Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Bill

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Officials' Report to the Finance and Expenditure Committee on Submissions on the Taxation (Tax Credits, Trading Stock and other Remedial Matters) Bill

10 June 1998

CONTENTS

1……THE TAX CREDIT SYSTEM

2. TRADING STOCK TAX REFORM

3. OTHER AMENDMENTS TO THE INCOME TAX ACT

4. AMENDMENTS TO OTHER ACTS

1. THE TAX CREDIT SYSTEM

OVERVIEW OF SUBMISSIONS

The tax credit system (TCS) will provide a mechanism that allows people who save through superannuation and life insurance products to pay tax on their investment income at their correct tax rate. The current 33% rate is a disincentive to saving for lower rate taxpayers (those earning below $38,000) who, after the tax cuts on 1 July 1998, will be on a rate of 21%.

Background

Investment earnings in life office and superannuation funds are currently taxed at a flat and final rate of 33%. This disadvantages taxpayers earning less than $38,000, who end up paying tax on their investment income at a much higher rate than the tax they pay on other income. Narrowing the gap between the different tax rates would be the obvious solution to the problem. However, given that there is a significant differential between tax rates, the best solution is to tax income from savings in life and superannuation funds at savers' personal tax rates, as happens in the case of interest and dividend income. However, attributing annually the income of life offices and superannuation funds to individual investors is not easy because of the way that life offices and superannuation funds operate. In response, the Government set up a process for full consultation, including a working party chaired by the Retirement Commissioner, to identify workable options. This working party, known as TOLIS, reported to Government in April 1997.

The working party identified three options for solving the problem: a tax credit system, a revised rate proxy, and a qualifying fund regime. Each method has its advantages and disadvantages. Ultimately, there must be a trade-off between achieving a level playing field with other similar investments (by an accurate allocation) and limiting additional compliance costs. The Government decided that the tax credit system was the best fit. This then formed the basis of Government's subsequent discussion document, published in August 1997. The outcome is included in the tax bill before the Committee.

Submissions

Eighteen written submissions and three supplementary submissions on the tax credit system were received. Ten submitters were heard by the Select Committee.

Submissions dealt with both the tax credit system and a change relating to superannuation contribution withholding tax (SSCWT).

Submitters generally agreed that the tax credit system (TCS) achieves the desired result, allowing savers to be correctly taxed at their personal tax rates. Of the systems considered, this was the only one that could achieve this accuracy. However, submitters were concerned about the complexity and costs involved for savers electing into the tax credit system. Submitters were concerned that income attributed to electing savers under the tax credit system will increase the savers' taxable income and consequently may reduce their entitlement to social assistance.

Submitters sought clarification of the change relating to SSCWT. This change addresses the issue of over-taxation of contributions to a superannuation fund made by an employer in respect of employees. Officials agree that clarification is required so that employer and employees can agree to treat the contribution in such a way that the employee is subject to tax on the contribution at their personal tax rate rather than at a flat 33%.

Submissions on the SSCWT change also recommended that contributions by the employer on behalf of the employee should not be included in taxable income for the purpose of determining entitlement to certain social assistance.

The submissions can be broadly categorised into two groups: significant policy issues and technical and drafting issues.

THE TAX CREDIT SYSTEM: SIGNIFICANT POLICY ISSUES

SAVER ELECTIONS

Clauses 8 and 27 Section CO1, LH3
Clause 8 Section CO1(1)

Submissions
5W - Roger and Judy Collins
10 - Watson Wyatt
11 - NZ Anglican Church Pension Board
12 - William M Mercer
13W - National Provident Fund
14 - ASFONZ
16 - Armstrong Jones
17W - General Accident Asia-Pacific Ltd
22 - Investment Savings and Insurance Association of NZ Inc. (ISI)
24 - Retirement Commissioner

The submissions above raised the following points:

- Savers' understanding of the TCS for the purposes of electing into the system

  Savers will have difficulty understanding how the changes will work and how much benefit they will receive from electing the TCS.

- Savers on incomes close to the 33c tax threshold

  In particular, those close to the 33c tax threshold may find it difficult to manage their tax position accurately as they find themselves with higher allocated income than anticipated if the fund does better than expected or through overtime payments and the like. Similarly, those receiving social assistance may not understand the implications of electing the TCS.

- Social assistance impact

  Including attributed income from the tax credit system in income calculations in relation to social welfare benefits will actively discourage use of the TCS by low income savers and therefore undermines a key objective of the TCS.

- Timing of saver's elections

  There is a practical problem of an election being made some time before it impacts on a saver’s income. In the meantime the saver's circumstances in relation to social assistance may have changed, so that electing into the TCS proves to be a poor decision.

- Income to pay any additional tax

  The attributed income is notional and not paid annually in cash because the investment has not been realised. In contrast, interest and dividends are from realised income and paid in cash.

Submissions' suggested solutions

(i) There should be a taxpayer education campaign regarding the implication of electing the TCS option. Inland Revenue, Social Welfare or the Retirement Commissioner should take a key role in any campaign rather than the onus being placed on superannuation schemes, who could be sued for incorrect advice to members regarding elections.

(ii) There should be a one-year transition whereby taxpayers who enter the regime are not penalised for miscalculating, with all attributed income being taxed at 21% regardless of the taxpayer's actual income, provided their income was less than $38,000 in the previous year.

(iii) Tax credits should be attributed to electing savers at a rate of 33% rather than 21%. Consequently, electing savers would receive their tax refund through their personal tax return.

Officials' comments

Savers' understanding the TCS for the purposes of electing into the system

Election by savers into the TCS will be optional. In making a decision whether to elect into the system savers will need to take into account what level of income they earn in a year and whether they receive social assistance. Inland Revenue officials have been working with the industry, and will continue to work with them, to develop guidelines for savers who want to make a decision as to whether they elect or not.

Once the legislation is enacted, Inland Revenue will publish a *Tax Information Bulletin* covering the operation of the tax credit system.

Savers on incomes close to the 33% tax threshold

Savers close to the threshold have the option of electing into the TCS but may be concerned about doing so because their income may ultimately go over the 33% threshold. In this case the credits at 21% will not cover their attributed income under the TCS. To help savers make the right decision, we understand that funds are likely to provide savers who are considering electing into the scheme with an indication of the level of income they are likely to be attributed under the TCS. This will be important in determining whether the saver will go over the 33c threshold. We also understand that funds may make available to electing savers the 12c "refundable credit". As a result, if electing savers have a tax liability on the attributed income from the TCS of more than 21% they will have the 12c available to them to help with this liability.

Social assistance impact

Attributed income under the TCS will not be included in the social security definition of "income" for the purposes of determining benefit entitlement under the Social Security Act. These benefits include unemployment and sickness benefits, widows, domestic purpose and invalids benefits.

However, social assistance which is based on taxable income may be affected by a saver's receiving income under the TCS. Electing savers will include the income they are attributed under the TCS in their taxable income. Benefits for which entitlement is based on taxable income include family support and student allowances. Child support payments are also determined with reference to an individual's taxable income.

Officials have considered whether the income from TCS, which will form part of electing savers' taxable income, should be overlooked for purposes of determining levels of social assistance. We do not recommend this course of action. It would mean that savers receiving social assistance would not pay the correct amount of tax. Moreover, these savers would be in a preferred investment vehicle that would have an advantage over other forms of investment. Such a move would encourage people who receive social assistance to invest in this type of vehicle rather than, for example, a bank account. In this regard it would be possible for people to avoid a reduction in their social assistance by using a superannuation fund, for example, in the same way as a bank account. The avoidance of the National Superannuation surcharge is an example of where this type of avoidance occurred.

It is likely that funds will advise savers who are on incomes of greater than, say, $20,000 and in receipt of social assistance not to elect into the TCS.

Fiscal cost

The "best guess" fiscal cost of excluding attributed TCS income from the definition of income for the purposes of calculating family support entitlements is $10-30m. Of the social assistance programmes affected, family support has by far the greatest fiscal implications and hence this estimate relates only to family support.

The actual cost is dependent on how many recipients of family support are also investors in life insurance and superannuation products, and the extent of their investment. This estimate assumes that around 25-50% of recipients of family support have these types of investments and receive on average $500-$1000 attributed income.

The estimate also assumes that in the absence of exempting attributed income from the calculation of family support entitlements, the affected taxpayers will not opt for the TCS. This means that their life insurance/superannuation investment income would continue to be taxed at 33% rather than their true effective marginal tax rate, which could be as high as 100%. However, should the exemption be provided, the savers are assumed to move to an effective tax rate of 21%.

Timing of saver's election

Funds are given flexibility as to when elections are made by savers. Flexibility is also given to the funds in respect of their acceptance of the revocation of saver elections. It is likely that funds will allow for savers to revoke elections when their income changes, so that the 33% rate applies.

Income to pay any additional tax

We understand that funds who offer tax credits may choose to provide in cash the 12c refundable credit they receive on the tax credits they attribute to electing savers. This cash could be used to meet any additional tax the saver faces.

Tax credits attributed at 33% rather than 21%

The proposal would require savers to file a tax return merely to seek a refund from Inland Revenue, a measure that is in direct conflict with tax simplification moves to reduce the numbers of those who must file returns. The funds prefer that the 12c refund be reinvested in the funds on behalf of savers.

Recommendation

That these submissions be declined. It should be noted that officials and the industry are working together on how to provide advice to savers who are considering electing into the TCS.

COMPLIANCE COSTS FOR THE FUNDS

Clause n/a

Submissions
5W - Roger and Judy Collins
7 - Eriksen & Associates Ltd
11 - NZ Anglican Church Pension Fund
12 - William W Mercer
16 - Armstrong Jones
22 - ISI

Compliance costs should be reduced or an alternative system should be adopted.

While supporting the need for reform, a number of submissions are concerned that the changes appear to be very complex with high compliance costs. This is a particular concern for employer subsidised schemes which in many cases do not have professional trustees.

Other changes such as the Securities Commission and Financial Reporting requirements have already materially increased compliance costs and the Tax Credit System (TCS) adds to this. As a result, the submissions predict that many employer schemes will not offer the TCS option to staff or some employers may speed up their decisions to cease offering superannuation schemes to staff.

In terms of the larger non-employer funds, the systems changes to implement the TCS coincide with changes such as the year 2000 problem so there is a shortage of software systems people for the programming required for the TCS.

Officials' comment

In response to these submissions, we note that:

- TCS is optional for life insurers and superannuation funds.

- The compliance costs for life insurers and funds operating the TCS in respect of new business will be less than for existing business. Consequently, we understand funds are more likely to offer the TCS on new products, designed to take account of the TCS.

- TCS has been developed in consultation with interested groups. A considerable focus during consultation was the reduction of compliance costs. To this end, the TCS legislation contains flexibility as to the methods that can be used in order to determine the tax credits that can be attributed to electing savers. This takes account of the many possible methods funds currently have for allocating income to savers.

- The TCS rules are less complex than company imputation rules. For example, the TCS rules contain no continuity of ownership provisions and no share repurchase rules.

- TCS will put life offices and superannuation funds in a very competitive tax position.

Recommendation

That this submission be declined, noting that life insurers and superannuation funds will have a fair degree of flexibility over how they administer the scheme should they opt for it.

ALTERNATIVE SYSTEMS TO THE TAX CREDIT SYSTEM

Clause n/a

Submissions
7 - Eriksen & Associates Ltd
11 - NZ Anglican Church Pension Fund
12 - William W Mercer
14 - ASFONZ
22 - Investment Savings and Assurance Association (ISI)

Suggested alternative options referred to in these submissions are:

- Reduced proxy rate (ISI suggests this in conjunction with a cap mechanism).

- One single flat rate of tax for all investment earnings, incomes and GST.

- In employee schemes employers would pay tax based on the marginal rate of the employee. The employer would determine this based on salary information.

- Qualifying fund. This is seen as being very similar to the TCS in its application.

- Tax credits would be attributed at 33% (instead of 21% as proposed) with taxpayers claiming a tax refund from Inland Revenue if they are on a tax rate of less than 33%. This has also been suggested for those taxpayers receiving a pension.

- Schemes would not be required to attribute income and tax credits to members but the benefit of tax credits would be reflected through unit prices for all investors. The difficulty arises in the attribution of the tax credits whereby the tax expense used in the unit pricing will differ from the actual tax paid, principally owing to unrealised gains and losses on equities and real property.

Officials' comment

Revised proxy rate

A lower proxy rate (with or without a cap) would merely lower the current rate of 33% to, say, 27%. A cap would limit the benefit of the lower rate on an individual basis. With a cap, all taxpayers would be required to specify in their tax return whether the total value of their superannuation and life insurance investments (based on, say, their surrender values) exceeded, say, $100,000 at any time during the income year.

We note:

- A lower proxy rate means that all investors are incorrectly taxed. Some will remain overtaxed, while others will be undertaxed.

- A lower proxy rate will favour higher income earners (the opposite group targeted by the reform), who will be able to invest their money in these schemes and be taxed at less than 33% on their earnings.

- It provides a competitive advantage to life offices and superannuation funds over other comparable investment vehicles, leading to likely complaints from those other investment intermediaries.

- There is no statistical approach to determining what the proxy rate should be.

- The cap will be arbitrary, will not produce an accurate result and can be manipulated (for example, by dividing investments between family members or trusts so as to remain under the cap for each investment).

- The cap mechanism is inconsistent with the aim of reducing the need to file a tax return. The operation of the cap is likely to lead to savers under $38,000 having to file tax returns. Under the cap mechanism the compliance costs shift to investors to determine whether they have breached the $100,000 cap. If they have, they will also have tax to pay.

- TCS is also more fiscally sustainable than the revised proxy rate. The fiscal cost for a 27% proxy rate is $60-70m, whereas for TCS is only $20-30m.

- The lower rate proxy has been acknowledged by many submitters as not a viable long-term solution to the problem of overtaxation of lower tax rate payers.

One single tax rate for savers

This was outside the ambit of the options that were considered by the TOLIS working party. Narrowing the gap between the different rates would be the most obvious solution but has wider implications.

Qualifying fund

This option enables funds to be created or formed by the sub-division of existing funds, which cater only for lower rate taxpayers. It is a variation on the proxy rate regime but with two rates - 21% and 33%. Conceptually, the option would result in the application of the right effective tax rate to many individual savers in a reasonably cost effective way. However, a key disadvantage is that it involves compliance and administrative costs in ensuring that taxpayers on effective tax rates greater than 21% do not enjoy the benefits of 21% schemes. Furthermore it is not certain how those who incorrectly end up in, say, the 21% fund would be "penalised" for an incorrect election. Also, there are many taxpayers on effective marginal tax rates in excess of 33% because of social assistance. This would imply the need for more than two types of qualifying fund to cover the range of effective marginal tax rates. In contrast, the TCS does in fact pick up the marginal rate of the saver.

Tax credits at 33% rather than 21%

The proposal would require savers to file a tax return merely to seek a refund from Inland Revenue, a measure that is in direct conflict with tax simplification moves to reduce the numbers of those who must file returns. The funds prefer that the 12c "refundable credit" be reinvested in the funds on behalf of savers.

Non-allocation of tax credits

Under this option, it would be up to the fund as to what benefit the saver received. The tax benefit would be implicitly built into the unit price in a widely held superannuation fund so that all savers, not only the 21% savers would benefit. There would also be problems about how to square off insufficient tax paid because of incorrect elections given that the saver would not need to include the tax credits and attributed income in their tax return.

Recommendation

That these submissions be declined.

