TAXATION (ANNUAL RATES AND REMEDIAL MATTERS) BILL

Commentary on the Bill

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Taxation (Annual Rates and Remedial Matters) Bill
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(Clauses 3 and 5)

Summary of proposed amendments

The anti-avoidance rule that applies when certain dividends received from shares held for sale or as part of a share dealing business is being amended to ensure it better fulfils its purpose.

Application date

The amendment will apply from the day after the date of introduction of the bill.

Key features

Section FC 3 of the Income Tax Act 1994 will be amended so that it applies to all company shares held on revenue account and to all dividends (or equivalent amounts) paid from pre-acquisition profits to associates where the shares that give rise to the dividend are held on revenue account.

Background

Section FC 3 of the Income Tax Act 1994 may apply when a company owns shares that it intends to sell. This rule is designed to ensure that the exempt dividend provisions cannot be used to avoid the tax that should be paid upon the disposal of the shares.

However, section FC 3 does not cover situations where the taxpayer does not deal in shares and has not acquired the shares for the purpose of selling them, but nevertheless holds the shares on revenue account. It also fails to extend to situations where the dividend from pre-acquisition profits is paid tax-free to an associated company of the taxpayer.

The amendment will address these deficiencies.

NEW ZEALAND RASPBERRY MARKETING COUNCIL

(Clauses 10 and 40)

Summary of proposed amendments

The Income Tax Act 1994 and the Estate and Gift Duties Act 1968 are being amended to give certainty as to the tax consequences arising from the forthcoming dissolution of the New Zealand Raspberry Marketing Council, its committees and the Raspberry Marketing Export Authority.

Application date

The amendments will apply from the date the regulations providing the dissolution process for the council and the committees are made.

Key features

- There will be no income tax or gift duty consequences to the New Zealand Raspberry Marketing Council and its committees, and to the shareholders of the council and committees as a result of the introduction of the regulations providing for the dissolution process. The regulations are intended to confirm the shareholders' entitlement to the assets of the council and committees on dissolution, so there should be no tax cost.

- There will be no income tax or gift duty consequences to the Nelson Raspberry Marketing Committee and its members as a result of the vesting of Cold Storage Nelson Limited shares by the Nelson Raspberry Marketing Committee in a new company, Rubus Investments Nelson Ltd. The subsequent distribution of the new company's shares to Nelson Raspberry Marketing Committee members will be treated for tax purposes as a distribution of those shares by the Nelson Raspberry Marketing Committee to its shareholders on winding up. This will clarify the current law on distributions by the producer board on wind up.

- The distribution to shareholders of the Raspberry Marketing Council and the four committees on their winding up will, for tax purposes, be treated for income tax purposes as a distribution by a company to its shareholders on winding up.

Background

The New Zealand Raspberry Marketing Council, the Raspberry Marketing Export Authority and the four district marketing committees are each to be dissolved. The Raspberry Marketing Regulations 1979 are to be revoked. Regulations will provide for the dissolution process.

QUALIFYING COMPANY ELECTION TAX ON AMALGAMATIONS

(Clause 11)

Summary of proposed amendment

The retained earnings of a non-qualifying company can be distributed tax-free if it amalgamates with a qualifying company. This is a deficiency in the law which creates opportunities for avoidance.

The proposed amendment will require qualifying company election tax (QCET) to be paid on the non-qualifying company's retained earnings if it amalgamates with a qualifying company and is subsumed by it.

Application date

The amendment applies from the day after the date of introduction of the bill.

Key features

Section HG 11 of the Income Tax Act 1994, which requires a non-qualifying company to pay QCET on its retained earnings if it becomes a qualifying company, is being extended. QCET will also be payable if a non-qualifying company amalgamates with a qualifying company and is subsumed by the qualifying company.

Background

Retained earnings that a company distributes directly to its shareholders are usually a dividend that is taxable in the shareholders' hands, subject to the availability of imputation credits. However, a qualifying company can distribute its retained earnings free of tax (even when imputation credits are not available).

