

COMMENTARY

# **Supplementary Order Paper to the Taxation (Annual Rates for 2023– 24, Multinational Tax, and Remedial Matters) Bill**

### FIRST PUBLISHED

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

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

ISBN 978-1-98-857358-8 (Online)

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



© Crown Copyright

This work is licensed under the Creative Commons Attribution 4.0 International Licence. In essence, you are free to copy, distribute and adapt the work, as long as you attribute the work to the Crown and abide by the other licence terms.

## Table of Contents

---

Overview.....	5
Deductibility of co-operative company dividends.....	9
Summary of proposed amendment.....	9
Effective date.....	9
Background.....	9
Key features.....	10
Detailed analysis.....	10
Bright-line and other land-based timing tests.....	15
Summary of proposed amendment.....	15
Effective date.....	15
Background.....	15
Key features.....	16
Detailed analysis.....	16
Extension to the main home exclusion.....	21
Summary of proposed amendment.....	21
Effective date.....	21
Background.....	21
Key features.....	21



## Overview

---

Supplementary Order Paper No 423 contains further measures to be added to the Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill.

The proposed changes would:

- extend the deductibility of co-operative company distributions to include distributions on an additional category of shares, and
- ensure the bright-line and other time-related tests in the Income Tax Act 2007 do not apply when there is a Crown/local authority buy-out of a North Island flood affected property
- ensure that the main home exclusion from the bright-line test covers situations where a person vacates their home for more than 12-months so that repairs to damage caused by the North Island flooding events can be carried out.

The proposed changes would amend the Income Tax Act 2007. This Commentary provides information on the proposed changes.



# **Deductibility of co-operative company dividends**

---





## Deductibility of co-operative company dividends

---

*Clauses 2(12B), 9B, 9C, 20B, 21B and 59(10B), (13B), (13C), (13D), (15B), (15C), (15D)*

### Summary of proposed amendment

The proposed amendment would temporarily extend Fonterra's existing ability to deduct certain distributions to its shareholders. These deductions would be consistent with the deductions that would have been available had Fonterra continued to apply its previous constitution.

### Effective date

The proposed amendment would be effective for the 2022–23, 2023–24 and 2024–25 income years.

While the 2022–23 income year has already finished, the Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill is expected to be enacted before the final date for filing an income tax return for the 2022–23 income year. Officials will develop a permanent solution to apply beyond the 2024–25 income year.

### Background

Section CD 34B of the Income Tax Act 2007 (ITA) provides the ability for a co-operative company to choose to treat distributions paid to its shareholders as a deductible expense that reduces the co-operative's taxable income, and not to treat them as dividends.

Fonterra historically required its shareholders to hold one share for each kilogram of milk solids they supply<sup>1</sup> to Fonterra but has recently changed its constitution so that farmers are only required to hold one share for each three kilograms of milk solids they supply. One share per kilogram continues to be referred to as the share standard, but now Fonterra suppliers have a minimum holding of 33% of the share standard. This allows, but does not require, farmers to hold fewer shares than under the previous constitution. However, it also reduces the linkage between supply and ownership.

Inland Revenue has considered this scenario and concluded that, under the current legislation, distributions on the 33% of shares required to be held remain deductible, but that distributions on the 67% that farmers may (and often will) voluntarily hold have become non-deductible.

---

<sup>1</sup> Generally based on average supply over the previous three years.

This means that, given the interaction of rules under the ITA and the Companies Act 1993, Fonterra would pay non-deductible distributions that could not have imputation credits attached, which would result in the income derived by Fonterra and then distributed to its shareholders being effectively overtaxed — ie, once as a tax on Fonterra's profit and then again when that profit is distributed to the shareholder.

## Key features

The proposed amendment would introduce new section CZ 41, which would apply only to Fonterra for the 2022–23, 2023–24 and 2024–25 income years. Proposed section CZ 41 would:

- retain Fonterra's existing deductions for distributions, and
- introduce deductions for two additional classes of shares that support supply, but suppliers are not required to hold.

The proposed amendment would also introduce consequential amendments to sections CD 2, CD 34B and DV 11 to ensure proposed section CZ 41 operates in the same manner as CD 34B.

## Detailed analysis

Proposed new section CZ 41 would determine the treatment of distributions made by Fonterra to a supplying shareholder for Fonterra's 2022–23, 2023–24 or 2024–25 income year. It would specify that the distribution is not a dividend to the extent to which the distribution is for the supplying shareholder's:

- *Transaction shares* – equivalent to the same term in section CD 34B – the number of shares that the supplying shareholder is required to hold for their supply to Fonterra.
- *Projected transactions shareholding* – equivalent to the same term in section CD 34B – the number of shares that the supplying shareholder would have had to hold if the supply they had projected had actually occurred.
- *Qualifying non-transaction shares* – shares held above the number of transaction shares but capped at 2.0303 times the number of transaction shares.
- *Projected qualifying non-transaction shareholding* – the number of qualifying non-transaction shares the supplying shareholder would have had to hold if the supply they had projected had actually occurred.

