians

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### *Clause 58*

### **Summary of proposed amendment**

The proposed amendment would clarify the wording in the provision dealing with the receipt of a non-cash dividend by an intermediary to ensure that provision works as intended.

### **Effective date**

The proposed amendment would be effective for the 2017–18 and later income years.

### **Background**

Section RE 14C of the Income Tax Act 2007 deals with the situation where an intermediary, such as a custodian, receives a non-cash dividend from a foreign company and passes that non-cash dividend on to the owner of the underlying shares.

This section provides that the intermediary does not have to pay resident withholding tax in respect of the dividend.

However, some of the language used in the section does not reflect the custodial relationship correctly. Specifically:

- the section refers to the custodian “deriving” the dividend, when legally the custodian has no shareholding in the underlying company, and
- the ultimate shareholder is referred to as the “shareholder in the company”, which can be read as the custodial company rather than the underlying foreign company.

The proposed amendment would clarify the wording of section RE 14C to ensure it works as intended.

# Clarifying the meaning of “building” for depreciation purposes

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## Clause 59(6)

### Summary of proposed amendment

The proposed amendment would add a new definition of “building” into section YA 1 of the Income Tax Act 2007 (ITA) to clarify that, for the purposes of the depreciation rules, a “building” includes a part of a building owned under a unit title.

### Effective date

The proposed amendment would take effect on 1 April 2020.

### Background

Under the current depreciation rules, depreciation can be claimed on “non-residential buildings” but not “residential buildings”. Although the terms “residential building” and “non-residential building” are defined in the ITA, the word “building” is not.

In the recently published Interpretation Statement *IS 22/04: Claiming depreciation on buildings*, Inland Revenue confirmed its view that, in a depreciation context, a “building” will, among other things:

- be enclosed by walls and a roof,
- be able to function independently of any other structure, and
- have an appearance and function that fits with the idea of what a conventional building looks like and is ordinarily used for.

This interpretation arguably leads to the conclusion that a part of a building owned under a unit title is not a “building” in its own right and is therefore not depreciable, even though it may be used predominantly for “non-residential” purposes. Such an outcome is not considered to be consistent with the policy intent of the depreciation rules.

The proposed amendment would clarify the position with effect from 1 April 2020, the date on which depreciation for non-residential buildings was reinstated.

## Main home exclusion: construction period

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### *Clauses 9 and 20*

### Summary of proposed amendment

The proposed amendments would amend the “all or nothing” main home exclusion under the previous five-year bright-line test to ignore the period during which the person’s main home is constructed.

### Effective date

The proposed amendments would be effective for residential land acquired on or after 29 March 2018 and before 27 March 2021, regardless of whether the residential land has already been disposed of.

### Background

Under the bright-line test, disposals of residential land are taxable for different periods depending on when the property was acquired. If residential land was acquired:

- between 1 October 2015 and 28 March 2018, the bright-line period is two years
- between 29 March 2018 and 26 March 2021, the bright-line period is five years
- on or after 27 March 2021, the bright-line period is 10 years, unless the land qualifies for the shorter five-year new-build bright-line test.

### Main home exclusion

For residential land acquired on or after 29 March 2018 and before 27 March 2021, an exclusion is available under section CZ 40 of the Income Tax Act 2007 (ITA) if the person disposing of the residential land predominantly used the property as their main home for most of the bright-line period. Note that this exclusion was previously located in section CB 16A. When the main home settings were updated on 27 March 2021, the previous settings that applied to residential land acquired on or after 29 March 2018 and before 27 March 2021 were relocated to section CZ 40.

If the section CZ 40 main home exclusion applies, income derived from the disposal of the residential land within the bright-line period is not taxable under the bright-line test. If the exclusion does not apply, the income is taxable.

The exclusion requires actual use of the property as the person's main home for more than 50% of the bright-line period.

## **Problem definition**

If a person purchases their main home off the plan or constructs their main home, the construction period does not count as main home use, even if they subsequently only use the finished property as their main home. This is because, while the property was being constructed, they were not actually using it as their main home.

This was unlikely to be a concern under the original two-year bright-line test or prior to COVID-19. However with disruptions to the construction sector because of COVID-19 lockdowns, labour shortages, and supply-chain issues, it is possible that someone may not qualify for the main home exclusion solely because of construction delays.

This issue does not arise in relation to residential land acquired on or after 27 March 2021 as the way in which the main home exclusion now operates has changed and it includes a deeming rule for the construction period.

## **Key features**

Proposed new sections CB 16A(1B) and CZ 40(2B) would ignore the period during which the person's main home is constructed when determining whether the residential land was used as the person's main home for most of the bright-line period.