SUPERANNUATION CONTRIBUTIONS INCLUDED IN SALARY AND WAGES

Clause 32

Submissions
Submission (i)
7 - Eriksen & Associates Ltd
11 - NZ Anglican Church Pension Board
12 - William M Mercer
14 - ASFONZ
17W - General Accident
21 - NZ Society of Actuaries
25 - Rudd Watts & Stone

The legislation should enable employees to change their election only with the consent of their employer.

There appears to be a drafting error that enables employees to instruct their employer to include employer superannuation contributions in their salary and wages and, therefore, be subject to PAYE and the associated impact on family support, ACC levies, and the like. This impinges on the contractual relationship between employee and employer. It also leads to additional compliance costs for the employer because of variations between employees as to the amount, if any, deducted from their salary as a super contribution.

The legislation does not have sufficient safeguard to stop employees claiming the employer's contributions as having immediately vested as they are salary and wages, and seeking to spend the money rather than putting it into the super scheme.

Submission (ii)
9 - NZ Employers Federation
10 - Watson Wyatt
14 - ASFONZ
17W - General Accident

Employer superannuation contributions should be treated as salaries and wages *for taxation purposes only*.

The salary and wages that consist of specified superannuation contributions in terms of paragraph (j) of the "salary and wages" definition should be added to the list of exclusion in paragraph (b) of "earnings of an employee" in the ACC regulations 1992.

The proposal in respect of employee contributions has the following implications:

- will increase ACC payments for both the employer and employee, amounts paid out as holiday entitlements, family support payments, student loan repayments, redundancy payments and any other salary linked pay outs (eg death benefits);

- increases expectation of staff not in scheme to receive matching pay increases,
- would be difficult to unwind if the super scheme was wound up,
- would put an element of salary and wages outside employers control because contributions are determined by the trust deed and trustee not the employer,
- would create confusion in the event of receivership or liquidation where salary and wages are given priority and super is normally paid out in accordance with the trust deed,
- taxes employees that leave before full vesting on income they do not receive.
- is unclear on what happens where an employer receives a "contribution holiday" because the scheme has sufficient reserves.

As a result, employers are less likely to offer subsidised superannuation plans, so in the course of trying to remove one disincentive to savings have created another.

Submission (iii)
9 - NZ Employers Federation
11 - NZ Anglican Church Pension Board

Employer funded contributions should be subject to SSCWT at the appropriate rate which reflects the salary and wage level of each employee.

Officials' comment

- We agree with S*ubmission (i)* that there is a need to clarify the legislation so that employers and employees must agree to the new treatment. It was not the intent of the legislation to enable an employee to have sole discretion over whether an employer's superannuation contribution is included in salary and wages and taxed at the employee's personal rates. Rather it was intended that whether an employer's superannuation contribution is included in an employee's salary and wages would require joint agreement between both employers and employees.
- In respect of *Submission (ii)* requiring joint agreement between employer and employees on whether contributions are included in salaries and wages should remove much of the concern about the flow-on effect this would have on other costs to employers for ACC payments, holiday pay, superannuation contributions and redundancy payments. When making a decision on whether to offer employees a choice of how superannuation contributions are to be treated, employers will be able to weigh up the implications of the flow-on effects in relation to competitive salary packages.
- Similarly, employees will, when making their decision, need to weigh up issues such as their likelihood of leaving before full vesting against the benefits of a lower longer-term tax rate based on their personal rate.

- Treating contributions as salaries and wages for tax purposes does not imply that there is any change in the contribution status in relation to receivership or liquidation law.

- Where there is a "contribution holiday" there will consequently be no employer contributions subject to SSCWT, so this change will not apply.

- In the case of the option for contributions to be treated as salaries and wages and its impact on social assistance eligibility, again this is only replicating the treatment given to other forms of salary and wages, that is, ensuring a level playing field. Ultimately, the scheme is optional and employees can continue to have the contributions taxed at a flat rate of 33 cents (under SSCWT) notwithstanding that their effective marginal tax rates could be in excess of this, given the receipt of social assistance.

- If employees could opt to include superannuation contributions in their salary and wages without impacting on their family support, child repayment obligations, student loans, they could take an immediate pay cut and substitute that for employer superannuation contributions and avoid any abatement effect. Hence there could be a substantial fiscal cost.

- As regards *Submission (iii)*, a key problem with applying SSCWT at the appropriate rate which reflects the salary and wages level of each employee is determining what is the appropriate rate. Incomes may vary so that the rate of deduction proves to be incorrect. In these circumstances, it is far from clear how to correct the under or over deduction given that SSCWT effectively operates as a final tax. For example, should the adjustment be done at the employer or employee level?

Recommendation

- That submission (i) to clarify the legislation be accepted so that an employee's election to have an employer's superannuation contribution treated as salaries and wages can only apply if the employer also agrees to offer this option; and

- That submissions (ii) and (iii) be declined.

THE TAX CREDIT SYSTEM:
TECHNICAL AND DRAFTING ISSUES

APPLICATION OF TCS TO SUPER SCHEME RESERVES

Clause n/a

Submission
(13W National Provident Fund)

Investment income derived on reserves should be subject to tax at the average rate of tax payable by the superannuation scheme after taking account of elections made by contributors and annuitants without increasing the attributed income to electing annuitants. NPF has substantial reserves to minimise the Government's risk, given guaranteed minimum crediting rates.

Officials' comment

Reserves and investment income on reserves will be subject to a tax rate of 33% in the first instance, as will all income of superannuation funds. Tax credits can be carried forward in respect of tax paid reserves in the tax credit account. These tax credits could then be attributed to savers when the reserves concerned are subsequently allocated to savers.

While applying the average rate across electing savers instead of the 33% rate seems at first glance appealing, it is not necessarily the correct rate as the mix of savers is likely to be different when the tax is actually attributed as tax credits.

Recommendation

That the submission be declined.

ROLLOVER RELIEF

Clause n/a

Submission
(14 - ASFONZ)

For ease of administration, trustees may wish to split schemes into 33% and 21% taxpayers. Therefore, rollover is requested to avoid the tax consequences of such splits.

Officials' comment

Any rollover relief provisions would of necessity be complex so as to avoid the possibility of their being abused as a means of tax planning. They would add a further layer of complexity to the TCS that in the end is likely to be unnecessary. Our discussions with the industry on this point indicate that lack of rollover relief should not be a problem, because:

- The TCS legislation already provides mechanisms to enable funds to effectively split their funds for the purposes of offering tax credits to a group of their savers without setting up separate legal entities.

- Tax credits are likely to be offered more for new products rather than existing products.

For example, funds could apply section MJ9 to attribute tax credits in relation to part of the business or section MJ11 to establish multiple tax credit accounts.

If, however, funds wish to separate out their assets into separate legal entities they will be subject to the tax consequences of asset transfers, as would any other entity during the normal course of its business.

Recommendation

That the submission be declined.

USE OF MONEY INTEREST ON PROVISIONAL TAX OVERPAID

Clause n/a

Submission
10 - Watson Wyatt
22 - ISI

Use of money interest (UOMI) should be payable on provisional tax overpayments made to generate tax credits. Insurers and super funds may wish to do this in years where there is no tax liability. In the absence of any change to the legislation, UOMI would be payable. Bringing tax forward benefits the Crown and interest recognises this cash advantage. The situation is different from dividends as there are underlying differences from the imputation regime. Under the imputation regime dividends represent a transfer of wealth, but under TCS there is no transfer, merely a notional distribution.

Officials' comment

We do not agree with paying interest in this instance. This approach is consistent with the company imputation regime.

The wider picture needs to be considered in that while it is true that the fund will pay tax before its tax liability has crystallised, the savers will have the benefit of the tax credits generated by the prepayment immediately.

As regards comparable treatment for notional distributions, we see the TCS as analogous to a company making a taxable bonus issue to pass imputation credits out to shareholders without having to distribute cash. In that situation no interest is paid on the prepaid tax used to generate the imputation credits.

Recommendation

That this submission be declined. The legislation should make clear that it is not intended to pay interest on prepaid tax that is used to generate tax credits. In relation to superannuation, a specific legislation amendment will be required; however, in relation to life insurers this issue is already covered.

AMENDMENT OF TRUST DEEDS AND/OR THE SUPERANNUATION SCHEMES ACT

Clause n/a

Submissions
(i) 12 - William M Mercer
13W - National Provident Fund

The legislation should specifically provide for trust deeds to be altered to accommodate TCS without requiring funds to obtain the consent of all members under section 9 of the Superannuation Schemes Act 1989. NPF suggest similar provisions to those included in the Human Rights Act.

(ii) 14 - ASFONZ
21 - NZ Society of Actuaries (NZSA)

The Superannuation Schemes Act 1989 should be amended to enable schemes to recover higher administration costs of TCS from members on different bases, such as a different declared rate for the TCS electors. Otherwise section 9 of that Act will be breached as the additional charges would reduce the surplus available to the non-electing members in the event of a wind-up. Suggested draft wording is provided in the submission, including a provision to address the concerns of the Government Actuary.

Officials' comment

Clearly there is an issue of how superannuation funds will handle allocating the costs of TCS across their members given that non-electing members would otherwise bear some of the costs without getting any benefit.

Administratively, there is some doubt as to whether trust deeds or the Superannuation Schemes Act need to be amended to provide superannuation funds with the flexibility to handle this situation.

Notwithstanding the administrative difficulties, it seems desirable for funds to get the consent of the affected members to the higher costs from offering the TCS.

These issues have been discussed with the Government Actuary, who has advised that no amendment should be made to this Act. However we are discussing this issue further with the industry and Ministry of Commerce

We note that in practice funds may avoid the problems above by offering new products to a group of savers who elect the TCS and who all agree to the associated costs.

Recommendation

That the submission be declined. We note that we are continuing to discuss the issue of amendment of the Superannuation Schemes Act.

ABILITY TO OBTAIN A TAX CREDIT UNDER THE POLICYHOLDER BASE AND LIFE OFFICE BASE TAX

Clause 27 section LH9 and LH15
Clause 30 section MJ6

Submissions
6W - Tower Corporation
7 - Eriksen & Associates
21 - NZ Society of Actuaries
22 - ISI

(i) Section ME18(1) of the Act should be amended to allow a credit to the PCA for the refundable credit in the proposed section LH9(2).

(ii) Section MJ6 should be amended to clarify that there is no double counting of credits in the TCA for tax paid in respect of the policyholder tax base liability.

(iii) Life insurers should be able to obtain a refundable credit under the TCS at the life insurer and policyholder base. The base for taxing life insurers involves two separate calculations to derive the total tax payable. As currently drafted, the legislation allows for tax credits to be offset against only part of the calculation so that the actual tax paid by the life insurer would not be reduced, and the benefits passed on to individual policyholders would be met by participating policyholders or the shareholders.

(iv) Sections LH9, LH15 and MJ6 should be amended to ensure equal treatment of insurers and superannuation schemes in relation to refundable credits. The current wording renders the TCS ineffective in all situations where the tax liability in relation to the life insurer base income exceeds the tax liability on policyholder base income (after the allowance of tax credits).

(v) The credits should recognise the actual tax incurred and paid by the life insurer. The original policy intention was to limit the credits available to the amount of the policyholder tax liability. The provisions in the bill actually credit to the TCA all tax paid by the life insurer. Life insurers calculate their tax liability on two bases - the life insurer base and the policyholder base. If the tax creditable to the TCA is limited to the policyholder base liability, significant limitations on the application of the TCS rules will arise and life insurers will be disadvantaged vis a vis superannuation funds.

(vi) Clarification is required as to whether the income tax liability referred to in LH9(3) is a reference to an income tax liability on policyholder income.

Officials' comment

As this issue was raised by a number of submitters, we discussed the details with the industry and have revised the proposals as follows:

- A refundable credit will be available to credit against a tax liability at both the life office and policyholder base.

- However, a cash refund of tax relating to the refundable credit will only be available at the life office base if there is a sufficient credit balance in the company's imputation credit account.

- Where refundable credits exceed the current year's income tax liability at the policyholder base, the excess can only be carried forward as a loss at this base.

- When imputation credits from the life office base are transferred to the policyholder credit account, the tax credit account will be credited with the same amount.

- Where amounts are transferred from the policyholder credit account to the imputation credit account, the tax credit account must be debited by the same amount.

- A cash payment of tax in respect of a policyholder base tax liability can be credited directly to TCA.

Recommendation

That the Committee note that this area has been revised in consultation with the industry and that points raised in the above submissions have been addressed in the legislation.

TRANSFER OF LIFE INSURANCE BUSINESS

Clause 6 Section CM15(1)
Clause 30 Subpart MJ

Submission
(6W - Tower Corporation)

- Items v1 and v0 contained in section CM18(1) should be amended to incorporate the proposed changes to v1 and v0 contained in the proposed section CM15(1).

- A provision should be included in the TCS similar to section ME19A so that the life insurer may elect to transfer a credit balance in its credit account (TCA) on the transfer of its life insurance business to a company in the same wholly owned group of companies, and section MJ7(1)(g) would not cause a debit to the TCA in such cases.

- A provision should be included to ensure that the status of an "elected fund", "electing policyholder or electing member" and "non-electing policyholder or non-electing member" are not altered by a life insurer transferring its life insurance business to another company in the same wholly-owned group of companies.

Officials' comment

These submissions relate to the implications for the TCS when there is a transfer of life office business. The legislation should contain provisions relating to the transfer of life office business. This includes the consequences on transfer for the TCA.

Recommendation

That submissions be accepted.

CONSOLIDATION AND AMALGAMATION

Clause n/a

Submission
(6W - Tower Corporation)

The relevant sections in the Income Tax Act 1994 that deal with consolidation and amalgamation of companies should be appropriately integrated with the TCS rules.

Officials' comment

Officials agree that consolidation and amalgamation rules covering the TCS are needed.

Recommendation

That the submission be accepted and note that if time allows, the necessary changes to the legislation should be made.

IMPLEMENTATION DATE FOR THE TCS

Clause - various

Submission
(16 - Armstrong Jones)

The TCS should be implemented as soon as possible.

Officials' comment

The TCS is planned to apply from 1 April 1998. Funds can use the scheme from this date, notwithstanding that in some cases this does not coincide with the beginning of their income year.

Recommendation

That the submission be accepted, noting that 1 April 1998 is the earliest feasible time for implementing the TCS.

ATTRIBUTION FROM A LIFE INSURER TO A SUPERANNUATION FUND

Clause 27 Section LH10-15

Submission
15W - ICANZ
21 - NZ Society of Actuaries
22 - ISI

The proposal enabling a superannuation fund to attribute income to another superannuation fund should be extended to allow life insurers to attribute income to superannuation funds. It is not uncommon for superannuation funds to invest not only in other superannuation funds but also in life insurance products.

Officials' comment

Officials agree with the submission and recommend that if time allows, the necessary changes to the legislation should be made.

Recommendation

That the submission be accepted.

BACKDATING A TAX CREDIT CERTIFICATE

Clause 39 Section 30C(1) of the TAA

Submission
(19W - WestpacTrust Financial Services)

The TCS regime should be amended to allow a superannuation scheme to backdate a tax credit certificate sent in one income year to the previous year, if it is sent within six months of balance date. Under the proposed legislation, it is possible for attributed income not to become assessable until the income year after the election to enter the regime is made even though it is earned in the year of election. This is because the tax credits and income are credited to the electing member on the date specified on the tax certificate, which is effectively when it is sent. As a result, an electing member's circumstances may have changed (for example, his or her income may be now over $38,000). Having the ability to backdate the tax credit certificate to the year in which the income is "earned" would overcome this problem. A similar provision (LH6(5)) already exists for the backdating of debits.

Officials' comment

In the case of individual savers, backdating is complex. Funds have different balance dates, as do savers. An example of a practical problem that backdating would create is where a saver may have already completed a tax return and subsequently receives a backdated tax credit.