A qualifying company is a company that is not a foreign company, is owned by five or fewer natural persons, and whose directors and shareholders have formally elected that the company become a qualifying company. Such companies are seen as analogous to partnerships, and the Income Tax Act allows them to be taxed in a manner similar to partnerships. A key objective is to allow shareholders tax-free access to capital gains made by the company without having to wind the company up.

A non-qualifying company can elect to become a qualifying company, and then make tax-free distributions to its shareholders, but it must first pay QCET. The tax acts as a proxy for the income tax that would be payable on the company's retained earnings if the company were wound up.

Currently, a non-qualifying company that amalgamates with a qualifying company, and is subsumed by it is not required to pay QCET. However, the qualifying company is then able to distribute the other company's retained earnings tax-free. The result is that the retained earnings of the other company can be distributed without any tax being paid at all.

This result was never intended and creates opportunities for avoidance.

CONSOLIDATED GROUP DIVIDEND WITHHOLDING PAYMENT ACCOUNT

(Clause 18)

Summary of proposed amendment

The amendment ensures that the anti-avoidance rules for inappropriate dividend withholding payment credit allocations also apply to consolidated groups.

Application date

The amendment applies to the 1999-2000 and subsequent imputation years.

Key features

A new section MG 16A of the Income Tax Act 1994 contains operative provisions to apply the anti-avoidance rules for inappropriate dividend withholding payment credit allocations to consolidated groups.

Background

When a company has a debit balance in its dividend withholding payment account at the end of an imputation year (meaning it has credited its shareholders with more dividend withholding payment credits than it has paid), a 10 percent penalty arises on that debit balance. The same principle should apply to a debit balance in a consolidated group's dividend withholding payment account.

At present, however, there is no provision in the Act to impose a penalty on a debit balance in a consolidated group's dividend withholding payment account. This means that a consolidated group could pay dividend withholding payment-credited dividends to its shareholders without paying any underlying tax, with no obligation to pay the underlying tax, and with no penalty for its action.

Inland Revenue could deny a credit to the shareholders under section LD 8(4) in such circumstances. However, this is not likely to be a very practicable exercise, particularly for non-resident shareholders. An amendment is being made, therefore, to ensure consolidated groups are sanctioned if they have a debit balance in their dividend withholding payment account at the end of an imputation year.

CONDUIT TAXATION

(Clauses 6-8, 13-17, 19-21, 25, 26(3) and 30-31)

Summary of proposed amendments

Extensive amendments are being made to integrate consolidated groups into the conduit tax rules. A number of remedial amendments are also being made, to address other deficiencies identified in the rules.

Application date

The amendments will be back-dated to the 1998-99 income year, the year for which the conduit tax rules first applied.

Key features

New sections MI 14 to MI 22 are being introduced into the Income Tax Act 1994. They will enable a consolidated group to maintain a conduit tax relief account. Consequential amendments are also being made to ensure the new rules interface correctly with other provisions in the Act affecting conduit taxation.

Amendments are also being made to address a number of remedial issues identified in a review of the conduit rules.

Background

The consolidated group rules, enacted in 1992, allow a wholly-owned group of companies to be treated as a single company for tax purposes. The rules simplify the tax calculations for corporate groups and allow them to improve their efficiency by rationalising large and complex structures.

Conduit tax reform was enacted in March 1998. Before the reform, New Zealand's controlled foreign company and foreign investment fund rules had the unintended effect of taxing income derived on behalf of non-residents from outside New Zealand, at 33 percent on an accrual basis. Conduit reform effectively switched off the New Zealand tax on this income. In doing this, a significant disincentive to conduit investment was removed. New Zealand does, however, continue to impose non-resident withholding tax of 15 percent on any distributions of conduit income to non-residents.

When conduit reform was enacted, it was not considered that there would be sufficient affected companies to justify introducing the extensive additional rules necessary if consolidated groups were to be fully integrated into the reform. This has not turned out to be the case, so it is desirable that consolidated groups be integrated into the conduit rules.