The definitions of "transaction shares" and "projected transactions shareholding" do not exactly match the methodology Fonterra applies to calculate the number of shares each supplying shareholder is required to hold. However, proposed section CZ 41 attempts to

follow the existing approach of section CD 34B to the extent possible. Officials are not aware of any difficulty of section CD 34B applying to Fonterra prior to its change in constitution.

The 2.0303 number in the definition is based on Fonterra's constitution setting the minimum holding (referred to as transaction shares in the legislation) at 33% of the share standard. 2.0303 is calculated as  $1 \div 0.33 - 1$ . Officials do not expect Fonterra will change this 33% in their constitution during the three income years that the proposed section would apply for.

By applying to distributions to the extent that they meet the above, the proposed new section covers the shares up to the share standard (one share per kilogram of milk solids).

In contrast to section CD 34B, proposed section CZ 41 does not refer to limited non-transaction shares. This is because section CD 34B(3) ignores limited non-transaction shares where a member holds, or a constitution allows a member to hold, shares above those required to be held to enter trading transactions. As Fonterra's constitution allows a supplying shareholder to hold more shares than the share standard it has not been able to include limited non-transaction shares in its calculation and, therefore, they have been intentionally omitted from proposed section CZ 41.

"Supplying shareholder" is defined in proposed section CZ 41(4) as within the meaning of that term in section 34 of the Co-operative Companies Act 1996, in relation to Fonterra. A distribution to a shareholder who was not a supplying shareholder would continue to have the existing treatment consistent with prior to the constitution change (ie, a non-deductible dividend).

Proposed section CZ 41(3) applies a consistent treatment to existing section CD 34B(9) to allow Fonterra to pay a distribution more than 20 days after the end of its year. This allows the distribution to be deductible in the year the income that supports that distribution was derived rather than the year in which that distribution is made.

The proposed amendment also includes consequential amendments to sections CD 2 and DV 11 of the ITA. These changes ensure that a distribution that is not treated as a dividend under proposed section CZ 41 will apply that treatment consistently throughout the ITA. Proposed section CD 34B(1B) will ensure that section CD 34B will not also apply to a distribution that is covered by proposed section CZ 41. Further, consequential definitions are proposed to be added to section YA 1.



# **Income tax relief for buy-outs of North Island flood affected properties**

---



## Bright-line and other land-based timing tests

---

*Clauses 18B and 59*

### Summary of proposed amendment

These new clauses would ensure that both the 5-year and 10-year bright-line tests and other land-based timing tests in the Income Tax Act 2007 (ITA) do not apply when the Crown or a local authority purchases a property affected by a North Island adverse weather event.

### Effective date

The proposed amendment would be effective for the 2022–23 and later income years.

### Background

As part of its work to support the Future of Severely Affected Locations (FOSAL), the Government has announced its willingness to enter into a funding arrangement with councils in regions severely affected by the January 2023 Auckland flood events and Cyclone Gabrielle. Central government support is likely to include contributions towards property acquisitions (buy-outs).

The ITA contains a set of time-based tests which, if not met, result in any gain or loss on disposal of the property being either taxable or deductible<sup>2</sup>:

- The most well-known test is the “bright-line”. For properties purchased on or after 27 March 2021, the minimum ownership period is 10 years unless it is a new build, in which case the minimum ownership period is five years. The main home is generally excluded from the bright-line test.
- Properties purchased between 29 March 2018 and 26 March 2021 (inclusive) continue to be subject to the previous 5-year bright-line test. (Given that property prices have declined over the last two years, losses on a buy-out are probably more likely to arise under this test.)
- Separate 10-year tests apply to properties that are owned by dealers in land, property developers/subdividers, builders, and their associates.

---

<sup>2</sup> In the case of a bright-line loss deduction, it can only be applied against income from land, including bright-line gains.

These tests could be triggered through a buy-out as it is a disposal for tax purposes. Because the time-based tests have exclusions for the person's main home, most buy-outs will not be impacted, but landlords of rental properties, for example, could be impacted. It is also feasible that such landlords may be property developers, builders or subdividers, or be tainted by association with such parties for tax purposes.

If so, any gain over the purchase price as a result of the owner accepting the buy-out offer would be taxable. Under normal circumstances, the owner could have held on to the property for more than the minimum period. However, because of the weather events, the owner has, in effect, little option other than to sell to the local authority (or potentially, in some cases, the Crown).

The normal tax policy approach is that the various time-based tests should potentially apply when there is a compensatory buy-out. However, given the nature of the specific flooding events, there are grounds for an exception, as was done for the Canterbury earthquakes where the Crown purchased properties under the Greater Christchurch Regeneration Act 2016.

## Key features

New clause 18B proposes to insert new section CZ 26B into the ITA to ensure that the bright-line tests and other time-related tests in the ITA that tax disposals of land do not apply when there is a Crown or local authority buy-out of a property affected by a "North Island adverse weather event".