We note that if a superannuation fund invests in another superannuation fund, it may receive income up to six months after balance date. This income will be deemed to be received as at the balance date of the fund providing the tax credit where that fund has claimed the refundable credit in the previous income year.

Recommendation

That the submission be declined. However, the legislation should provide that when a superannuation fund invests in another superannuation fund and income is attributed up to six months after balance date, that income is deemed to have been received by the superannuation fund on the balance date of the fund providing the tax credits.

RESERVE ACCOUNTS AND SURPLUSES

Clause 27 Section LH5

Submission
10 - Watson Wyatt
21 - NZ Society of Actuaries

The legislation should make it clear that reserve account and surplus assets will be treated as non-elected savings for the purposes of allocation in order to attribute tax credits.

Officials' comment

It depends on the allocation method chosen as to whether reserve account and surplus assets are allocated to savers for determining their interest in the fund for the purpose of attributing tax credits. There is a range of possible allocation methods, the key criterion being that the allocation is fair and reasonable across all savers. A prescriptive rule excluding reserve accounts and surplus accounts could, therefore, lead to an allocation that may not meet that criterion.

Recommendation

That the submission to have a prescriptive rule be declined.

NOTIFICATION OF ELECTION AND CESSATION

Clause 40 Sections 78B and F of the Tax Administration Act

Submission
15 - ICANZ
25 - Rudd Watts & Stone

The five working days' notice period should be replaced with a requirement to notify the Commissioner of the event at the time of filing, and by inclusion, in the annual tax return. The provision requires an electing fund to give notice to the Commissioner no later than five working days before its tax return is filed. Also, five days' minimum notice before the end of the income year is required for cessation of an election. ICANZ do not see the need for prior notification.

Section 78B should be clarified to allow retrospective elections. The section appears to allow a fund to elect to attribute tax credits by notice to the Commissioner at any time up to approximately four months after the end of the income year. However, 78B(3) is not clear as to when the election takes effect from - for example, is it the time of notice or from the start of the previous income year? The latter case implies an ability to make a retrospective election.

Officials' comment

The requirement to give five working days' notice should be deleted and replaced by a requirement to give notice to Inland Revenue that it intends to offer the TCS within 63 days of the beginning of an income year.

This requirement is to assist Inland Revenue administration and is necessary for the smooth operation of the scheme. To facilitate meeting this requirement, a form will be designed. Notification will be one-off, to advise Inland Revenue that the fund is offering the TCS and keeping a TCA. Depending on when the scheme decides to opt into the TCS, this would be:

- within 63 working days of the beginning of an income year, or
- within 63 working days of the beginning of business, or
- within 63 working days of enactment of this legislation.

Ceasing to offer the TCS will also require notification to the Commissioner. The Commissioner should have discretion to accept late elections.

Recommendation

That the submission be declined but note that the original proposal should be changed to, in general, a notice period of 63 working days.

REFUND OF ATTRIBUTED TAX CREDITS

Clause 25 Section LB 1A and LB 2

Submission
(14 - ASFONZ)

If a tax credit is not credited against the income tax liability of the taxpayer for the income year, the residual amount should be refunded to the taxpayer rather than be required to be carried forward.

Officials' comment

The treatment proposed for the TCS is consistent with the company imputation rules. In both cases any excess credits received by taxpayers can be used in future years by their conversion to a loss that is carried forward. As with other tax losses, they cannot be used until there is sufficient income to offset.

Recommendation

That the submission be declined.

DATE OF ATTRIBUTION

Clause 27 Sections LH6(4) and LH20(4)

Submission
15 - ICANZ
22 - ISI

The provision should be clarified by referring to the date on which the certificate is issued. This could be done by reference to section 30C (1)(e) of the Tax Administration Act. The provisions currently specify that electing funds attribute credits (and income) on the date specified on the tax credit certificate.

Officials' comment

We agree that the provision needs to be clarified.

Recommendation

That the submission be accepted.

GUIDELINES SOUGHT FOR ASSISTING TRUSTEES IN DECIDING HOW TO ALLOCATE INVESTMENT INCOME TO EACH MEMBER

Clause 27 Sections LH2, LH5 and LH6

Submission
(i) 13W - National Provident Fund

The legislation should include specific authority to trustees to decide how the system is to be implemented, the ability to allocate costs and tax savings to electing members, and so forth.

(ii) 14 - ASFONZ
15 - ICANZ
21 - NZ Association of Actuaries
22 - ISI

A further income allocation method should be added to those in LH5(3), that is, a method approved by the Commissioner upon application to the Commissioner by the electing fund. This will add certainty that that method will not be subsequently rejected by Inland Revenue during an audit.

(iii) 21 - NZ Association of Actuaries
22 - ISI

Because of the range of allocation methods and range of practitioners, a guidance note should be developed for those involved in the allocation process.

(iv) 22 - ISI

Section LH5 should incorporate a further method that allows the allocation to be based on actual member-by-member tax-based methodology. ISI are happy to work with officials on drafting appropriate wording.

(v) 22 - ISI

The legislation should specifically outline the choices available where a method results in negative income (or a loss) for a policyholder or superannuation fund member. ISI understand that officials are intending to allow flexibility in this regard as follows:

- A member's income in a particular year will be able to take into account losses arising from this calculation for a prior year, or
- if a fund chooses to simplify the calculation, the income in a particular year is determined ignoring any prior year losses that arise out of this calculation.

Officials' comment

Submission (i)

There is flexibility as to the method of allocating income in order to attribute tax credits. There should only be a general rule that the method must be consistent across both electing and non-electing savers (also see comments on submissions (ii)-(iv)).

The legislation does not require the fund to pass on to savers the benefit of the refundable credit that the fund receives on the basis of the attributed 21% tax credits. However, unless savers can see that they will benefit from their election, they are unlikely to elect to join the scheme. Hence commercial pressure is likely to encourage funds to pass on the 12% refundable credit benefit to savers.

Funds may operate a separate "21% fund" under the tax credit system for 21% savers. Those in this fund may have increased administration costs and would go into the fund accepting this. This approach may lead to lower additional costs relative to an existing fund splitting itself into 21% and 33% savers.

There is no intention to specify in the legislation that the costs of operating the tax credit system be allowed to be offset against the benefit of refundable credits passed on to the electing savers through their accounts with the fund.

There is also the issue of whether the Superannuation Schemes Act needs to be changed or, alternatively, a separate provision is included in the tax legislation to enable funds to amend their trust deeds without needing to obtain all members' approval. This would avoid the costs of having to obtain approval. At this stage there are no changes, which means that members will need to agree to how the costs are borne. As noted earlier, we have discussed this aspect with the Government Actuary and will continue to work through this issue with the industry and Ministry of Commerce.

Submissions (ii)-(v)

It has been agreed following discussions with the industry that the allocation options will be more generally phrased so that whatever method is used, the resulting allocation has to be fair (treating all policyholders/members the same). In this context, any losses would also need to be allocated on a fair basis, so no specific provision is needed on how to allocate losses. To assist in aiding certainty for taxpayers, funds/life insurers will be able to seek the Commissioner's sign-off on whether their allocation method is acceptable.

Recommendation

That submission (i) be declined and note that submissions (ii)-(v) should be addressed through redrafting the allocation provisions.

63 DAYS' ALLOWANCE FOR RECTIFYING DEBITS TO THE TCA

Clause 30   Section MJ12

Submission
14 - ASFONZ
15W - ICANZ
22 - ISI

(i) An electing fund should be allowed *63 working days* after the end of the fund's income year within which to pay further income tax in respect of any debit balance to its TCA.

(ii) Further income tax should be payable on the last date for filing income tax returns (including extension of time arrangements) with a 10% penalty for late payment. The 63-day period will be difficult to comply with owing to the reliance on actuarial valuations for the calculation of the policyholder base tax liability. The ICANZ suggestion is similar to imputation.

(iii) Funds should be given *180 days* to square off any debit in their TCA. The proposed time of 63 days is unrealistic given the added complexities of the TCS. Even though only an estimate is required, ISI consider their members will not be comfortable with a maximum of 63 days.

Officials comment

Funds and life insurers will have 63 calendar days (ie not working days, so two months) after balance date to square off any debits in their ICAs without penalty. This is not the case for the imputation credit account, where a debit needs to be squared off at 31 March if the company is to avoid any penalties.

The reason for the 63 days is a concession to allow the funds time to determine the non-electing savers' debit. That debit, which needs to be calculated as at balance date, is based on the fund's "estimated income tax liability" for the year. This is defined as the taxpayer's income tax liability as recorded on the tax return.

Recommendation

That the submission be declined.

COMMISSIONER'S ABILITY TO ISSUE ASSESSMENT WITHOUT OBTAINING ADVICE OF AN ACTUARY

Clauses 27 and 30 Sections LH8, LH21 and MJ11

Submission
(22 – ISI)

(i) The Commissioner should be required to obtain the advice of an actuary before issuing an assessment that alters the calculations made by an insurer or superannuation fund. This advice is considered necessary because electing funds are themselves required to obtain approval of an actuary or external auditor in relation to matters associated with the TCS.

(ii) If the submission above is accepted, a consequent amendment should be made to section CM8(3), which relates to the Commissioner's ability to make assessments in the context of the calculation of actuarial reserves for the purposes of the life insurance regime.

Officials' comment

The current draft legislation is consistent with section CM8(3) of the Act. Under that provision, in making an assessment of a life insurer's income, the Commissioner may seek the advice of an actuary. There is, however, no obligation to do so.

Recommendation

That the submission be declined.

DUTIES OF ACTUARY RESPONSIBLE FOR ELECTING FUND

Clauses 27 and 30 Sections LH8(2), LH14(2), LH21(1) and MJ9(3)

Submission
14 - ASFONZ
15W - ICANZ

The trustees of a fund should be required to perform the duties under sections LH8(1), LH14(1), LH21(1) and MJ9, rather than it being the responsibility of their actuary or external auditor. This is particularly an issue for funds that do not employ actuaries. Ultimately it is the trustees' responsibility anyway.

Officials' comment

The concern was to ensure that where, for example, an actuarial method of allocating tax and income was used it was signed off or validated by an actuary. We agree that trustees have the ultimate responsibility for the correct management of the fund and should, in order to ensure that they are not in breach of their duty, have recourse to the necessary technical experts.

Recommendation

That the submission be accepted.

MINIMUM INFORMATION TO BE PROVIDED TO SAVERS

Clause n/a

Submission
(21 - NZ Society of Actuaries)

The legislation should prescribe minimum information requirements to be provided to policyholders/savers to assist in their decision on whether to elect into the TCS - for example, the effect on an individual's tax return, how and when the refund will be applied and what costs will be levied.

Officials' comment

Prescribing minimum information standards runs the risk that they are mis-targeted or encourage only minimal information disclosure. Instead Inland Revenue is working with the industry so that industry players that offer the TCS can educate savers on whether to elect the TCS. Ultimately, however, savers may need to obtain independent advice on their specific circumstances.

Recommendation

That the submission be declined.

VALIDITY OF ELECTION

Clause 27 Section LH3(5)

Submission
15 - ICANZ
22 - ISI

The investor's election should be valid notwithstanding an incorrect IRD number being given by the investor. Under the proposals, an incorrect IRD number invalidates the election. However, the fund would not be aware that the number given by the investor is incorrect and would proceed to allocate tax credits. In contrast, resident withholding tax deductors are able to take a tax file number provided by an electing member at face value.

Officials' comment

The provision requires electing policyholders or electing members to give their tax file number to an electing fund for the election to be valid. Inland Revenue proposes to administer this provision on the same basis as the RWT rules, so that if a number is taken by the payer as genuine, the election is not invalidated.

Recommendation

That the submission be accepted but note that no legislative change is required.

USE OF THE TERM "MUST"

Clause 27 Sections LH4, 5, 7, 8, 9, 11, 13, 14, 18 and 20

Submission
(22 – ISI)

These provisions should be redrafted to remove any implication that an electing fund is required to attribute income to electing policyholders. These provisions currently contain the term "must", which seems inconsistent with an elective regime.

Officials' comment

While the TCS is elective, once in the regime the electing fund must apply the provisions in accordance with the legislation. However, we agree with the submission in relation to sections LH7 and LH13 and recommend that those provisions be redrafted.

Recommendation

That the submission be accepted in part.

SAFEGUARDING OF RECORDS

Clause 39 Section 30D of the Tax Administration Act (TAA)

Submission
(i) 15W - ICANZ

The provision, which requires taxpayers to take all reasonable steps to safeguard their records, should be removed and section 22 of the TAA extended to encompass any information required for the administration of the TCS.

ICANZ consider that this provision imposes a higher standard of conduct on life insurers and superannuation funds than that imposed on other taxpayers. They do not consider it to be appropriate to impose additional obligations on a specific group of taxpayers in respect of an issue that impacts on all taxpayers.

If it is the Government's intention to impose more stringent record retention requirements on taxpayers, this should be done consistently across all taxpayers by amendment to section 22 of the TAA, and all taxpayers should be given the opportunity to submit on that matter in a manner consistent with the Generic Tax Policy Process.

ICANZ believe that section 22 of the TAA imposes a sufficient standard of record retention and should be extended to encompass any information required for the administration of the TCS.

(ii) 22 - ISI

The only requirement should be to retain records. The provision requires that the taxpayer take all reasonable steps to safeguard his/her records. However, it is inappropriate that a life insurer or super fund could be prosecuted for failure to take reasonable care of the records in addition to failure to retain the records when no other taxpayers face such double jeopardy.

Officials' comment

The provisions are modelled on section 26 of the TAA, which covers record-keeping in relation to RWT, rather than the general record-keeping obligations on taxpayers of section 22. Section 26 was considered more appropriate as it focuses only on a specific aspect that has close parallels with the proposed TCS. The proposed legislation, therefore, is not trying to change a taxpayer's wider record-keeping obligations.

No new offences are created for failing to keep records and only the standard penalties could apply to life insurers and superannuation funds. So there is no double jeopardy.

Recommendation

That the submissions be declined.

FORMULA FOR CALCULATING REFUNDABLE CREDITS (A)

Clause 6 Section CM15(1)

Submission
(21 - NZ Society of Actuaries)

Adjustments to ensure that the policyholder base tax excludes the capital amount of the TCS refund may be more effectively achieved by premium adjustments rather than adjustments to v0, v1. Suggested changes are provided in the submission.

The current proposed legislation has some ambiguity in the v0 adjustment and there may be practical difficulties with the v1 adjustment. Making changes to v0,v1 also introduces some uncertainty in the underwriting income calculation.

Officials' comment

It would be difficult to amend the "premium" definition because the term is used in many places in the Act and the implications of making such a change would need to be carefully considered to avoid any uncertainty.

Recommendation

That the submission be declined.

FORMULA FOR CALCULATING REFUNDABLE CREDITS (B)

Clause 6 Section CM15(1)

Submission
(21 - NZ Society of Actuaries)

The proposed legislation should clarify that v0 and v1 do not include any obligations relating to the extent that refundable credits are expected to be credited to the benefit of policyholders.

Officials' comment

We agree that the policy intent is that v0 and v1 should not include any obligations relating to refundable credits to the extent that refundable credits are expected to be credited to the benefit of policyholders.

Recommendation

That the submission be accepted.

EXCLUDING REFUNDABLE CREDITS INCLUDED IN RESERVES

Clause 6 Sections CM15(1) item "v0"

Submission
(22 – ISI)

Item v0 should also exclude the amount of refundable credits in any income year prior to that one.

Officials' comment

We agree that these should be excluded and recommend that the legislation be redrafted to achieve this.