The two proposed sections are identical, except for specific terminology unique to section CZ 40.

The proposed amendments would apply to residential land acquired on or after 29 March 2018 and before 27 March 2021, regardless of whether the residential land has already been disposed of.

Section CB 16A was replaced in its entirety with effect on 27 March 2021. Proposed new section CB 16A(1B) would therefore only apply to disposals occurring before 27 March 2021, as the existing section CB 16A that applies from 27 March 2021 already deals with this issue. Proposed new section CZ 40(2B) would apply to disposals occurring on or after 27 March 2021.

The ordinary meaning of "construction" would apply, as it does in existing section CB 16A(1C). Construction would encompass work to build or erect the main home, including the design phase.

In many cases, construction would be considered complete once the code compliance certificate has been issued under the Building Act 2004. However, the exact length of the construction period would depend on the facts and circumstances of each case.

**Example 50: Off-the-plan main home and construction delays**

In December 2019, Ben entered into an agreement to purchase residential land “off the plan” in a new development. Construction was due to be completed in early 2021, but due to delays, construction was not completed until June 2022.

Ben moved into the property immediately following settlement in June 2022 and used the residential land as his main home until December 2023.

In December 2023, Ben enters into an agreement to dispose of the property.

Under existing section CZ 39(5), Ben’s bright-line period starts in December 2019 (rather than when the legal title is registered in his name) as he purchased the residential property off the plan. Ben’s bright-line period ends in December 2023. Ben is subject to income tax under the five-year bright-line test.

Under the current law, Ben does not qualify for the main home exclusion because he did not use the property as his main home for more than 50% of his total bright-line period. He lived in the property for approximately 18 months, but the construction period was 30 months.

Under the proposed amendment to section CZ 40, Ben would ignore the 30-month construction period and only look at the period from June 2022 to December 2023 when determining whether he qualifies for the main home exclusion. Ben used the property as his main home for that whole period and therefore would qualify for the main home exclusion.

# Clarifying that the child support time bar does not apply to temporary exemptions

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*Clauses 88 and 89, and schedule 2*

## Summary of proposed amendment

The proposed amendment would clarify that under the Child Support Act 1991 the Commissioner of Inland Revenue (the Commissioner) is able to grant, end or overturn a temporary exemption in a period that would otherwise be time barred.

## Effective date

The proposed amendment would take effect on 26 October 2021.

## Background

The Child Support Amendment Act 2021 (the Amendment Act) introduced a four-year time bar to reassessments of child support. Beyond the four-year period, reassessments will not occur, subject to specified exceptions. This was intended to provide more certainty for parents and reduce administration costs, while balancing equity concerns through specified exceptions.

Currently, there is no exception to allow the Commissioner to grant a liable parent a temporary exemption in the time-barred period. Additionally, the Commissioner is not able to backdate a change to an existing exemption in the time-barred period. This is contrary to the original policy intent of the Amendment Act and inconsistent with the exemption relating to victims of sexual offending, which is specifically excluded from the time bar.

Temporary exemptions from paying child support are available to liable persons when certain criteria are met. They are granted on the grounds that a person has limited income and limited capacity to earn income. These exemptions apply to liable persons who are:

- in prison, hospital or a treatment facility for at least 13 weeks,
- suffering a long-term illness or injury for at least 13 weeks and unable to do paid work because of the illness or injury, or
- under 16 years old.

It was intended that these exemptions could be applied or adjusted in periods that would otherwise be time barred but the Amendment Act does not achieve this outcome. This will

cause issues for liable persons who continuously qualify for temporary exemptions for periods more than four years ago, such as those in prison. The proposed amendment would clarify that the time bar does not apply to prevent these persons from having their temporary exemption backdated. Additionally, it will allow them to have their temporary exemption amended or cancelled.

## Flooding tax relief remedials

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*Clauses 11, 14, 15, 19, and 59(3) and (13)*

### Summary of proposed amendments

The proposed amendments:

- extend the timeframe for employees to relocate to a flood-affected area to work on projects of limited duration
- amend the definition of North Island flooding events to standardise this with other government legislation, and
- correct cross references to the new flooding provisions that were omitted in the original amendments.

### Effective date

The proposed amendments would take effect on 8 January 2023.

### Background

Between 8 January 2023 and 3 February 2023, a series of fronts crossed the upper North Island delivering extremely heavy rain, high winds, and widespread flooding in the Auckland, Bay of Plenty, Northland, and Waikato regions. Then, between 12 February 2023 and 16 February 2023, Cyclone Gabrielle moved across the North Island, also resulting in heavy rain, high winds, and flooding.