Detailed analysis

To effect the integration of consolidated groups into the conduit rules, new sections MI 14 to MI 22 are being inserted, and consequential amendments being made to sections ME 12, MG 14, MI 5 and OB 1 (definition of "conduit tax relief account company"). These amendments are broadly patterned on the existing rules for consolidated group dividend withholding payment accounts.

Amendments are also being made to address a number of conduit remedial issues that have been identified:

- An amendment to section FH 5 corrects a cross-reference error.
- Amendments to sections FH 7 and KH 1(2) address deficiencies in the formulas for determining respectively the amount of excessive interest expense allocated to New Zealand companies and the amount of conduit relief. If a company is able to offset branch equivalent tax account debits from another group member, the existing formulas inappropriately take that offset into account a number of times, even though it can be credited against an income tax liability only once.
- An amendment to section FH 8(5) ensures that an inadequate debit does not arise to a conduit tax relief account if excessive interest expense allocated to New Zealand is applied against a company's dividend withholding payment liability. When excessive interest is applied to that liability, some conduit relief previously given to the company is clawed back. The company's conduit tax relief account is debited to reflect this claw-back, but the rules do not currently debit a sufficient amount in some circumstances.
- Amendments to sections KH 1(1), NH 7(1) and OB 1 (definition of "conduit tax relief account company") ensure that when a company has ceased to be a conduit tax relief company, it will not be entitled to conduit relief on subsequent income tax and dividend withholding payment liabilities.
- Amendments to sections KH 2(2) and NH 7(3) allow a listed company to use any commercially justifiable date on which it determines its non-resident shareholders as a measurement date. New sections KH 2(2A) and NH 7(3A) are compliance cost saving measures which require 100 percent subsidiaries of listed companies to use the measurement date determined for their listed parent.
- An amendment to section MG 8(5) ensures that an allocation deficit debit does not arise for life insurance companies that have elected to use the conduit rules. These companies are prohibited by section MG 7(1) from transferring from their imputation credit account to their policyholder credit account, so any transfer from their dividend withholding payment account to their policyholder credit account would currently trigger an inappropriate allocation deficit debit.
- An amendment to section MI 2(4) effects the policy intent that companies electing into the conduit rules would continue to be subject to the rules in subsequent years, without having to make a subsequent election. New subsections (5A) and (6A) clarify the effective date for the revocation of an election, and tie-in with the amendments being made to sections KH 1(1) and NH 7(1).

- An amendment to section MI 5(2)(b) ensures that the descriptive term used for an entry in a conduit tax relief account is consistent with its description in subsection (1).
- An amendment to section NH 7(2)(b) addresses a drafting deficiency, which could otherwise result in a newly incorporated company inadvertently being denied conduit relief on foreign-sourced dividends derived in its first two years of operation.
- New section NH 7(2)(c) ensures that a newly incorporated company is not inadvertently denied conduit relief on foreign-sourced dividends derived in its first two years of operation.
- Amendments to section 29 of the Tax Administration Act 1994 correct terminology and insert a cross-reference to section 30A. An amendment to section 30A removes the need to include the amount of conduit tax relief credit on shareholder dividend statements.

The amendments to the conduit rules have retrospective effect to when the conduit rules came into force (the 1998-99 income year, 1998-99 imputation year, or dividends paid on or after 1 April 1998). Because the rules have only been in place for one year, it is cleaner to give the amendments retrospective effect than to address transitional effects that might otherwise arise. Retrospective application is also expected to favour taxpayers, as the amendments correct anomalies that are generally disadvantageous to them. For consolidated groups, in particular, retrospective application will ensure there is no confusion about how the conduit rules might otherwise apply to the group for the 1998-99 year.

JOINT BANK ACCOUNTS BETWEEN RESIDENTS AND NON-RESIDENTS

(Clause 24)

Summary of proposed amendment

The amendment removes doubt over whether a party paying interest on an account held jointly by residents and non-residents should deduct resident withholding tax or non-resident withholding tax.

Application date

The amendment will apply from the date of enactment.

Key feature

New section NG 1(2)(d) of the Income Tax Act 1994 excludes interest income from the definition of non-resident withholding income if it is from a bank account jointly held by a New Zealand resident.