Recommendation

That this submission be accepted.

FILING OF TAX CREDIT CERTIFICATES

Clause 39 Section 30C(2)

Submission
(22 – ISI)

(i) Provision should be made to give the tax credit certificates to Inland Revenue in either electronic or written form.

(ii) The legislation should retain 31 May as the date for filing the certificates. There would be strong resistance to 20 April, for example.

Officials' comment

We agree with this submission.

Recommendation

That the submission be accepted.

FURTHER CONSULTATION WITH THE INDUSTRY

Clause n/a

Submission
(22 – ISI)

Officials should be requested to consult with the Industry on the final form of the provisions before the bill is reported back. Given the complex and innovative nature of the TCS, there may be problems with the provisions that could be reduced if the industry has further opportunity to review the provisions.

Officials' comment

Officials are continuing to discuss various issues with the industry. We request that the Committee agree to officials providing the amendments to the legislation arising from this report to the industry for their comment.

Recommendation

That the submission be accepted and that the Committee agree to officials providing the amendments to the legislation arising from this report to the industry for their comment.

APPORTIONMENT IN THE TRANSITIONAL RENEWAL OF TAX PAYMENTS AND LIABILITY FOR FIRST AND SECOND SUPER FUNDS

Clause 17 Sections FB8(1)(b)(ii) D and E

Submission
(22 – ISI)

(i) Attributed credits and income should be excluded from the amount apportioned under the proposed section FB8(3) and (5) and instead be added to the result of the formula that exists in that provision.

(ii) There should be no apportionment of the amount of attributed income and it should be excluded from the definition of "taxable income" in section FB7(1)(b), and the formula specified in FB7(3) and (5) be modified accordingly.

Officials' comment

As tax credits can only be received by first superannuation funds after 1 April 1998 there is no need to require that the tax credits be apportioned in the transitional year.

Likewise, in respect of the taxable income apportionment, attributed income under the TCS need not be apportioned in the transitional year.

Recommendation

That the submission be accepted.

HYBRID SUPERANNUATION FUNDS

Clause 27 Sections LH10 and 15

Submission
15 - ICANZ
22 - ISI

These provisions should be redrafted to ensure that hybrid superannuation funds (those that have both individuals and super funds as members) can operate the TCS as intended.

As currently drafted, the provisions do not appear to cover the situation where a superannuation fund can be both a first fund and second fund (for example, where a superannuation fund has both individuals and other superannuation funds as members).

Officials' comment

We agree that in principle "hybrid funds" should be able to operate the TCS and also be "electing savers". We will discuss this issue further with the industry to ascertain the problems with the provisions as they are currently drafted that would inhibit a hybrid fund from operating the TCS and also being an electing saver.

Recommendation

That this submission be accepted but note that officials will work through how to incorporate the hybrid superannuation fund issue into the legislation.

DEFINITION OF ATTRIBUTED ANNUITY INCOME

Clause 27 Sections LH18-LH20

Submission
(21 - NZ Society of Actuaries)

The definition of attributed annuity income should be amended to recognise that annuity income received by annuitants is after allowance for tax. Annuity payments pass to annuitants with appropriate deductions for tax. This means that the section LH18(2) income component needs to be grossed up. Sections LH19 could be altered to read: "The income component of an annuity as determined under section LH18 is the net of tax income component, in accordance with the actuarial assumptions in LH18(4). The attributed income of an annuity is the before tax income component, in accordance with the assumptions in LH18(4)".

Officials' comment

We agree that the definition needs to be clarified in recognition that annuity income is received by annuitants on an after tax basis. We are looking at appropriate wording and the implications for the formula referred to in the next submission.

Recommendation

That this submission be accepted.

ANNUITY INCOME CALCULATIONS

Clause 6 Section CM15(1), item "a"
Clause 7 Section CM19(1)

Submission
15W - ICANZ
22 - ISI

(i) The calculation of "annuity income" in CM19(1) should be grossed up by 0.67.

The proposed formula for CM15 ignores the fact that the annuity paid out is an after-tax amount. By subtracting item "a" outside of the brackets in the proposed policyholder base income formula, the benefit of taxing annuity income at the lower rate is understated. Item "a" should be grossed up when subtracting it from policyholder base income and when taxing it in the hands of the life insurer at 21.75%.

(ii) The annuity income amounts should be grossed up to a pre-tax amount as annuity income is a net of tax amount. In contrast, the provisions are adjusting a gross income amount.

Officials' comment

We agree with this submission. The problems noted in these submissions are tied up with the submission above.

Recommendation

That this submission be accepted.

STATUTE BAR OF DETERMINATION OF INCORRECT CREDIT

Clause 30 Section MJ13

Submission
(15W – ICANZ)

Section 92(5) of the TAA should be amended to include a determination of incorrect entry made under section MJ13.

Section MJ13 enables the Commissioner to determine that an incorrect entry has been made to the TCA, to correct it and to issue a "determination of incorrect entry". The provision is similar to the corresponding provision in the imputation rules that enables the Commissioner to correct an incorrect entry to the ICA (ME40) or the PCA of a life insurer (ME20). Section 92(5) of the TAA deems, for the purpose of Part VIIIA and various specific sections relating to re-assessments and the statute bar, a determination of incorrect entry made under ME20 or ME40 to be "assessments". The effect is to impose a statute bar on such determinations, similar to the statute bar applying to assessments, thereby increasing taxpayer certainty.

ICANZ considers that similar certainty is required as to the tax position of a life insurer and superannuation fund as it applies to those entities' TCAs. They suggest that section 92(5) be extended to encompass determinations made under section MJ13.

Officials' comments

Our understanding is that clause 45 of the proposed legislation already provides for this point.

Recommendation

That the Committee note that the point outlined in the submission has already been incorporated in clause 45.

TREATMENT WHEN POLICIES OR SUPERANNUATION FUND MEMBERSHIPS ARE HELD BY MORE THAN ONE INDIVIDUAL

Clause n/a

Submission
(22 – ISI)

Careful consideration should be given to how the TCS will apply to multiple policyholders or superannuation scheme membership and the issues should be resolved at the same time as wider consideration is given to the application of resident withholding tax to joint accounts, and so forth.

Officials' comment

We agree that there is an issue when there is more than one member/policyholder of a life policy or superannuation fund investment. Inland Revenue would prefer that details such as the tax file numbers of all the owners and their proportions of ownership of the asset be provided. However, we realise that this would create systems problems for funds. The same issue arises in the case of RWT on joint bank accounts. We, therefore, agree with the submission that this issue be addressed in a wider context at a later stage.

Recommendation

That this submission be accepted and note that this issue could be addressed in a wider context at a later stage.

SEPARATE TCA ACCOUNTS FOR DIFFERENT PRODUCT TYPES

Clause 30 Section MJ11

Submission
(22 – ISI)

There needs to be provision for separate TCA accounts for different product types where there are acceptable actuarial accounts or accounting records to identify income and tax separately.

Officials' comment

The legislation already provides for multiple TCAs, which should cover the point made by the submission.

Recommendation

That the Committee note that this legislation already appears to enable the proposal covered in the submission.

REVISING THE ESTIMATE OF THE NON-ELECTING MEMBERS' DEBIT TO THE TCA

Clause 30 Sections MJ4 and MJ6

Submission
22 - ISI
25 - Rudd Watts & Stone

There should be a provision for the estimated liability to be revised once final figures are available. There needs to be a correction mechanism to rebalance the account once the actual numbers are known.

It should be clarified for the purposes of estimating the income tax liability for the year (to enable calculating of the non-electing savers' debit):
- what the estimate is based on;
- and when this estimate must be made.

Officials' comment

We agree with the submission. The "estimated tax liability" for the purposes of the TCS fund's tax liability will be as recorded in its tax return. The legislation will provide a definition of estimated tax liability. This is used in calculating the fund's non-electing savers' debit. This debit is recorded in the TCA as at balance date, notwithstanding that it will be calculated some time after.

If a fund adjusts its tax liability after it has filed its tax return then an adjustment will need to be made in the TCA to reflect the change to the non-electing saver debit. This adjustment will also be as at balance date.

If Inland Revenue reassess the fund's tax liability an adjustment will be required in the TCA to reflect the change to the non-electing saver debit. This adjustment will be required at the time the reassessment is issued.

We note that the fund has 63 days from balance date to square up the TCA without penalty. For this reason it is likely that the funds will use the best estimate they have at that point of their "estimated tax liability" in calculating the non-electing saver debit.

Recommendation

That this submission be accepted.

APPORTIONMENT OF TAXABLE INCOME IN THE TRANSITIONAL PERIOD FOR NON-STANDARD BALANCE DATE TAXPAYERS

Clause 16 Section FB7

Submission
14 - ASFONZ
15W - ICANZ
22 - ISI

The methods available for apportionment should be expanded to enable funds to apportion income on (1) a time of derivation basis and (2) an accounting basis, as well as a simple daily pro rata basis. The other methods are seen as more equitable and accurate where adequate records are available.

Officials' comment

We agree with the submission and recommend an appropriate redrafting of the section to accommodate acceptable alternative methods of apportioning income in the transitional period.

Recommendation

That this submission be accepted.

APPORTIONMENT OF TAX PAYMENTS IN THE TRANSITIONAL PERIOD

Clause 17 Section FB8

Submission
15W - ICANZ
22 - ISI

The daily pro rata method currently required be a "safe harbour" option with an actual allocation of tax payments being available if accounting records are adequate.

Officials' comment

We agree with the submission and recommend an appropriate redrafting of the section to accommodate acceptable alternative methods of apportioning the tax payments in the transitional years.

Recommendation

That this submission be accepted.

ELIGIBILITY OF TAX CREDITS IN RELATION TO TAX PAID FOR 1997/98 AND 1998/99

Clause 30 Sections MJ(1)(a)(vi)-(vii) and MJ6(b)(iv)-(v)

Submission
(22 – ISI)

These sections should be redrafted to make specific reference to what credits are available to funds in relation to particular years depending on their balance dates. These provisions appear to preclude a tax credit for any fund with a standard balance date.

Officials' comment

This issue should be addressed by redrafting of MJ6.

Recommendation

That the submission be accepted and that MJ6 be redrafted to address this.

PAYMENT OF TAX ON ANNUITY INCOME

Clause n/a

Submissions
12 - William Mercer
13W - National Provident Fund
15W - ICANZ
25 - Rudd Watts & Stone

(i) Section MJ7 appears to be deficient in providing for a debit for tax attributed to electing annuitants.

(ii) Annuities should be treated no differently from superannuation savings.

(iii) Provision should be made to enable tax on an annuity to be paid by way of debit to the policyholder credit account. As policyholder income, the tax liability on annuity income should be able to be met through a debit to the insurer's policyholder credit account.

(iv) Electing annuitants should be able to claim a tax refund directly from Inland Revenue for the tax paid by the superannuation scheme at a rate in excess of that which applies to the electing annuitant.

Officials' comment

Annuity income is taxed at the life office level and not at the policyholder level. (It is specifically deducted from the policyholder level.) Annuity income is deducted from life office income to enable it to be taxed at 21%. This approach has generally been accepted by the industry.

Under this approach, it is not appropriate to provide debits to the PCA as suggested. It should also be clarified in the legislation that the tax paid on annuity income should not be included in the ICA of the life office. Likewise the TCA of the superannuation fund should not include any tax payments on annuity income.

Recommendation

That these submissions be declined and the legislation be clarified to ensure that the tax paid on annuity income is not included in ICAs, TCAs and PCAs.

MECHANISM FOR REDUCING ATTRIBUTED INCOME BY ANNUITY INCOME TO ENSURE NO DOUBLE TAXATION

Clause 5 Section CL 3(4)

Submission
12 - William M Mercer
13W - National Provident Fund
15W - ICANZ
22 - ISI

(i) Provision should be made for a superannuation fund to have a deduction from its taxable income for the amount of the annuity income. The provision contemplates in section CL 3(4) that a net loss arises to the extent that annuity income exceeds the superannuation fund's taxable income but there does not appear to be a mechanism which allows the fund's taxable income to be reduced by attributed annuity income. Without this mechanism there would be double counting.

(ii) Similarly, in conjunction with section CM 15(1), there should be a similar exclusion of the amount of attributed annuity income from the life insurer base income of the insurer who issued the annuity. Otherwise there is double counting.

Officials' comment

We recommend amending these provisions to address the problem identified in the submission.

Recommendation

That the submission be accepted.

TREATMENT OF DEFINED BENEFIT SCHEMES

Clause 32 Section NE(2A)

Submission
10 - Watson Wyatt
12 - William M Mercer

The legislation should be clarified as to the eligibility of defined benefit schemes in relation to the proposals.

It is not clear what the intended treatment is for contributions to defined benefit schemes. Watson Wyatt question what is meant by "made by the employer for their benefit". This term may inadvertently exclude defined benefit super schemes (as opposed to defined contribution schemes). So the submission proposes to clarify the legislation to refer to the level of employer contribution made on behalf of the member.

William M Mercer query whether the intention is to include 100% of employer contributions to defined benefit schemes as part of the employee's income even though the amount of ultimate benefit is determined by the trustees.

Officials' comment

Contributions to defined benefit schemes will be eligible to be included as salary and wages rather than be subject to SSCWT should both the employee and the employer agree. However, the problem is that employees do not generally get any direct benefit from the reduced tax rate from applying their own tax rate rather than SSCWT as their benefits are already defined. There may be instances in which an employee may receive some additional benefit as a top-up or may be able to negotiate a share of any savings to the employer. But in practice the option is unlikely to be taken up by many defined benefit scheme employees. For those who do, we recommend amending the wording to refer to contributions made by the employee on "behalf of the employee" rather than "for their benefit".

Recommendation

That the submissions proposing clarification of the wording in NE(2) be accepted to ensure that employer contributions to defined benefit schemes will be eligible to be included in salaries and wages.

DEFINITION OF WHO IS TO MAKE DECLARATION VERIFYING INCOME TAX LIABILITY

Clause 30 Section MJ11(4)

Submission
(14 – ASFONZ)

The declaration verifying the income tax liability and tax paid for each investment portfolio should be made by the trustees of the fund rather than "the person responsible for control of the fund's accounts" as the latter is not defined at law and is too vague. Ultimately it is the trustees' responsibility.

Officials' comment

We agree with the submission. Given that we are also recommending that trustees ultimately sign off the attribution of tax credits and income, then it is also appropriate for them to verify the income tax liability and tax paid for each of the investment portfolios kept separately.

Recommendation

That the submission be accepted.

CALCULATION OF ANNUITY INCOME

Clauses 3, 5, and 27 Sections CB9, CL3, and LH18-20

Submission
13W - National Provident Fund
25W - Rudd Watts & Stone

(i) The reference in the proposed section CB9(2) should be to attributed income under section LH19(2) rather than LH20.

(ii) The reference in section CL3 to section LH20 should more appropriately refer to section LH19. Section CL3 requires a superannuation fund to add the amounts of income attributed under LH20 to determine total annuity income.

(iii) Investment income derived by an annuity fund should not be included in gross income. This tallies with the position under the current legislation. Alternatively, if annuity income is to represent gross income, then the provision should exclude gains and losses that are currently non-taxable.

Officials' comment

We agree with submissions (i) and (ii).

Submission (iii) has been raised by NPF. The income methods in LH18 are intended to cover this possibility. However, we are considering NPF's concern further and will recommend a legislative change to clarify this if required.

Recommendation

That submissions (i) and (ii) be accepted, and that submission (iii) be considered further.

IMPUTATION CREDIT TO INCLUDE TAX CREDIT

Clause 25 Sections LB1A and LB2

Submission
(14 – ASFONZ)

Taxpayers' gross income should include the tax credit, otherwise section LB2 is ineffective and the system is inoperative.