A "North Island adverse weather event" is defined in clause 59 as any of the following:

- 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.

These are the two weather events that the FOSAL buy-out scheme is intended to cover.

## Detailed analysis

Proposed section CZ 26B specifically turns off both the 5-year and 10-year bright-line tests (sections CZ 39 and CB 6A) and the timing tests in sections CB 9 (Disposal within 10 years: land dealing business), CB 10 (Disposal within 10 years: land development or subdivision business) and CB 11 (Disposal within 10 years of improvement: building business).

Section CB 14 was also included in the equivalent Canterbury earthquake provision (section CZ 26) but has not been included in proposed section CZ 26B because it is considered unlikely to be relevant in this case. That section relates to disposals within 10 years of



acquisition where the disposal results in a gain and at least 20 percent of the gain arises from a consenting or planning change.

The proposed turning off of the timing tests for the buy-outs would mean that not only would there be no gains but also no losses for tax purposes. For example, some property owners who have bought their properties in the last couple of years may have wanted to utilise any losses from a buy-out against any land income, and that will not be possible if the legislation is amended as proposed. However, it is considered fairer to neutralise the timing test implications for all parties receiving a buy-out.

The proposed amendments are intended to ensure that the timing tests are turned off irrespective of the legislative vehicle used to make the buy-out offers, provided that the disposal is as a result of a "North Island adverse weather event". For example, councils could use their powers under the Public Works Act 1981 or the Local Government Act 2002 to buy out properties.



# **Extension to the main home exclusion from the bright-line test for North Island flood affected properties**

---



## Extension to the main home exclusion

---

### *Clause 9(1B) and (1C)*

### **Summary of proposed amendment**

The SOP extends the main home exclusion from the 10-year bright-line test to any reasonable period where a person vacates their property affected by a North Island flooding event to enable damages to be repaired.

### **Effective date**

The proposed amendment would take effect on 8 January 2023.

### **Background**

The bright-line test taxes gains from residential land acquired and sold within a specified timeframe. The timeframe is five years for properties acquired between 29 March 2018 and 26 March 2021 (inclusive) and 10 years for properties acquired on or after 27 March 2021.

The main home is generally excluded from the bright-line test. Under current rules for the 10-year bright-line test, this exclusion can still apply even when the property owner has been away from their home for part of the period, provided they are away for no more than 12 months. This 12-month period can also be extended to any reasonable period when a person is constructing a dwelling used as a main home. This would cover cases where a property has been so irreparably damaged by a flood or cyclone that it needs to be rebuilt. However, the 12-month period cannot currently be extended when a person has been displaced from their home as a result of a flood or cyclone and they are repairing their home rather than rebuilding it.

### **Key features**

New clause 9(1B) replaces the definition of "exempt main home period limit" in section CB 16A(1C) of the Income Tax Act 2007. Section CB 16A contains the main home exclusion from the 10-year bright-line test. The existing law is included as paragraphs (a) and (b)(i) of the proposed new definition.

Proposed new paragraph (b)(ii) extends the "exempt main home period limit" to include a reasonable period in the case of a period during which a person remediates a dwelling affected by a North Island flooding event and that dwelling is used as a main home.

An updated definition of “North Island flooding events” is already included in clause 59(13) of the Bill. The following three events from early 2023 qualify:

- Cyclone Hale
- the heavy rainfall of late January (which was particularly associated with the Auckland floods), and
- Cyclone Gabrielle.

This amendment is not expected to have wide application, as all the following criteria would need to be satisfied for it to apply:

- the property is residential housing
- it is the main (family) home of the person
- it was purchased on or after 27 March 2021
- it was damaged by one of the North Island flooding events
- it is not rebuilt, but rather is repaired
- the owner is unable to occupy the property during the repair
- the repair takes longer than 12 months to complete, and
- the repaired property is then on-sold on or after 9 January 2024 and within the bright-line period.

An equivalent amendment has not been made to the 5-year bright-line test. This is because it is considered unnecessary due to how the main home exclusion from the 5-year bright-line test applies. In that case, the main home exclusion is an all or nothing test, and it will apply provided a property is used as a main home for at least 50% of the time it is owned.

The last day a property could have been acquired that would be subject to the 5-year bright-line test was 26 March 2021. By the time the first flooding event hit on 8 January 2023, the person would have been living in their main home for almost two years. In this case they will have at least 22 months to repair their main home. The earlier a person acquired their property during the 5-year bright-line period (29 March 2018 to 26 March 2021 inclusive), the longer they will have to repair and move back into their main home before triggering the bright-line test. It is considered unlikely that, in addition to meeting all the above criteria, the repair to their property would take more than 22 months to complete, such that the main home exclusion no longer applied, and that the person would then sell their property before the expiry of the 5-year bright-line period. However, officials would welcome submissions from any property owners who may be affected by the application of the 5-year bright-line test as a result of the North Island flooding events.