Background

Interest payments made to New Zealand residents are required to have resident withholding tax deducted at a rate of 33 percent. Interest payments to non-residents are required to have non-resident withholding tax deducted instead, at a rate of 15 percent.

Under existing rules, there is doubt over what a payer should deduct from an interest payment made jointly to both a resident and a non-resident. This is because the payer often does not have sufficient information to determine the recipients' respective beneficial entitlements to the interest income.

The amendment removes doubt over the appropriate withholding rate by making interest payments made jointly to both a resident and a non-resident subject to resident withholding tax. This is achieved by removing such payments from the definition of "non-resident withholding income" in section NG 1.

If a non-resident is resident in a country with which New Zealand has a double taxation agreement, it is likely that the resident withholding tax deducted will exceed the maximum tax rate under the agreement (commonly 10 percent). In that case, the non-resident will need to apply to Inland Revenue for a refund of the difference between the 33 percent withholding tax rate and the maximum rate under the relevant agreement. In doing so, it would be necessary for the non-resident to establish the portion of the income to which it is beneficially entitled.

AVAILABLE SUBSCRIBED CAPITAL

(Clause 26(2))

Summary of proposed amendment

An amendment is being made to the definition of "available subscribed capital" to correct a deficiency in the definition. This deficiency can allow the tax-free conversion into available subscribed capital of reserves that are normally taxable on their distribution to shareholders. Therefore a further exclusion from "available subscribed capital" will be incorporated into the definition.

Application date

The amendment will apply from the date of introduction of the bill.

Key features

The amendment to section OB 1 of the Income Tax Act 1994 is designed to ensure that companies cannot make tax-free conversions into available subscribed capital reserves that would ordinarily be taxable when distributed to shareholders. "Available subscribed capital" will exclude consideration received by a company for the issue of its shares if that consideration is in the form of giving up or varying existing ownership rights or interests in the company. If available subscribed capital for those rights already exists it will be preserved.

Background

Available subscribed capital is the amount that a company could distribute to shareholders tax-free in a repurchase of the company's shares (if certain "bright line" tests have been met) or on its winding up. The concept of available subscribed capital is similar to the traditional company law concept of "paid up capital".

It is contrary to policy to allow reserves that are normally taxable when distributed to shareholders to become available subscribed capital without a tax cost.

CROWN ENTITIES AND THE ASSOCIATED PERSONS TESTS

(Clauses 27, 28, 42 and 45)

Summary of proposed amendments

The Income Tax Act 1994 contain several tests for determining whether parties to a transaction are associated persons. The concept of associated persons is intended to combat tax avoidance or tax minimisation in specific situations. It targets parties who are not necessarily dealing on an arm's length basis.

Although Crown entities always follow Government policy and treat each other on an arm's length basis, the tax laws do not fully preclude the associated persons test from applying to certain Crown entities. The amendment will ensure that these associated persons tests do not apply to the following special corporate entities that are owned by the Crown: state-owned enterprises, crown research institutes, hospital and health services, and crown health enterprises.

Application date

The amendment will have retrospective application back to 1992, except that a position taken in a tax return that has been filed before the bill was introduced may not be changed.

Key features

Sections in the Income Tax Act 1994 and the Income Tax Act 1976 are retrospectively amended.

In the 1994 Act, sections OD 7 and OD 8 define the associated persons tests. Amendments to sections OD 7 and OD 8 ensure that special corporate entities owned by the Crown are exempt from the ambit of the sections.

In the 1976 Act, sections 8, 67, 214E and 245B are amended so that associated persons tests do not apply to special corporate entities owned by the Crown.

These amendments merely confirm both Government's intention and existing practice.

Background

Several tests measure "association" under the various associated persons rules in sections OD 7 and OD 8.

Sections OD 3(3) and OD 4(3) ensure that the voting interest and market value interest tests cannot apply to cause special corporate entities owned by the Crown to be associated.

However, the “income interest” test and arguably the “control by any other means whatsoever” test could cause these entities to be incorrectly regarded as “associated”.