Officials' comment

We agree with the submission.

Recommendation

That the submission be accepted.

DEBITS ARISING TO TAX CREDIT ACCOUNT

Clause 30 Section MJ4

Submission
(14 – ASFONZ)

The term "estimated income tax liability" in the variable "ITL" should be defined for the purposes of section MJ4. This is to provide better guidance as to the calculation of the non-electing members' debit in section MJ4(1)(a).

Officials' comment

We agree with this submission.

Recommendation

That this submission be accepted.

IS A SUPERANNUATION FUND A BUSINESS?

Clause 30 Section MJ9

Submission
14 - ASFONZ
15 - ICANZ
22 - ISI

Section OB1 should be clarified to ensure that the definition "business" incorporates a superannuation fund. Following the high court case of *Piers & Ors* v *CIR* there is some uncertainty that a superannuation fund is in business. ICANZ suggests clarification by replacing "business" with "activities" or "investments".

Officials' comment

We recommend changing "business" to "activities".

Recommendation

That the submission be accepted and the word "business" be replaced with the word "activities" in section MJ9.

DEFINITIONS AND CROSS-REFERENCING

Submission
14 - ASFONZ
22 - ISI
25 - Rudd Watts & Stone

(i) Clause 33, Section OB1

The definition of "non-electing policy holder or non-electing member" should be amended to mean "a person who does not elect to receive tax credits from an electing fund or who cannot elect to receive tax credits" rather than "a person who elects not to…". The change is proposed as there is no requirement for members of electing funds to elect not to receive tax credits.

(ii) Clause 27, Section LH9

The reference in the definition of "TC" in proposed section LH9(1) to section MJ4(1)(b) should be a reference to section MJ4(1)(c).

(iii) Clause 27, Section LH12(4)

The reference to section LH4 should be to LH5.

(iv) Clause 27, Section LH15(1)

The reference in variable "TC" should be to section MJ8(1) not section MJ10(1)(a).

Officials' comment

We recommend that these changes be incorporated.

Recommendation

That the submission be accepted.

DEFINITION OF ANNUITY

Clause 27 Section LH18

Submission
15 - ICANZ
22 - ISI

The term "annuity" should explicitly encompass pensions offered by qualifying superannuation schemes. Section LH18, which determines how an annuity is calculated, makes no reference to pensions, although the intent is to treat them the same way as annuities.

Officials' comment

We recommend that the change be made.

Recommendation

That the submission be accepted.

Clause 27 Section LH18

Submission
(22 – ISI)

The word "lost" in section LH18 should be changed to "unavailable" to more appropriately reflect the situation.

Officials' comment

We do not agree with this submission. "Lost" is the word used elsewhere to refer to information the taxpayer cannot get because no one knows where it is anymore. In contrast, "not available" could imply that the taxpayer is too busy or unwilling to get the records from wherever they are, for example, their branch in Auckland in the case of a Wellington headquartered firm. In other words, "not available" can be contrived to suit the taxpayer.

Recommendation

That the submission be declined.

CLARIFICATION OF EXPRESSION IN PURPOSE

Clause 27 Section LH1

Submission
15 - ICANZ
22 - ISI

The expression "…pay income tax…" should be replaced with "…have their earnings from those investments taxed at the same tax rate…". The term "pay income tax" may imply the tax is payable by the saver.

Officials' comment

We agree with this submission.

Recommendation

That the submission be accepted.

TAX CREDIT ACCOUNT ENTRIES

Clause 30 Sections MJ3(1)(a)(vi)-(vii) and MJ6(1)(b)(iv)-(v)

Submission
(15 – ICANZ)

Consideration should be given to redrafting the provisions to make specific reference to the credits available to funds in relation to particular income years depending on their tax balance date situation for that year. For example, section MJ6(1)(b)(v) denies a credit for income tax paid in relation to the 1989/99 income year for a standard balance date electing fund.

Officials' comment

We agree with this submission and recommend that the provisions be redrafted accordingly.

Recommendation

That this submission be accepted.

ANTI-AVOIDANCE CONSEQUENCES

Clause 30 Section MJ10

Submission
15 - ICANZ
21 - ISI

(i) The provision should be redrafted to clarify the mischief.

(ii) A provision should be inserted to specify the remedial action to be taken by the Commissioner in the event of an arrangement being a tax avoidance arrangement (so that electing funds and policyholders can understand the consequences of their action. (ICANZ)

Officials' comment

We agree that the section should be redrafted. It is aimed at covering the mischief of a deliberate streaming of income that results in an unfair income allocation (and hence attribution of tax credits). In these circumstances the Commissioner may declare an allocation to be a tax avoidance arrangement.

If the Commissioner declares an allocation to be a tax avoidance arrangement, section GB1 will apply, the same as for other anti-avoidance arrangements. That section leaves open the action that the Commissioner can take.

Recommendation

That the submission be accepted and redrafted to cover the mischief outlined above.

CREDITING OF REFUNDABLE TAX CREDIT

Clause 27 Section LH9(3)

Submission
(15W – ICANZ)

The provision should be redrafted to clarify against which income year's tax liability the refundable tax credit should be credited. To which year does this provision currently refer - the year of allocation or year of attribution?

Officials' comment

We agree the provision needs to be clarified to ensure the policy intent, as set out below, is clear:

- When a tax credit is attributed up to six months after the end of its income year, a fund has the option of claiming the refundable credit against its income tax liability in *either* that income year *or* in the previous income year. In the latter case, the attributed income is recorded in the TCA as at the last day of that previous year.

- In all other cases the tax credit is attributed in that income year.

Recommendation

It is recommended that this submission be accepted.

TERMINOLOGY

Clause n/a

Submission

(22 – ISI)

Consideration should be given to altering the nomenclature of tax credits, attributed income and similar to remove the potential for confusion. The labels and terminology used in the legislation need to be changed to make them meaningful and to avoid unnecessary confusion and complexity. For example:

> "Attributed income" should be "Attributed savings income"
> "Tax credits" should be "Savers' tax credits"
> "First superannuation fund" should be "member superannuation fund"
> "Second superannuation fund" should be "master superannuation fund"
> Subpart LH should be "Savers' Tax Credit System"
> Subpart CO should be "Attributed Savings Income"
> Subpart MJ should be "Savers' Tax Credit Accounts".

Officials' comment

We have carefully considered these proposed changes of nomenclature, including in relation to other areas of the Tax Acts, and have concluded that they would not be an improvement over the current terminology in terms of assisting taxpayer understanding of TCS.

Recommendation

That the submission be declined.

Clause 25 Section LB1(1A)

Submission
15W - ICANZ
22 - ISI

The provision should be redrafted as a separate section for tax credits. Forcing the tax credits into the imputation rules by reading the imputation rules as if a number of words and phrases were disregarded is not good drafting practice, and the provision becomes unnecessarily complex and confusing.

Officials' comment

In essence, section LB1A provides that section LB2 applies to tax credits. Rather than repeat section LB2 and make the appropriate reference changes, we have chosen to refer to the operative provision. This practice is used elsewhere in the Income Tax Act 1994. Section LB1A will ultimately be rewritten as part of the Rewrite of the Income Tax Act.

Recommendation

That the submission be declined.

SAVER ELECTION REQUIREMENTS

Clause 27 Section various

Submission
15W - ICANZ
22 - ISI

The requirements as to content of the savers' election notices should be consolidated into a single provision.

Various provisions impose requirements on the election notice from savers. For example, section LH3 requires a tax file number, section LH20 requires the notice to be signed, 30C [TAA] effectively requires full name and address of the saver, and section LH6(1) implicitly requires the election to be dated. Separating these requirements into different provisions could cause providers to make errors which could invalidate the election. All of the requirements for the election notices should be consolidated into one provision within the Tax Administration Act.

This provision could also be used to clearly define an electing saver and make it clear that only an electing saver can receive attributed income and tax credits. This approach would remove the duplication in the existing provisions and simplify the balance of the TCS legislation.

Officials' comment

Part LH provides minimum requirements for elections into the tax credit regime – an electing saver must provide their tax file number for their election to be valid, and an electing fund cannot attribute tax credits without a signed election notice. The form and timing of election notices is a matter between the electing saver and the fund.

Section 30C of the Tax Administration Act 1994 relates to tax credit certificates. Similar to resident withholding tax certificates, tax credit certificates must be provided to savers and a copy to Inland Revenue. They are separate from election notices, although a fund would need information from a saver (whether from an election or from existing records) to be able to meet the requirements of a tax credit certificate.

At this stage, we consider that it is inappropriate for election notice provisions to be contained in the Tax Administration Act 1994, as the Act relates to the administration of income tax by Inland Revenue and not to administrative requirements between taxpayers. The rewrite of the Income Tax Act 1994 is considering whether administrative rules for taxpayers should be placed in the Tax Administration Act.

Recommendation

That the submission be declined.

Clause 27 Section LH3

Submission
15W - ICANZ
22 - ISI

The provision should be clarified to remove the following contradiction: subsection LH3(1) does not allow a trustee to become an electing member whereas subsection (2) expressly allows this. Subsection (1) should include the words "except as allowed in subsection (2)…"

Officials' comment

We agree that section LH3(1) and LH3(2) should be consistent and recommend that the legislation be redrafted to ensure this.

Recommendation

That the submission be accepted.

TIMING OF DEBITS TO TCA

Clause 27 Sections LH6(5) and LH12(5)

Submission
15W - ICANZ
22 - ISI

These provisions should be included in sub-part MJ. The provisions state the time at which a debit arises to a provider's TCA. The provisions more sensibly fit within the subpart MJ, which deals with TCAs. Merely having a cross-reference in subpart MJ as currently drafted is not appropriate.

Officials' comment

We agree that these provisions be included in Subpart MJ.

Recommendation

That the submission be accepted.

DETERMINATION OF SHARE OF INCOME

Clause 27 Section LH5(2)

Submission
(15W – ICANZ)

Consideration should be given to clarifying the wording of this provision. Section LH5(2) prohibits the taking into account, when determining a saver's share of income, the fact that tax credits are to be attributed to that saver. This is ambiguous as the after-tax income allocated to a member will clearly take the value of tax credits into account.

Officials' comment

In response to earlier submissions we propose redrafting this section. The point raised in the submission would no longer be an issue in the revised legislation.

Recommendation

That the submission be accepted.

LABELS AND TERMINOLOGY USED IN THE LEGISLATION

Clause n/a

Submission
(22 – ISI)

(i) Consideration should be given to the term "tax credit" having specific meaning for the purposes of the TCS to distinguish it from ordinary tax terminology.

(ii) The term "attributed income" should be made more definitive as there may be many forms of attributed income.

Various wording changes are suggested in the submission (page 19).

Officials' comment

We have considered the identification referred to and believe that no further clarification of these terms is needed.

Recommendation

That the submission be declined.

Clause 27 Sections LH19-20

Submission
(22 – ISI)

The provisions should tax only that proportion of the annuity paid during the income year. There is concern that the proposed provision will tax the full income component of an annuity.

Officials' comment

The concern here arises out of a potential timing difference between when income is attributed under the TCS and the actual cash payment of the annuity. Timing differences result out of the different methods an annuity provider could choose to calculate attributed income in a particular year. Annuity providers are given considerable flexibility as to the method they use and can therefore minimise these timing differences.

Recommendation

That the submission be declined.

DUPLICATION OF SECTIONS LH20(1) AND LH20(3)

Clause 27 Sections LH20(1) and LH20(3)

Submission
(22 – ISI)

Section LH20(1) is unnecessary because of section LH20(3).

Officials' comment

We disagree. Section LH20 follows the approach taken in section LH6. It is not enough for an annuitant to say "I elect". An annuity provider must have proof of the election, hence the requirement for a signed election notice.

Recommendation

That the submission be declined.

TERMINOLOGY IN SECTION MJ4(2)(A)

Clause 30 Section MJ4(2)(a)

Submission
(22 – ISI)

The term "debit for non-electing members" should be "income tax paid in respect of non-electing members". The current wording appears to be inconsistent with the balance of subsection (2) and the implied cross-reference to subsection (1).

Officials' comment

We agree with the submission and recommend that it be redrafted accordingly.

Recommendation

That this submission be accepted.

COMMISSIONER'S FAILURE TO APPLY THE ACT

Clause 30 Section MJ13(6)

Submission
(22 – ISI)

Section MJ13(6) should be removed as it is inconsistent with the rest of the Income Tax Act. The section notes that the Commissioner's failure to apply the Act does not invalidate his/her actions.

Officials' comment

The submission is incorrect. The section is consistent with sections ME20(4), ME40(8), MF6(8), MG12(8) and MI12(5), which all relate to the Commissioner's failure to give notice not invalidating the Commissioner's determination that a taxpayer's entry is incorrect.

Recommendation

That the submission be declined.

Clause 27 Section LH9(3)

Submission
(21 – ISI)
Section LH9(3) should be clarified as to:

(a) whether the income year referred to is the year of allocation or attribution; and
(b) whether the income tax liability referred to is the life insurer base or policyholder base.

Officials' comment

The income year is the year of attribution (including for a deemed attribution). Issue (b) is covered in an earlier submission.

Recommendation

That the submission be accepted.

INCOME REFERENCE IN SECTION LH5

Clause 27 Section LH5

Submission
(25 - Rudd Watts & Stone)

The reference to "income" in the proposed section LH5 should be clarified. The section relates to the methods of allocating income to savers. The term income could mean "taxable income", "gross income", "net income" or some separate notion of accounting income.

Officials' comment

The term "income" is deliberately non-specific so as to allow funds and life insurers to use a range of location methods as requested by the industry.

Recommendation

That the submission be declined.

CLARIFICATION OF LH11(1)

Clause 27 Section LH11(1)

Submission
(25 - Rudd Watts & Stone)

Section LH11(1) should be clarified so that it is clear that the first fund is notifying the second superannuation fund of the rate at which tax credits are to be attributed to it. Specifically, the words "to it" should be added to the end of the proposed section.

Officials' comment

We agree with the submission.

Recommendation

That the submission be accepted.

FIRST AND SECOND SUPER FUNDS AND CREDITS AT ANY RATE LESS THAN 33%

Clause 27 Section LH15

Submission
(25 – Rudd Watts & Stone)

A tax credit should be allowed under section LH15 for a second superannuation fund if the first fund has elected to receive credits at any rate less than 33%.

The section allows a second superannuation fund a refundable credit in respect of any first superannuation fund that elects to receive tax credits at the 21% rate. However, it does not allow a refundable credit if any other rate is chosen.

Officials' comment

A superannuation fund can receive tax credits at either 33% or 21%. Funds can also choose to receive some attributed income with 21% tax credits and other income with 33%. This is likely to be based on the proportion of TCS electing savers versus non-electing savers in the receiving superannuation fund.

If a superannuation fund chooses to receive 33c tax credits, it can choose to attribute 21c of the tax credits to its electing savers and claim a refundable credit in its tax return based on this attribution.

Recommendation

That the submission be declined.

REQUIREMENT TO PAY TAX TO THE EXTENT THAT THE TCA IS IN DEBIT AS A RESULT OF TAX DEBITED IN RESPECT OF THE NON-ELECTING SAVERS' BALANCE

Clause 30 Section MJ12

Submission
(25 - Rudd Watts & Stone)

Section MJ12 should not require a payment of further income tax to the extent that the tax credit account debit balance relates to tax debited under sections MJ4(1)(a) or MJ7(1)(a).

Officials' comment

The legislation already provides that further income tax in respect of a debit balance in the TCA can be paid within 63 days of balance date without penalty.