These weather events impacted taxpayers' businesses and livelihoods. In response to the events, the government enacted several provisions that provided tax relief from income tax and fringe benefit tax for certain aid in the form of cash and benefits provided by employers to flood-affected employees.

In addition, the government enacted a provision that provides for the tax-free provision of accommodation to employees who are required to relocate and work on projects of limited duration for rebuilding or recovery in areas covered by the North Island floods.

This existing provision extends the time limit for a "project of limited duration" from three to five years and applies to employees starting work at that workplace in the period commencing on the starting date of the relevant flooding event and ending six months after that date.

However, the six-month timeframe does not match the timeframe that was permitted for the Canterbury earthquakes, and officials have been informed that is too short given the timeframes required to assess the work required.

In addition, since the flooding provisions were enacted, other government legislation covering the flooding events has been enacted that uses a different definition of the flooding areas. This definition is wider than the one that was originally used in the tax legislation. The proposed amendments align the definition of “North Island flooding events” with the definition of the affected areas in the Severe Weather Emergency Recovery Legislation Act 2023 for consistency across government. See further at [Item: “Taxation rollover relief – Definition of flooding events and affect area”](#) above.

The proposed amendments also include some cross references to the new provisions in the definition of accommodation that were omitted from the original drafting.

## Maintenance amendments

### Summary of proposed amendments

The proposed amendments in table 5 reflect minor technical maintenance items arising from both the rewrite of the income tax legislation and subsequent changes.

### Effective date

Effective dates for the proposed amendments are outlined in table 5.

### Key features

The proposed amendments in table 5 would correct any of the following:

- ambiguities
- compilation issues
- cross-references
- drafting consistency, including reader's aids – for example, the defined terms lists grammar
- consequential amendments arising from substantive rewrite amendments, and
- inconsistent use of terminology and definitions.

**Table 5: Maintenance amendments**

Act	Clause	Section	Amendment	Effective Date
Income Tax Act 2007	8	CB 6A(7)	Correcting terminology	27 March 2021
	12	CH 8(1)	Correcting cross-reference	1 April 2008
	28	FC 2(3)	Correcting cross-reference	Day after Royal assent
	29(1)	FC 9B(b)	Correcting terminology	1 April 2022

Act	Clause	Section	Amendment	Effective Date
	29(2)	FC 9B(e)	Correcting terminology	1 April 2022
	41	HF 1(2)(f)	Correcting cross-reference	1 April 2008
	42	HG 4(4)	Correcting terminology	1 April 2008
	49(1)	MB 7(3)	Correcting terminology	Day after Royal assent
	49(2)	MB 7(4)(a)	Correcting terminology	Day after Royal assent
	49(3)	MB 7(7)(a)	Correcting terminology	Day after Royal assent
	49(4)	MB 7(8)(a)	Correcting terminology	Day after Royal assent
	49(5)	MB 7 (list of defined terms)	Removing defined term	Day after Royal assent
	50	MK 2	Removing defined term	1 April 2008
	59(2)	YA 1 (accommodation)	Correcting cross-reference	8 January 2023
	59(8)	YA 1 (council-controlled organisation)	Correcting terminology	Day after Royal assent
	59(14)	YA 1 (residential land)	Correcting terminology	27 March 2021
Tax Administration Act 1994	70(1)	79	Correcting cross-reference	7 December 2020

Act	Clause	Section	Amendment	Effective Date
	71(1)	80	Correcting cross-reference	7 December 2020
	73	120KBB(1)(a)	Removing example	30 March 2022
Goods and Services Tax Act 1985	79	10(15C)	Correcting cross-reference	Day after Royal assent
	80	11A(1)(r)	Correcting terminology	Day after Royal assent
	81	19N(7)(a)	Correcting cross-reference	1 April 2023
	82	20(3J)(a)(iv)	Correcting cross-reference	1 April 2023
	83(1)	25(4)	Correcting terminology	30 March 2022
	83(2)	25(4)	Correcting terminology	1 April 2023
Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Act 2022	90(2)	227(8)	Correcting cross-reference	30 March 2022
Taxation (Annual Rates for 2023–2023, Platform Economy, and Remedial Matters) Act 2023	91(2)	152(4)	Correcting terminology	31 March 2024

## Order revocations

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### *Clause 92*

### **Summary of proposed amendments**

The Bill would revoke the following Orders, which are spent:

- COVID-19 Resurgence Support Payments Scheme (March 2021) Order 2021
- COVID-19 Resurgence Support Payments Scheme (July 2021) Order 2021
- COVID-19 Resurgence Support Payments Scheme (August 2021) Order 2021
- COVID-19 Support Payments Scheme (Omicron Outbreak) Order 2022

### **Effective date**

The revocations would take effect on the day after the date the Bill receives the Royal assent.