These amendments ensure that the associated persons tests are properly targeted insofar as they affect special corporate entities owned by the Crown. This confirms the Government’s policy of competitive neutrality between its entities.

CONFIRMATION OF ANNUAL INCOME TAX RATES FOR 1999-2000

(Clause 46)

The bill confirms the annual tax rates for the 1999-2000 income year. The rates are set out in Schedule 1 of the Income Tax Act 1994.

SCHEDULE OF RATES TO BE CONFIRMED – 1999-2000 INCOME YEAR

Policyholder Income	33 cents for every $1 of schedular taxable income
Maori Authorities	25 cents for every $1 of taxable income
Undistributed Rents, Royalties and Interest of the Maori Trustee	25 cents for every $1 of taxable income
Companies	33 cents for every $1 of taxable income
Trustee Income (including that of trustees of superannuation funds)	33 cents for every $1 of taxable income
Trustees of Group Investment Funds	33 cents for every $1 of schedular taxable income in respect of Category A income
Taxable Distributions from Non-Qualifying Trusts	45 cents for every $1 of taxable distribution
Other Taxpayers (including individuals)	Income not exceeding $38,000: 19.5 cents for every $1 of taxable income
	Income exceeding $38,000: 33 cents for every $1 of taxable income
Specified Superannuation Contribution Withholding tax	33 cents for every $1 of the contribution

Application date

The income tax rates will apply for the 1999-2000 income year.

GST - TREATMENT OF EXPORTED SERVICES

(Clauses 37 and 38)

Summary of proposed amendments

The main amendment will ensure that GST is charged on the supply of services that are physically performed in New Zealand but are contracted for with a non-resident who is outside New Zealand. The amendment aims to protect the integrity of the tax base by ensuring that domestic consumption of services is subject to GST, even though a non-resident may have purchased the services.

Other amendments clarify the application of the law in this area.

Application date

The amendments will come into force from the date of introduction of the bill.

Key features

The bill inserts new subsections 11(2A) and 11(2B) into the Goods and Services Tax Act 1985. The new subsection 11(2A) ensures that the supply of services physically performed in New Zealand but contracted for with a non-resident who is outside New Zealand is not zero-rated.

When it is reasonably foreseeable that supplies relate to the making of taxable or exempt supplies by New Zealand based recipients they are excluded from the new subsection 11(2A).

The new section 11(2B) will ensure that a presence in New Zealand of a non-resident that is unrelated to a supply of services, or that is minor, would not mean that a non-resident was no longer "outside New Zealand" for the purposes of section 11(2)(e) or 11(2)(fa).

In addition, new subsections 10(16A) and 10(17A) will apply for the purposes of the amendment if the right to receive the services is granted in exchange for a token, stamp or voucher. It will recognise the value of the supply as arising at the time the token, stamp or voucher is acquired, rather than at the time it is redeemed.

Examples of impact of amendments

A non-resident parent contracts with a New Zealand school to educate the parent's non-resident child in New Zealand. The education service is subject to GST at 12.5 percent as it is consumed in New Zealand.

A non-resident tour operator pre-purchases accommodation and transport in New Zealand from New Zealand suppliers and sells travel packages for tours of New Zealand to non-residents using this accommodation and transport. The New Zealand suppliers would charge GST at 12.5 percent on the supplies of accommodation and transport made to the non-resident tour operator, as those services will be consumed in New Zealand by the non-resident tourists.

A New Zealand law firm provides legal services relating to the take-over of a New Zealand company by a non-resident company. At the time these services are performed the non-resident company's managing director and several executives are in New Zealand on unrelated business. As their presence in New Zealand is not linked to the supply of the legal services, the non-resident company will be treated as being "outside New Zealand", and the provision of those services will be zero-rated under section 11(2)(e).

Background

In March 1999 the Government released the tax policy discussion document *GST: A Review*, which outlined proposals for changes to GST resulting from a review of the Goods and Services Tax Act 1985. One of the proposals in that discussion document was that the GST Act should be amended to exclude from zero-rating the supply of services that are physically performed in New Zealand but are contracted for with a non-resident who is outside New Zealand.