Recommendation

That the submission be declined.

CONSOLIDATION OF DEFINITIONS IN SINGLE SECTION

Clauses various

Submission
(25 - Rudd Watts & Stone)

The definitions should be included in section OB1 instead of in the substantive provisions of the Act. One of the principles of the Act is that all definitions are included in OB1 instead of being spread throughout the substantive provisions.

Officials' comment

We do not agree with the submission. The definitions are working definitions and, accordingly, are appropriately placed in the operative provisions.

Recommendation

That the submission be declined.

CONSOLIDATED STATEMENT OF TAX CREDITS FOR SAVERS' TAX RETURNS

Clause n/a

Submission
(Inland Revenue)

Superannuation funds and life offices should provide each saver with a consolidated statement of tax credits and income attributed to the saver in the year to 31 March.

Officials' comment

This is to assist savers with determining their tax position at year end in circumstances for example where they lose their certificates during the year. It should also be helpful in providing a correct income statement to the Commissioner if the Government's tax simplification proposals are adopted.

We have spoken to some industry representatives on this and while they see merit in providing such a statement to savers they note that there will be a cost for them in providing this.

Recommendation

That the submission be accepted.

TRANSITIONAL PROVISIONS - APPORTIONMENT OF TAXABLE INCOME

Clause 17 Section FB7

Submission
(Officials)

For clarification, the legislation should provide that it is the income tax liability arising from the apportioned taxable income that should be calculated in order to determine the non-electing savers' debit in the transitional years.

Officials' comment

The legislation currently provides for an apportionment of taxable income. This should be extended so that the apportionment is of the estimated income tax liability. Estimated income tax liability is used in the calculation of the non-electing savers' debit.

Recommendation

That the submission be accepted.

FOREIGN TAX CREDITS CANNOT BE USED AGAINST ANNUITY INCOME

Clause n/a

Submission
(Officials)

The legislation should provide that foreign tax credits cannot be used against a liability for tax on annuity income at 21%.

Officials' comment

This is consistent with the policy of companies not being able to pass on foreign tax credits they receive to their individual shareholders.

Recommendation

That the submission be accepted.

2. TRADING STOCK TAX REFORM

OVERVIEW OF SUBMISSIONS

Seven submissions were received on trading stock tax reform, from:

Merrill Lynch (2)
Retail Merchants Association (4)
New Zealand Chamber of Commerce (8)
Institute of Chartered Accountants of New Zealand (15)
Corporate Taxpayer Group (18)
Motor Industry Association (20)
Rudd Watts & Stone (25)

Two submitters (Retail Merchants Association and Motor Industry Association) were heard by the Committee in support of their submissions.

Two submitters (ICANZ and Corporate Taxpayer Group) commented that on the whole they were satisfied that the legislation proposed will result in a much fairer regime for taxpayers with much reduced compliance costs than would have been the case under the proposals contained in the discussion document. Submissions reflect this general satisfaction with the overall package of trading stock tax reform. The only area where the reform is clearly criticised is in the impact of the repeal of the obsolescence provision on the motor vehicle industry. Transitional income spreading rules are also addressed. Many issues raised are technical points to improve the quality and clarity of the legislation.

The submissions can be broadly categorised into three groups: significant policy issues, technical issues and drafting issues. This report has been organised along these lines.

TRADING STOCK TAX REFORM: SIGNIFICANT POLICY ISSUES

OBSOLESCENCE PROVISION

Issue: Repeal of obsolescence provision

Clause 11 Section EE12 Page 11

Submission
(4 - Retail Merchants Association, 20 - Motor Industry Association)

The proposed amendments do not address the issue of stock held surplus to requirements which still has a market selling price above cost. *(4)*

The motor vehicle industry opposes a trading stock regime that does not have a specific mechanism to address obsolescence. *(20)*

The motor vehicle industry opposes the removal of the specific writedown formulas for the motor vehicle industry contained in *Public Information Bulletin* No. 82. *(20)*

Comment

Both submissions address the repeal of the obsolescence provision but have different suggested solutions.

The Retail Merchants Association submission appears to focus on spare parts and trading stock which is like spare parts, giving the example of bolts. The submission argues that the taxpayer should be able to seek pre-approval from the Commissioner of Inland Revenue for formulas under the binding rulings regime. The Motor Industry Association did not consider the binding rulings process to be appropriate for setting formulas.

The submission from the Motor Industry Association states that the motor vehicle industry opposes the presumption that obsolescence of an item is always reflected by its market value. The submission considers that the writedown formula based on age is a simple and accurate solution to the obsolescence that the industry experiences with half of its product lines. The submission indicates that the Motor Industry Association may consider as appropriate an alternative formula, should the Select Committee consider the basis used in *Public Information Bulletin* No. 82 does not accurately reflect the obsolescence patterns arising currently in the industry. The industry submission was very clear that if the obsolescence provision was removed and the formula no longer applicable that it would take an aggressive approach to determining market value to reflect obsolescence.

Both submissions state that the value required to comply with generally accepted accounting principles for obsolete and slow moving stock will be significantly different from the value determined under the proposed legislation.

It is important to consider the issue of valuing obsolete and slow moving stock in the context of the total package of trading stock reforms. The majority of taxpayers value most of their trading stock at cost. For these taxpayers, their compliance costs will be substantially reduced because they will be able to use the valuation prepared for financial reporting purposes. The new rules will result in a fairer regime for taxpayers overall. However, taxpayers who have obtained generous writedowns based on the age of stock will take some time to adjust to the reforms. This is the reason for transitional income spreading for additional income over a three-year period.

The formula in *Public Information Bulletin* No. 82 was approved by Inland Revenue in 1974. It allows motor vehicle dealers who are master agents or sub-agents to write-off the cost of spare parts over three years. The formula has been adopted by these taxpayers for both tax and financial reporting purposes. It is regarded to be an appropriate "net realisable value" for financial reporting purposes.

A net realisable value or a formula based on writedowns from cost relating to the age of stock does not give an accurate measurement of income for tax purposes. For example, after holding spare parts for three years, the taxpayer is holding them at a nil market value, when they will clearly be expecting to receive additional income from the remaining spare parts held. Allowing a writedown means that an unrealised loss is recognised in the accounts reducing income in the period of the writedown. Taxpayers should not be able to value slow moving stock at very low, or nil, values only to sell those goods in a subsequent income year for an amount in excess of that value. This allows taxpayers to defer recognition of gross income and effectively reduces the cost of holding excess stock and may interfere with optimal inventory investment decisions.

Stock which is genuinely obsolete and will be sold for an amount less than cost may be valued at the market selling value.

Oral submissions were unclear about the behavioural impacts the new rules would have on taxpayers. It is not clear that the public will be disadvantaged if the motor vehicle industry held lesser quantities of spare parts than at present. Holding less stock will mean fewer costs being passed on to the public. If a particular item is not held by a dealer, modern transport and communications systems should not result in lengthy delays to obtain a replacement part.

The submissions claim that the motor vehicle industry is in a unique position with its holdings of spare parts. The Motor Industry Association stated that the industry services products which have established second-hand markets, which was not the case for other products. The written submission states that the motor vehicle industry is unique in the high levels of inventories of spare parts which are retained as a result of the longevity of the product to be serviced and legal obligations under the Consumer Guarantees Act.

The Consumer Guarantees Act requires manufacturers to take reasonable action to ensure that a supply of parts for the goods is reasonably available for a reasonable period after the goods are supplied. These obligations apply to all manufacturers, whereas currently only franchised motor vehicle dealers get the benefit of the published formula in *Public Information Bulletin* No. 82. In addition, franchise motor vehicle dealers do not have a monopoly on providing spare parts for vehicles. The submission acknowledges that second hand parts may be obtained from wreckers or customers might purchase substitute/non-genuine parts.

Other examples of products that may be held for a long period of time are whiteware and some electrical appliances. In these cases people may hold appliances for a similar period of time to owning a car.

The formula in *Public Information Bulletin* No. 82 gives a tax advantage to the motor vehicle industry which is not available to other taxpayers, unless they have negotiated a similar formula with Inland Revenue. By removing the formula and requiring taxpayers to value obsolete stock using market selling value, all taxpayers will be in the same position. Taxpayers holding slow moving stock will effectively be required to value slow moving stock at cost. We believe taxpayers can reduce their spare parts holdings whilst maintaining sufficient quantities to meet legal and customer requirements.

It is significant to note that the repeal of the obsolescence provision is no longer opposed by the Institute of Chartered Accountants and other groups representing business interests, such as the Chamber of Commerce.

In summary, we continue to recommend the repeal of section EE1(7) on the basis that:

- The market selling value takes into account declines in value of assets below cost.
- Writing off the cost of slow moving stock is advantageous to some taxpayers and may therefore affect inventory investment decisions.
- It is not clear that the change will have adverse impacts on business and/or consumers.
- All industry groups should be treated in the same way.

Recommendation

That the submissions be declined.

TRANSITIONAL RULES FOR REPEAL OF OBSOLESCENCE PROVISION

Issue: Spread income over five years

Clause 11 Section EE17 Page 14

Submission
(4 - Retail Merchants Association)

Five years is a more appropriate period over which to spread additional income tax payable, because many retailers are currently struggling in a sluggish domestic economy.

Comment

Income is proposed to be spread over a three-year period. This is also the length of time proposed for spreading of income arising from the cost only valuation rule for excepted financial arrangements.

Recommendation

That the submission be declined.

Issue: Spread increase in income

Clause 11

Submissions
(8 - NZ Chamber of Commerce, 15 - ICANZ, 18 - Corporate Taxpayer Group, 25 - Rudd Watts & Stone)

Spread any increase in income that may arise from revaluation of excepted financial arrangements over the 1998/99 and the two succeeding income years.

Spread either the gross income or allowable deduction arising as a consequence of the cost only rule for excepted financial arrangements. *(25)*

Comment

Submissions have indicated that there are circumstances where the managed funds industry, particularly employer superannuation schemes, had adopted a lower of cost or market approach in valuing excepted financial arrangements. These taxpayers may be affected by the changes requiring excepted financial arrangements to be valued at cost.

Transitional income spreading over three years has been provided for the repeal of the obsolescence provision to ease the transition to the new valuation methods. Similar issues arise for taxpayers that will be required to value shares at cost. An increase in income is unlikely for taxpayers that have valued all of their excepted financial arrangements either at cost or at market value. However, those that have valued at the lower of cost or market value will likely have an increase in income from valuing shares at cost which have previously been valued at a market value less than cost. It is appropriate to allow income spreading over a three-year period, to be consistent with the transitional rules for the repeal of the obsolescence provision.

The submission from Rudd Watts & Stone indicated that any allowable deduction should also be able to be spread. We understand this submission to mean that if taxpayers had been valuing all excepted financial arrangements at market value, under the cost only rule they might have a reduction in gross income or a “loss” from trading stock in the 1998/99 income year. The submission argues that this should be spread. If taxpayers are in this position, they should treat the “loss” as a loss in the 1998/99 income year. It would be unnecessarily complex to provide for taxpayers who may not wish to use this loss in the 1998/99 income year for other reasons, and wish to retain the flexibility of spreading it across income years.

Recommendation

That the submission regarding spreading gross income from excepted financial arrangements over three years be accepted.

That the submission regarding spreading allowable deductions be declined.

APPLICATION DATE

Issue: Application date should be changed to the 1999-2000 income year

Clause 11(2) **Page 16**

Submissions
(8 - NZ Chamber of Commerce, 25 - Rudd Watts & Stone)

The new legislation will apply retrospectively to taxpayers with early balance dates because they will have paid provisional tax prior to enactment of the legislation.

Comment

The first provisional tax payment date in the 1998/99 income year for 31 March balance date taxpayers is 7 July 1998. Early balance date taxpayers will have made their first payments before then.

Taxpayers will need to take into account any increase in income from the new rules in provisional tax instalments, prior to the bill being enacted. Many taxpayers, particularly large taxpayers, who are facing an increase in income should have a high level of awareness about the new rules and the 1998-99 application date because of the extensive consultation and publicity about the changes over the past year.

The most likely areas where there may be increased income are from:

- the repeal of the obsolescence provision;
- valuation of excepted financial arrangements at cost;
- valuing trading stock at cost under FRS-4.

Transitional income spreading will alleviate some of the effects on income. It is available for the repeal of the obsolescence provision and we have recommended that it also be available for excepted financial arrangements. These transitional income spreading arrangements mean that the increase in income will be spread over three years, so only one-third will relate to the 1998-99 income year.

Recommendation

That the submission be declined.

VALUATION OF EXCEPTED FINANCIAL ARRANGEMENTS

Issue: Market value option for shares

Clause 11 Section EE13 Page 11

Submission
(2 - Merrill Lynch)

Retain current option allowing valuation of shares at market value but remove the ability to value shares on a "line by line" basis at the lower of cost or market.

Alternatively, an option should be available to allow companies to elect (either irrevocably or only able to change with the Commissioner's approval) to apply consistently a market value for all shares held at balance date.

Comment

The submission is proposing a mark-to-market valuation option for all shares. Merrill Lynch is the only taxpayer which has sought this option. The effect is that unrealised gains would be taken into account for tax purposes.

Initially a mark-to-market valuation option appears to be an attractive option because it may provide a more accurate reflex of income than the cost only rule and it would generally be consistent with the valuations for financial reporting purposes, and if so, would decrease compliance costs.

However, we consider that there is no widespread demand for a mark-to-market valuation option and therefore one should not be available because of the disadvantages of this option. If a mark-to-market option is an alternative to the cost only rule this would increase the complexity of the legislation, because of the rules required to elect into and out of the option. In addition, shares that are trading stock would be treated differently from shares held on revenue account (which are valued at cost), creating pressure on that boundary.

The submission states that Merrill Lynch values shares at market selling value for both accounting and taxation purposes. Under the proposed rules they would need to maintain separate valuation systems for accounting and tax. The submission indicates that the development of a system to track the original cost of shares on hand at balance date will be a significant cost. It is not clear whether they have considered using the weighted average method to determine the cost of shares on hand. This might involve fewer compliance costs than determining the actual cost of shares.

There is an apparent conflict with this submission and those made by the funds industry seeking specific identification for excepted financial arrangements. In that case, taxpayers are seeking to apply the actual cost of excepted financial arrangements purchased.

Recommendation

That the submissions be declined.

Issue: Valuation of excepted financial arrangements at cost

Clause 11 Section EE13 Page 11

Submission
(15 - ICANZ)

Excepted financial arrangements should not be subject to differential treatment.

Comment

The submission considers that it is illogical to differentiate excepted financial arrangements from many other forms of trading stock, such as commodities. Excepted financial arrangements are primarily shares.

The proposal that excepted financial arrangements be valued at cost followed the recommendations of the Valabh Committee in its *Tax Accounting Issues* and *Final Report*. The proposal was designed to address a concern that taxpayers defer recognition of gains by valuing shares that have increased in value at cost but recognise the unrealised losses on those shares that have lost value through the market value option. Although this practice also occurs with lines of tangible trading stock, the problem is magnified in the case of shares because of the volatility in the value of shares on the market. The asymmetrical treatment of gains and losses is not justified in the case of shares, which are as likely to increase in value as fall in value. In addition, shares have no holding costs and therefore are qualitatively different from other trading stock.

If shares that are trading stock have access to a market value option, whereas shares that are held as revenue account property or on capital account must be valued at cost, this also creates pressure on these boundaries, and taxpayers may have some discretion to transfer assets between revenue and capital portfolios. This was a key reason for the Valabh Committee declining to change its recommendation for shares to be valued at cost, when submissions disagreed.

Recommendation

That the submission be declined.