In these cases, the non-resident pays for the goods and services while offshore. However, the goods and services are not exported for offshore consumption by the non-resident. Rather, the services are consumed in New Zealand by another person. Examples of such services are education of non-resident students at New Zealand schools or universities and accommodation and other consumption in New Zealand by non-resident tourists.

The policy intent of GST is to tax this domestic consumption of services, even though a non-resident has purchased them. However, because of the 1995 Court of Appeal decision in *Wilson & Horton* v *Commissioner of Inland Revenue*, these services may be zero-rated.

The amendment ensures that when a contract for a service is made offshore but the service is performed for another person in New Zealand the supply is subject to GST at the standard rate.

When it is reasonably foreseeable that supplies relate to the making of taxable or exempt supplies by New Zealand-based recipients they are excluded from the amendment as such entities cannot claim input tax credits for the GST on the services acquired. The exclusion also means that the provision is directed more to those to whom it is intended to apply, private consumers.

A secondary, but related problem arises in determining when a company is "outside New Zealand". It is uncertain whether a presence in New Zealand that is unrelated to a supply of services, or that is minor, means that a non-resident is no longer "outside New Zealand" for the purposes of the proposed amendment. This uncertainty also arises with section 11(2)(fa), which zero-rates certain services in relation to intellectual property rights.

The amendment addresses this issue by ensuring that such an unrelated or minor presence does not disqualify the non-resident company from being outside New Zealand.

If the right to receive the services is granted in exchange for a token, stamp or voucher, problems could arise as to the recognition of the value of the service and whether, in effect, more than one supply occurs. For example, if the voucher had a face value, section 10(16) would apply and recognise the value when the token, stamp or voucher is redeemed for services. If the token, stamp or voucher did not have a face value, section 10(17) would apply, and would recognise the value when the right to receive the services is granted.

Amendments inserting new sections 10(16A) and 10(17A) will ensure that the normal time of supply rules in section 9 of the Act will apply, and clarify that there is only one supply for GST purposes – that at the time of acquisition, which will be accounted for at the earlier of receipt of an invoice or payment.

Remedial Issues

TRADING STOCK - EXCEPTED FINANCIAL ARRANGEMENTS

(Clause 4)

Summary of proposed amendment

The rule requiring companies transferring excepted financial arrangements that are trading stock or revenue account property within a wholly-owned group to transfer them at cost will apply only to companies that are New Zealand resident. The amendment corrects an oversight in the recently enacted trading stock legislation.

Application date

The amendment applies to the sale, disposal or distribution of excepted financial arrangements on and after the date the bill is introduced.

Key features

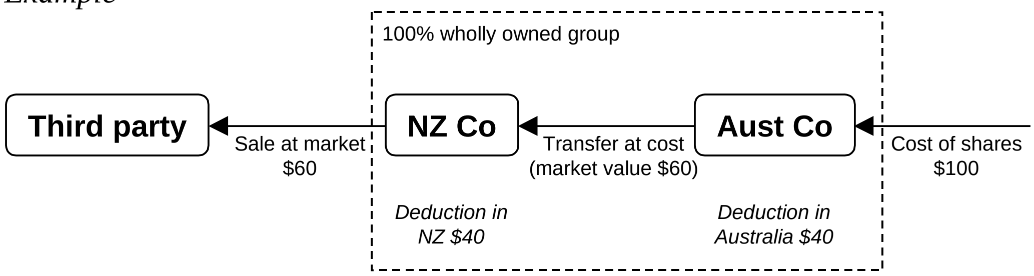
Section EE 14(2) of the Income Tax Act 1994 is being amended to restrict its application to New Zealand resident companies. If excepted financial arrangements are entering or leaving the New Zealand tax base, transactions should take place at market value.

Background

Under the new trading stock rules, excepted financial arrangements are to be valued at cost. To prevent wholly-owned groups of companies circumventing the rules by transferring excepted financial arrangements within a group, section EE 14 was enacted. The section states that if an excepted financial arrangement that has a market value less than cost is sold or disposed of within a wholly-owned group of companies, the transfer is deemed to take place at cost.