ACCOUNTING STANDARDS

Issue: Incorporating accounting standards into the tax law

Clause 11 Section EE5 Page 8

Submission
(25 - Rudd Watts & Stone)

Principles applicable in accounting standards should not be incorporated into the tax law.

Comment

The submission contends that accounting principles are not crafted or intended to be used with the same level of precision as a taxing statute and are prepared with quite different objectives in mind, which tend to understate income. It continues that it is undesirable as a matter of principle for a tax statute to rely on financial reporting standards in a way which has the effect that if the accounting standards are changed, so is the tax law, without reference to Parliament.

The sentiments expressed in the submission describe generally why accounting standards do not determine tax liability. However, there are specific examples when accounting standards are similar to the tax law and attempt to achieve the same purpose. The valuation of trading stock at cost is one example. In practice, taxpayers use the valuation calculated for accounting purposes and make adjustments for tax purposes. The proposed legislation gives effect to this practice and does not require taxpayers to incur the compliance costs of preparing a separate valuation for tax purposes.

The accounting standard that will be applied is Financial Reporting Standard No. 4: *Accounting for Inventories* (FRS-4). The standard is longstanding and is a relatively clear set of guidelines. Although there is some flexibility in the application of the standard, it is not open to widely varying interpretations. The risk that this area of accounting practice will be changed is small, and if it is changed, the situation can be reassessed.

The legislation does not adopt the accounting standard where practice is regarded to be uncertain, and where the potential to understate income is significant. For this reason, the legislation does not adopt the rules for determining net realisable value when the value of stock is below cost. Instead, it sets out rules for establishing a market selling value.

Recommendation

That the submission be declined, with respect to the incorporation of financial reporting standards for valuing trading stock at cost.

MATERIALITY

Issue: Incorporating materiality into tax law

Clause 11 Section EE5 Page 8

Submission
(25 - Rudd Watts & Stone)

Materiality is not a standard that should be incorporated into tax law.

Comment

The submission considers that materiality should not be enacted into tax law. In addition, it raises the issue of what materiality means, and whether understating income by 10% would be acceptable under the legislation.

If an accounting standard is incorporated into tax law, then materiality must also be incorporated to avoid taxpayers incurring the compliance costs of including all costs, including those that are material. In relation to trading stock valued at cost, this means that costs that are immaterial need not be included in the cost. It does not authorise a global discounting of the total value of stock of 10% or some other figure.

Section EE5(2) attempts to limit the application of materiality to valuation of trading stock by requiring it to be considered for the application of FRS-4 to determine the value of trading stock only, not the total application of materiality to income in financial statements.

Recommendation

That the submission be declined, with respect to the incorporation of materiality for valuations of trading stock at cost.

TRADING STOCK TAX REFORM:
TECHNICAL ISSUES

EXCEPTED FINANCIAL ARRANGEMENTS

Issue: Specific identification for excepted financial arrangements

Clause 11 Section EE5(4) Page 8

Submissions
(15 - ICANZ, 18 - Corporate Taxpayer Group)

If excepted financial arrangements are separately identifiable, taxpayers should have the option to specifically track separately identifiable parcels of shares.

Comment

The ICANZ submission contends that in addition to the cost only rule it is not necessary to go even further and eliminate specific identification as a cost flow option. ICANZ's information is that particularly in the funds management area stock parcels are separately identifiable, notwithstanding scripless trading.

The Corporate Taxpayer Group correctly identifies officials' concern about the ability of taxpayers to "cherry pick" blocks of shares sold so as to minimise their tax exposure. They consider that taxpayers should be free to plan their tax position to best advantage. The policy intention of the legislation is to ensure that taxpayers cannot minimise their taxable income in this way.

Specific identification is not appropriate for either tax purposes or accounting purposes if a large number of items of trading stock are ordinarily interchangeable because the selection of items can be made to manipulate income from trading stock. This is the case for shares and for all other trading stock. Taxpayers will be required to use cost flow methods for all trading stock that is ordinarily interchangeable, including excepted financial arrangements.

We note that both submitters considered that income spreading over three years would be desirable. We have recommended that this submission be accepted.

Recommendation

That the submissions be declined.

TRANSFERS OF EXCEPTED FINANCIAL ARRANGEMENTS WITHIN WHOLLY-OWNED GROUPS

Issue: Transfers of excepted financial arrangements that are on capital account

Clause 11 Section EE14 Page 11

Submissions
(15 - ICANZ, 18 - Corporate Taxpayer Group)

The limitation that transfers of excepted financial arrangements within wholly-owned groups must be at cost if the market value is less than cost should not apply when the transferee will hold the property on capital account.

Alternatively, the transferee should be entitled to a deduction for the loss which would otherwise have arisen to the transferor at the time of the transfer of shares by the transferor. *(18)*

Comment

The submission contends that if the property transferred is on capital account in the hands of the recipient, there is potentially no deduction allowed to any company within the group for the loss. This is a correct interpretation. No loss will be available until the excepted financial arrangements are transferred outside of the wholly-owned group of companies.

If there is an exception when the recipient will hold the property on capital account, this creates pressure on the boundary between shares held as trading stock or held on revenue account and those on capital account. It then becomes a potential way to avoid the cost only rule.

The discussion document stated that the Government was interested in hearing of any circumstances giving rise to transfers of trading stock or revenue account property to members within the group to hold on capital account. Neither submission gives examples of why this would be necessary, instead, commenting that the restriction should not apply. We are not persuaded therefore that the additional complexity and avoidance opportunities that will be available justify accepting the submission. The alternative submission has the same implications and should be declined for the same reasons.

Recommendation

That the submissions be declined.

Issue: Obtaining binding rulings on generally accepted accounting principles

Clause 43 Section 91E TAA Page 53

Submission
(15 - ICANZ)

The Commissioner should not be prohibited from issuing a private/product ruling which requires an opinion on generally accepted accounting principles or commercially acceptable practice.

Comment

The submission contends that the ruling process is intended to give taxpayers absolute certainty in relation to their tax obligations and this certainty should be available for valuing trading stock. As the use of expert external advice in relation to the interpretation of non-tax law criteria is permitted, ICANZ considers that there is no reason to make a distinction with regard to generally accepted accounting principles, an area which is currently considered by the Commissioner in relation to the analysis of case law referring to such principles.

Inland Revenue may not make a ruling determining questions of fact (such as the market value of a property or a taxpayer's purpose on acquisition) except in limited situations involving international tax. We do not consider it is appropriate for the Commissioner to rule on generally accepted accounting principles for the same reasons as questions of fact are excluded from the rulings regime. The Commissioner is not a recognised expert in these areas. It is possible to obtain expert evidence on market value and in relation to the application of generally accepted accounting principles. In both cases, there may be a range of views held by experts. An adjudication or a court is a more appropriate forum in which to weigh these views.

In addition, we do not consider it to be the best use of resources of the Adjudications and Rulings business group to rule on generally accepted accounting principles.

Recommendation

That the submission be declined.

BUDGETED/STANDARD COSTS

Issue: Adjustment for budgeted costs

Clause 11 Section EE5(3) Page 8

Submission
(15 - ICANZ)

Taxpayers should have the option of using a pool basis to allocate variances which can be reversed in the following year and re-established at the following year-end based on the subsequent variances arising.

Comment

The intention was for adjustments between budgeted or standard costs and actual costs incurred to be calculated in the manner described by the submission.

We recommend that the legislation be amended so that a taxpayer making an adjustment for a variance will treat the previous year's variance as an allowable deduction and include as gross income the variance relating to trading stock valued at cost in the current year.

Recommendation

That the submission be accepted.

Issue: Reference to "subsidiary"

Clause 33 Section OB1 Page 44

Submissions
(8 - NZ Chamber of Commerce, 15 - ICANZ)

Reference to "subsidiary" in the definition of small taxpayer should be replaced with a member of a "group of companies" using the meaning assigned by section IG1(2).

Comment

The submission considers that use of the term subsidiary adds an additional definition to the Income Tax Act, further complicating situations where a type of grouping test is required. Use of the term "subsidiary" is complex as the Financial Reporting Act further refers to sections 5 and 8 of the Companies Act 1993. To reduce compliance costs, both submissions recommend using grouping tests already in the Income Tax Act.

We recommend adopting the associated person's test in section OD7 of the Income Tax Act. Broadly, under this section companies are associated if a person or group has voting interests of 50% or more or control by any other means. This is nearer to the subsidiary definition in the Financial Reporting Act than the group of companies test and should also meet the compliance cost concerns of submitters arising from using definitions which refer to other Acts.

Recommendation

That the submission be accepted in part. The reference to "subsidiary" should be replaced by a reference to the associated persons test.

SMALL TAXPAYER USE OF FRS-4

Issue: Small taxpayers preparing one-off accounts using FRS-4

Clause 11 Section EE7 Page 9

Submissions
(8 - NZ Chamber of Commerce, 15 - ICANZ)

Section EE7 should be narrowed such that it only includes those taxpayers who prepare financial statements regularly for annual accounts.

Comment

The submissions consider that section EE7 should specifically exclude those taxpayers that may be required to prepare such accounts for a one-off purpose, such as a bank funding application. Section EE7 requires a small taxpayer that in an income year includes additional costs of production in financial statements or for tax purposes to include those costs consistently from income year to income year.

To avoid additional compliance costs, small taxpayers should include additional costs only in the income year in which those costs are included in financial statements. In years when the additional costs have not been included in financial statements, they should not be required to be included for tax purposes. This approach will satisfy the submission, although it is a different outcome.

Recommendation

That the submission be accepted in substance, so that taxpayers are required to include the additional costs only in the income year in which accounts are prepared in accordance with FRS-4.

SMALL TAXPAYER INCLUSION OF COSTS

Issue: Insurance costs

Clause 11 Section EE7(3) Page 9

Submission
(15 - ICANZ)

Clarification of the insurance costs referred to is desirable.

Comment

The submission assumes that the insurance costs referred to relate to the insurance costs of getting the stock to its current location and condition rather than the insurance cost for the year.

This assumption is correct. The legislation should clarify that freight, insurance and any other direct transportation costs should be included.

Recommendation

That the submission be accepted.

SMALL TAXPAYER THRESHOLD FOR DISCOUNTED SELLING PRICE

Issue: Level of threshold

Clause 11 Section EE9 Page 10

Submission
(15 - ICANZ)

The $1 million threshold may not be high enough.

Comment

The submission does not indicate what it considers to be the appropriate level for the small taxpayer threshold. It has been set at an arbitrary level, which will mean some taxpayers are always slightly above that level. The level set for exempt companies under the Financial Reporting Act 1993 is $1 million. The current threshold should capture all "corner dairy" type operations, which are the main targets for the simplified method.

Taxpayers who do not qualify will be required to use the regular method for discounted selling price. The only additional requirement is to apply margins to different departments or categories of trading stock rather than applying an average gross profit margin to all trading stock.

The threshold can be amended in future by Order in Council.

Recommendation

That the submission be declined.

APPLICATION OF DISCOUNTED SELLING PRICE METHOD

Issue: Calculation of the margin

Clause 11 Section EE8 Pages 9-10

Submission
(4 - Retail Merchants Association)

Change the margin requirement to a margin based on the full retail price.

Comment

The practical application of the discounted selling price is not at issue, although it is complex to express in legislation for the reasons outlined in the submission.

The alternative to the method outlined in the submission is to require stock to be valued at current selling prices less the normal gross profit margin, which is the method provided in FRS-4. Advice from the Institute of Chartered Accountants on the application of FRS-4 is that a correct application to stock that has been reduced from a full retail price will involve a compensatory adjustment to the normal gross profit margin so that an accurate approximation of cost results.

Using the method provided in FRS-4 is consistent with the legislation providing for valuation of cost in accordance with FRS-4 and solves the problem raised in the submission.

Recommendation

That the submission be declined but that an equivalent outcome be achieved by requiring stock to be valued at selling price less the normal gross profit margin in accordance with FRS-4.

USE OF COST IN THE ABSENCE OF MARKET SELLING VALUE

Issue: Availability of cost valuation method

Clause 11 Section EE12(3) Page 11

Submission
(15 - ICANZ)

Taxpayers who do not have sufficient evidence to substantiate market selling value be required to use a "cost valuation method" as opposed to cost.

Comment

The submission comments that it would be very difficult to establish cost in subsequent years, while it may be relatively easy to use discounted selling price as a cost valuation method.

This use of any of the cost valuation methods as an alternative to market selling value was intended.

Recommendation

That the submission be accepted.

USE OF MORE THAN ONE VALUATION METHOD

Issue: Using a combination of valuation methods

Clause 11 Section EE3(1) Page 7

Submission
(4 - Retail Merchants Association)

The legislation does not make it clear that the taxpayer can use a different valuation method for different sections of trading stock.

Comment

It is intended that different valuation methods apply for different groups of trading stock. This is implicit in legislation that provides the option of cost valuation methods or market selling value (if lower than cost). Current practice is for taxpayers to value groups of stock using different methods. This should not change under the proposed legislation.

Recommendation

That the submission be declined.

USE OF REPLACEMENT PRICE

Issue: Use of replacement price for stock acquired in a previous income year

Clause 11 Section EE11 Page 10

Submission
(4 - Retail Merchants Association)

Section EE11 does not cover the situation when the taxpayer acquired stock in the previous income year and the item is not normally on the market at the end of the income year.

Comment

Replacement price is defined as the market value for acquisition of trading stock on the last day of the income year, that is, the price at which the trading stock can be replaced at balance date. To satisfy the concerns of taxpayers who may not purchase stock at balance date because, for example, it is out of season, the option of using the price of stock purchased during the year was given.

If the concession is extended to stock bought in a previous year, the replacement price is not likely to be current, and bears no close relationship to replacement price at balance date. Other cost valuation methods should be used.

Recommendation

That the submission be declined.

DEFINITION OF COST

Issue: Dividing line between cost of trading stock and selling costs

Clause 11 Section EE5(1) Page 8

Submission
(4 - Retail Merchants Association)

Section EE5(1) requires all costs to be included by generally accepted accounting principles. The issue in FRS-4 is when the costs of "bringing the inventories to their present location and condition" end and "selling costs" begin.

Comment

FRS-4 is not explicit in addressing the dividing line between costs to be included in trading stock and selling costs. However, in practical terms, all entities complying with FRS-4 apply the standard currently. They should continue to do so, and this will be acceptable for tax purposes. It is not appropriate to elaborate on FRS-4 in tax legislation.

The submission appears to be particularly concerned about the inclusion of transport and storage costs once the trading stock is within the control of the taxpayer. The costs included for financial reporting purposes will be acceptable for tax purposes. Practice may vary slightly between taxpayers and may change over time as accounting systems improve.

Recommendation

That the submission be declined.

DEFINITION OF TURNOVER

Issue: Clarify the definition

Clause 33 Section OB1 Page 44

Submission
(25 - Rudd Watts & Stone)

The definition refers to "total gross income derived by a business . . . as a result of trading by that business." It should be clarified to ensure that it does not include gross income from the closing value of stock.

Comment

The definition was not intended to include gross income from trading stock calculated in accordance with section EE2(4). The legislation should be clarified to reflect this.

Recommendation

That the submission be accepted.

CONSISTENCY REQUIREMENTS

Issue: Make consistency requirements record-keeping

Clause 11 Section EE16(5) Page 14

Submission
(Issue raised by officials)

Comment

Under the proposed legislation small taxpayers who do not prepare financial statements and who vary their methods for valuing trading stock must notify the Commissioner of Inland Revenue at the time of filing their returns.