If a member of the group is a non-resident company, there is potential for a double deduction of a loss. The non-resident company can claim a loss overseas on a transfer of excepted financial arrangements to a New Zealand member of a group. The New Zealand resident member may also be able to deduct a loss once the excepted financial arrangements are transferred at market value outside the group.

Example



The amendment is intended to prevent potential losses being deducted twice.

TRADING STOCK - DEFINITION OF "FINANCIAL STATEMENTS"

(Clause 26(4))

Summary of proposed amendment

The definition of "financial statements" is being amended so that it applies to financial statements prepared by all taxpayers. The amendment corrects an unintended effect of the definition in the Financial Reporting Act 1993.

Application date

The amendment applies to the 1999-2000 and subsequent income years.

Key features

The definition of "financial statements" in section OB 1 of the Income Tax Act 1994 will be amended so that it applies to the financial statements of all taxpayers, not just entities as defined in the Financial Reporting Act 1993.

Background

The trading stock rules were intended in part to require taxpayers to comply at the same level for tax purposes with what had been done for financial reporting purposes. This was achieved by generally requiring taxpayers to adopt the same valuation methods that apply to financial statements. The definition of "financial statements" has the same meaning as in the Financial Reporting Act 1993. This definition is confined to an "entity", which is defined to mean a company or an issuer. Therefore others are not required to apply the same standards they apply to their financial statements. This effect was unintended, and is addressed by the amendment.

TRADING STOCK - "ASSOCIATED PERSONS"

(Clause 26(5))

Summary of proposed amendment

The associated persons rules which apply to determine whether a taxpayer is a "small taxpayer" are being amended. The amendment will associate taxpayers only when companies have at least 50 percent common ownership or a taxpayer has at least 50 percent ownership of a company. Narrowing the scope of the definition will make the trading stock rules more workable for small businesses.

Application date

The amendment applies from the 1998-99 and subsequent income years.

Key features

The amendment changes the associated persons test in the definition of "small taxpayer" in the Income Tax Act 1994 from section OD 7 to section OD 8(1)(a) and (b). Taxpayers will be associated only when companies have at least 50 percent common ownership, or a taxpayer has at least 50 percent ownership of a company.

Background

"Small taxpayers" have simplified requirements for the valuation of trading stock to reduce compliance costs. An associated persons test is used to aggregate the income of associated taxpayers to determine whether a taxpayer's business exceeds the $3,000,000 threshold allowed for small taxpayers. The associated persons test in section OD 7 of the Income Tax Act is currently used. The test is too wide as it includes relatives (to the fourth degree) and persons having a 25 percent interest in a company. Narrowing the definition will reduce compliance costs for taxpayers.

The application date is the same as the date from which the trading stock rules took effect. Using this application date prevents any potentially harsh applications of the rules to those small taxpayers who would be excluded from the definition of "small taxpayers" were the amendment not enacted.

(Clause 9)

Summary of proposed amendment

The amendment confirms that the transfer pricing rules do not apply to interest-free loans made to taxable New Zealand residents.

Application date

The amendment will apply retrospectively from the 1996-97 income year, the year for which the current transfer pricing rules first applied.

Key features

Section GD 13(5) of the Income Tax Act 1994 is being clarified to confirm that the transfer pricing rules do not apply to interest-free loans made to taxable New Zealand residents.

Background

The transfer pricing rules allow an arm's length price to be substituted for a taxpayer's transfer price, if the taxpayer's price has the effect of depleting the New Zealand tax base.

The transfer pricing rules were specifically designed not to apply to interest-free loans made to taxable New Zealand residents. Interest-free loans provide a cheap and economically beneficial source of capital to New Zealand. Further, applying transfer pricing rules to these loans would reduce the tax base, as the tax cost of the resulting deduction to the New Zealand resident would exceed any non-resident withholding tax collected.

It has been suggested, however, that the interface with the thin capitalisation rules could result in the transfer pricing rules applying to an interest-free loan. The argument is that if an arm's length amount of interest were to be substituted by section GD 13(4), the thin capitalisation rules could then apply to deny a deduction for the increased interest expense. In that case, the extra non-resident withholding tax revenue on the substituted interest amount would exceed the tax value of the increased interest deduction (nil), so the transfer pricing rules would be applied (technically, section GD 13(5) would not apply to preclude section GD 13(4) operating to substitute an alternative interest amount).

This was not the intended effect of the rules. A retrospective amendment is, therefore, being made to ensure the transfer pricing rules will not apply to these loans.

TAX SIMPLIFICATION

(Clauses 12, 22, 23, 32, 33, 35)

Summary of proposed amendments

Several minor amendments are being made to the recent tax simplification legislation. They ensure the effectiveness of the legislation by clarifying ambiguities and minor drafting omissions.

Application date

The changes will take effect from 1 April 1999, with two exceptions: the changes to family assistance will apply from 1 January 2000, and the clarification of the provision relating to the penalty for non-electronic filing will apply from enactment.

Key features

The main amendments involve:

- amending section NC 12A of the Income Tax Act 1994 to ensure that a tax code specified by Inland Revenue remains valid until the taxpayer's circumstances change;
- inserting a new section 36CA into the Tax Administration Act 1994 to provide for new employers to have six months to comply with the electronic filing requirements.

Background

Section NC 12A of the Income Tax Act 1994 gives the Commissioner of Inland Revenue authority to require an employer to change an employee's tax code if the employee is using an incorrect code. The new code ceases to apply from either the end of the income year or from a date specified by the Commissioner, and the employer reverts to the original incorrect code. Since the enactment of this legislation Inland Revenue systems have been developed that check the accuracy of tax codes every month. The automatic end-of-year expiry is, therefore, unnecessary and increases compliance and administrative costs without providing any benefits. Therefore section NC 12A will be amended so that corrected tax codes remain valid until an employee's circumstances change.

Employers who start up businesses after the electronic filing requirements came into force, on 1 April 1999, should have six months to comply with them. This would treat them consistently with existing employers required to file electronically because they have increased in size.

The other amendments serve to clarify ambiguities or to correct drafting errors and omissions. They include making consequential amendments to the family assistance legislation, correcting an incorrect tax code reference, clarifying the circumstances in which a taxpayer is liable for a non-electronic filing penalty and confirming that income statements are not to be issued to non-natural persons.

USE OF MONEY INTEREST ON FOREIGN INVESTOR TAX CREDITS

(Clause 34)

Summary of proposed amendment

An amendment affirms the policy intent that use of money interest calculations should not be adjusted to reflect foreign investor tax credits carried back and applied from future income years. The amendment corrects an omission in the compliance and penalties legislation.

Application date

The amendment will apply to foreign investor tax credits applied to the 1997-98 and subsequent income years.

Key features

A new section 120PA is being added to the Tax Administration Act 1994. It provides explicitly that foreign investor tax credits carried back and applied from future income years do not affect the interest calculations in the earlier income year.

Background

The foreign investor tax credit rules limit the New Zealand tax impost on non-residents' earnings from equity investment to 33 percent. The rules allow a company to pay supplementary dividends to its non-resident shareholders, based on company tax paid. The company is then entitled to apply a foreign investor tax credit for an equivalent amount against its income tax liability.

To ensure that companies are not placed at a significant cash flow disadvantage when funding a supplementary dividend, foreign investor tax credits are readily refundable through a carry-back rule, allowing credits to be applied against the four preceding income years. Because this rule is, however, merely a mechanism to allow a refund to be issued, and does not provide the Commissioner with the use of any funds in the earlier years, it is inappropriate for interest to be credited on any foreign investor tax credit refunded in this manner.

When the foreign investor tax credit rules were first enacted, use of money interest was expressly precluded for carried back credits. However, the recently enacted compliance and penalty rules inadvertently omitted a similar provision with effect from the 1997-98 income year. A retrospective amendment is being made, therefore, to correct this oversight.