To reduce compliance costs for these taxpayers, a record of the reason for the variation could be kept instead. This approach is consistent with that for other taxpayers, which requires compliance with the consistency and disclosure requirements of FRS-1. FRS-1 requires disclosure of changes in applying accounting policies in the statement of accounting policies in the financial statements. The effect is to create a record-keeping requirement.

Recommendation

That the issue of disclosing changes in valuation methods, raised by officials, be addressed in the bill as a record-keeping requirement instead of requiring small taxpayers to notify the Commissioner of Inland Revenue.

TRADING STOCK TAX REFORM:
DRAFTING ISSUES

GOODS AND SERVICES TAX

Issue: Inclusion of goods and services tax

Clause 11 Section EE8 Page 9

Submission
(15 - ICANZ)

It should not be necessary to state within particular sections whether output or input tax is to be included in value.

Comment

The submission comments that given the presence of section ED4 (which states amounts are GST exclusive), this should not be necessary.

The Income Tax Act is inconsistent about including explicit references to output and input tax in a value.

References to output and input tax were included to be consistent with other definitions in section OB1. However, the better view is to rely on section ED4, which will have the benefit of simplifying the legislation.

Recommendation

That the submission be accepted.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Issue: Definition of generally accepted accounting principles

Clause 11 Section EE5(2) Page 8
Clause 33 Section OB1 Page 44

Submission
(15 - ICANZ)

A definition of the term “generally accepted accounting principles” would be unnecessary if the legislation simply referred to the term “generally accepted accounting practice”.

Comment

The Income Tax Act contains several other references to “generally accepted accounting principles”, for example, in Part CG on attributed foreign income. To be consistent with these other references the term was used in Part EE instead of “generally accepted accounting practice”.

The *Explanatory Foreword to General Purpose Financial Reporting* refers to “generally accepted accounting practice”. This term has been adopted in the definition to link in with what taxpayers are doing for financial reporting purposes. The requirement is to comply with “generally accepted accounting practice” for inventory (FRS-4) as it applies to trading stock as defined in the Income Tax Act.

Defining “generally accepted accounting principles” for the purposes of Part EE simplifies the drafting of the sections in Part EE. If there were no definition, it would be necessary to qualify the phrase each time it is used.

Recommendation

That the submission be declined.

DEFINITIONS

Issue: Placement of definitions in the Income Tax Act

Clause 11	**Section EE8**	**Page 9**
Clause 11	**Section EE11**	**Page 10**
Clause 11	**Section EE12**	**Page 11**

Submission
(15 - ICANZ)

The definitions of the terms "discounted selling price", "replacement price" and "market selling value" should be defined in section OB1.

Comment

The substance to these definitions is contained in subpart EE because the definitions are only to be applied to subpart EE. Definitions that relate to the Income Tax Act as a whole are defined in full in section OB1. Those definitions which only have application to a particular subpart in the Act are included in section OB1, but the substantive definition is included in the subpart in the Act.

Recommendation

That the submission be declined.

DEFINITION OF THE TERM "RETAILER"

Issue: Meaning of the term "retailer"

Clause 11	**Section EE8**	**Page 9**
Clause 11	**Section EE9**	**Page 10**
Clause 11	**Section EE10**	**Page 10**

Submission
(15 - ICANZ)

A definition of the term "retailer" would be useful.

Comment

A definition is not necessary. In the absence of a definition, the ordinary meaning of a term will apply. This is acceptable for the term "retailer", which has a clear and widely understood meaning. The intention is not to exclude taxpayers from application of these sections, but to provide for the different application of the discounted selling price method for retailers, and for other taxpayers, commonly commodity exporters in the meat industry.

Recommendation

That the submission be declined.

3. OTHER AMENDMENTS TO THE INCOME TAX ACT

TAXATION OF PROPERTY OBTAINED WITHOUT COLOUR OF RIGHT

Issue: Victims' rights

Clauses 4, 9, 15, 33(6), 47 and 48

Submission
(*8W - NZCCI, 15W - ICANZ*)

The proposed legislation should either:

- instead of taxing money acquired "without colour of right", prevent taxpayers claiming losses which arose from activities funded from stolen money; or
- ensure that any allowable deductions relating to restitution to the victim is recognised in the year in which the income arises.

Comment

The submitters argue that the proposed provisions disadvantage victims' ability to recover their property. This is because, once convicted, taxpayers may have insufficient resources to pay all claimants such as the victim, Inland Revenue and other unsecured creditors such as the courts. They contend that the perceived real problem is the existence in some cases of tax losses being generated.

However, the main purpose of the proposed amendments is to prevent people from evading income tax by recharacterising their income as stolen. Preventing taxpayers from claiming losses on this income would not address the issue of tax evasion and, therefore, would still leave a potential hole in the New Zealand tax base. Officials consider the amendments critical from a base maintenance perspective.

With regard to victims' ability to recover their property, Inland Revenue is producing a practice statement outlining how it will administer these provisions. One of the core features of the statement is the focus on minimising any potential prejudice against victims' claims. Inland Revenue will not make an assessment or reassess a taxpayer until the victim has exhausted his/her legal rights or has decided to no longer pursue those rights. This should ensure most victims are not disadvantaged.

Furthermore, if victims materialise after the taxpayer has been assessed and the tax has already been collected, the proposed provisions minimise the potential effect on victims by allowing a deduction to the taxpayer for any reparation made.

Recommendation

That the submission be declined.

Issue: Legal sanction of criminal activity

Submission
(*3W - David and Margaret Troup*)

The proceeds from the criminal should be used for restitution to victims of crime in general.

Comment

The submitters believe that those who obtain property illegally should not have the privilege of paying income tax, and the taxation of stolen property provides in some way the semblance of a legal sanction.

Officials consider that the taxation of stolen property does not provide in any way a legal sanction to theft or like conduct. The taxation of stolen property can be justified on the basis that by not taxing it the tax system is in effect subsidising those who choose to steal property.

Officials also consider that the proposal to set aside any tax collected on stolen property to a fund for victims in general would be difficult to administer. Currently, Inland Revenue does not have the capacity to determine which revenue collected relates to stolen property. Furthermore, such initiatives as that suggested in the submission are generally funded out of the Crown account, into which tax revenue is deposited.

Recommendation

That the submission be declined.

Issue: Limited application to criminal convictions

Submission
(*8W- NZCCI*)

The application of the proposed legislation should be limited by changing the term "without colour of right" to "fraudulently obtained without colour of right". The taxation of such property should also be made subject to obtaining a criminal conviction.

Comment

The submitters argue that the application of the proposed provisions is too wide and includes property obtained by mistake, breach of trust or other fiduciary duty.

Officials do not agree that the provisions require any limitation or that a criminal conviction must first be obtained. The main purpose of the provisions is to prevent people evading income tax by declaring that their income to have been stolen. To require a criminal conviction would undermine that objective because taxpayers could recharacterise their income as stolen with impunity. Inland Revenue is prevented from revealing taxpayer information to the Serious Fraud office or the Police.

Furthermore, anyone who acquires property by mistake, and does not return it, should also be taxed on the basis that they have had the economic benefit of that property. Whether or not the action is criminally liable is not a consideration for the purposes of income tax. Generally, property obtained by mistake or through a breach of duty is promptly returned to the rightful owner. In the unlikely event that tax has already been collected from such mistakes, the taxpayer will still qualify for a deduction on the return of the property under the proposed legislation.

Recommendation

That the submission be declined.

CONSOLIDATION RULES AND SECTION LE 3 HOLDING COMPANIES

Issue: Excluding consolidated groups from section LE 3 holding company rules

Clause 21

Submission
(Issue raised by officials)

Comment

Clause 21 amends the consolidation rules to exclude the application of its exemption for intra-group transactions to dividends or supplementary dividends derived by a section LE3 holding company member of a consolidated group.

Officials recommend replacing this amendment with an amendment explicitly excluding consolidated groups from the section LE 3 holding company rules. This is because a consolidated group, by virtue of being generally treated as a single company for tax purposes, has no need to use these rules to ensure that it can utilise the FITC credit arising from the payment of a supplementary dividend to its non-resident shareholders. The section LE3 holding company rules were introduced primarily to allow non-wholly owned groups to utilise the FITC mechanism.

The amendment to exclude consolidated groups from the section LE3 holding company rules should be retrospective to when they took effect, in December 1995. This is justified because section LE3(3)(e) indirectly already has that effect. This provision treats a section LE3 holding company notice as revoked if dividends derived by the former section LE3 holding company are not taxable other than under section CB10. This would apply to dividends derived by a member of a consolidated group from another member of that group as such dividends are exempt from tax under existing section HB2(1)(a). However, the exclusion of consolidated groups from the section LE3 holding company rules should be stated explicitly, rather than being indirectly provided for through the deemed revocation of a section LE3 holding company election under section LE3(3). The proposed amendment would achieve this explicit exclusion.

A consequential amendment also needs to be made to section LE3(3)(e) to replace the reference to “exempt income” with “not gross income”. The reference to “exempt income” was inserted by the Taxation (Core Provisions) Act 1996. However, it is not consistent with the Core Provisions in Part B, which refer in section BD1(2)(a) to exempt income arising only under Parts C, D, or F (nor Part H). The correct terminology in section LE3(3)(e) is “not gross income” as this would be consistent with section BD1(2)(b), which includes as an amount that is not gross income an amount that is excluded from gross income under Part H (in particular, by the exemption for intra-group transactions in section HB2(1)(a)). This problem in section LE3(3)(e) did not exist before the Taxation (Core Provisions) Act 1996, which did not apply until the 1997-98 and subsequent income years.

Recommendation

That existing clause 21 be replaced by an amendment excluding consolidated groups from the section LE 3 holding company rules.

Issue: Foreign investor tax credit rules

Clause 21 Section HB2(1) Page 22

Submission
(1 - Arthur Andersen; 15 - ICANZ)

The tax credit ordering rules for section LE3 holding companies should be amended to correct an anomaly in the legislation.

Comment

The section LE 3 holding company rules were designed to allow the effective operation of the foreign investor tax credit rules when a New Zealand company pays dividends to non-residents through an intermediary company. The intermediary company is able to receive supplementary dividends under the rules, which it then on-pays to its non-resident shareholders.

The submission identifies that the mechanism does not operate as intended if the intermediary company (the section LE 3 holding company) does not on-pay the supplementary dividends in the same year in which it receives them. This is because of the effect of the tax credit ordering rules. Officials agree that the intended effect of the rules has not been achieved, and that an amendment should be made.

Recommendation

That the submission be accepted.

DEPRECIATION

Issue: To be depreciable, property must be used or available for use in deriving income

Clause 14 Section EG 2(1)(a)

Submission
(15 - ICANZ)

Property should be depreciable where it:

- is held pending imminent use in a business, or
- has been in use but is subsequently not used or available for use.

Comment

Last year Parliament enacted an amendment to the Income Tax Act which requires that depreciation deductions can be claimed by a taxpayer only in relation to assets that are *used* or *available for use* in the income earning process. The Valabh Committee, which proposed new rules for depreciation in 1992, recommended such a limitation, and the Government agreed to it. However, the legislation that followed was deficient in this respect. The amendment enacted last year ensured that the legislation reflected the original policy intent.

Last year's amendment was not effective in one set of circumstances, and the amendment in clause 14 rectifies that.

The submission in effect objects to the underlying rule enacted last year. Officials do not agree with the submission and consider that the current test is appropriate.

The submission proposes that depreciation should be allowed when property is not available for use in a business but is held pending imminent use in the business. The term "imminent" is uncertain, and if use is actually imminent, deductions will, in any event, shortly be available to the taxpayer under the current provisions.

The submission also argues that an asset that has been in use but is subsequently not used or available for use be depreciable. It argues that assets which are "mothballed" can be subject to a greater depreciating factor than an asset continually used in production.

Officials consider that the depreciation legislation adequately provides for such assets. When the taxpayer does not intend to use the asset again, the taxpayer may apply to the Commissioner to write off the asset. (Inland Revenue is currently considering removing the need to apply if assets have a value under a certain threshold). Alternatively, if the asset is again available for use in the business, it can be depreciated from that time.

Recommendation

That the submission be declined.

MINOR REMEDIAL AMENDMENTS TO INCOME TAX ACT

Issue: Low income rebate for the 1997/98 income year

Submission
(Matter raised by officials)

Section KC1(1)(c) should be amended to provide for the low income rebate for the 1997/98 income year.

Comment

Section 33 of the Taxation (Remedial Provisions) Act 1997 amended section KC1(1)(a) to provide for the low income rebate for the 1997/98 income year. A similar amendment is required to section KC1(1)(c).

Recommendation

That section KC1(1)(c) be amended to provide for the low income rebate for the 1997/98 income year.

Issue: Low income rebate for the 1998/99 and 1999/2000 income years

Submission
(Matter raised by officials)

Section KC1 should be amended to defer the application date of the veteran's pension amendments to the low income rebate from the 1997/98 and 1998/99 income years to the 1998/99 and 1999/2000 income years respectively.

Comment

Section KC1 was amended to treat recipients of a veteran's pension in the same way as New Zealand superannuitants for the purpose of the low income rebate. The application dates of these amendments were not deferred when the tax rate reductions were deferred.

Recommendation

That the application date of the veteran's pension amendments to the low income rebate be deferred from the 1997/98 and 1998/99 income years to the 1998/99 and 1999/2000 income years respectively.

Issue: Cross-reference errors

Submission
(Matter raised by officials)

Officials have identified four further cross-reference errors that were introduced into the Income Tax Act 1994 by the Taxation (Core Provisions) Act 1996.

They affect the operation of sections CB10(3)(b), GD13(4)(a), LC4(3), and the definition of 'unit trust' in section OB1.

Recommendation

That-

- in section CB10(3)(b), "section BB9" be replaced with "section BG1";
- in section GD13(4)(a), after "taxpayer", "for any income year" be inserted;
- in section OB1, in the definition of "unit trust", "section HE1" be replaced by "the definition of trust".

That each amendment be deemed to have come into force on 1 April 1995 and to have applied with respect to income derived in the 1995/96 and subsequent income years.

Issue: Cross-reference errors in definitions of "direct market value interest" and "direct voting interest"

Submission
(Matter raised by officials)

In section OB1, in the definitions of "direct market value interest" and "direct voting interest", references are made to section CH3 of the Income Tax Act 1994. In each case, the reference should be to section CF3 of that Act.

Comment

These errors occurred as a result of the conduit investment provisions in the Taxation (Remedial Provisions) Act 1998.

Recommendation

That each reference be amended from CH3 to CF3.

4. AMENDMENTS TO OTHER ACTS

NOTICE OF PROPOSED ADJUSTMENT

Issue: Date of application

Clause 42

Submission
(*Officials*)

The application date for the proposed legislation should be from 1 October 1998, a set date, rather than from the date of assent.

Comment

Officials have identified a problem with the current application date of the proposed provisions. A set date would provide sufficient time following enactment for taxpayers, tax agents and Inland Revenue staff to be informed of the amendment. This in turn would mean a smoother introduction of the law changes.

If the application date remains the date of assent we expect an increase in the number of late applications, thus increasing administrative and compliance costs.

Recommendation

That the application date be changed from the date of enactment to 1 October 1998.

Issue: Cross-reference error

Submission

(Matter raised by officials)

Section 62(5) of the Student Loan Scheme Act 1992 refers to section 82(5)(g) of the Tax Administration Act 1994. The correct reference should be to section 81(4)(g) of that Act.

Comment

This cross-referencing error, which occurred in the course of the 1994 re-ordering/renumbering of the Tax Acts, was identified during work on the amendment to section 62 contained in the bill.

Recommendation

That section 62(5) of the Student Loan Scheme Act 1992 be amended to refer to section 81(4)(g) of the Tax Administration Act 1994.