Taxation (Accrual Rules and Other Remedial Matters) Bill

Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

17 March 1999

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The Accrual Rules

OVERVIEW OF SUBMISSIONS

Sixteen submissions were received on the reform and rewrite of the rules governing the taxation of financial arrangements. They were from:

Ernst & Young (1W)
IHC New Zealand Incorporated (2W)
Denham Martin & Associates (4W)
Toyota Finance New Zealand Limited (5W)
Tranz Rail Holdings Limited (6W)
W M Patterson (7)
Deloitte Touche Tohmatsu (9W)
Inter Church Working Party on Taxation (10)
KPMG (11W)
Institute of Chartered Accountants of New Zealand (ICANZ) (12)
New Zealand Law Society (13)
Simpson Grierson (14W)
PricewaterhouseCoopers (16W)
Royal New Zealand Foundation for the Blind (19W)
Presbyterian Support (Northern) (21W)
Arthur Andersen (22W)
Rudd Watts & Stone (23W)

Of these submissions five related solely to the tax consequences of debt forgiveness to a family trust. Officials recommend that the provisions that exclude income arising from the forgiveness of debt in family situations be more accurately defined. It is also proposed that this concession apply irrespective of whether a charity is a beneficiary of a family trust. The changes should address the concerns raised by these submitters.

ICANZ, the Law Society and Rudd Watts & Stone provided comprehensive submissions on a range of policy and drafting issues associated with the tax rules relating to financial arrangements. The remaining submissions were, by and large, issue specific.

There was no major criticism of any one aspect of the new accrual rules.

Where there are a number of different submissions on the same topic the submissions appear as a group. Minor drafting changes are set out at the end of this section.

DEBT FORGIVENESS AND FAMILY ARRANGEMENTS

Issue: Scope of "natural love and affection" exception

Clause 21 Section EH 49

Submission
(2W - Hanning Connor (on behalf of its client IHC New Zealand Incorporated) (IHC); 10 - Inter Church Working Party on Taxation (ICWPT); 19W – BDO Chartered Accountants (on behalf of its client the Royal New Zealand Foundation for the Blind) (RNZFB); 21W - Presbyterian Support (Northern) (PS))

The proposed section EH 49 should be amended to clarify that a family trust that includes a charity as a beneficiary is not automatically outside the ambit of the "natural love and affection" exception.

Comment

The proposed section EH 49 will apply only in a trust situation if the creditor has "natural love and affection" for the beneficiaries of the trust. The provision does not specify whether the "natural love and affection" must exist between all, most or only some of the trust's beneficiaries.

The lack of detail in this area results in uncertainty for a trust that includes a charity as a beneficiary. This is because it is unclear whether a person can have "natural love and affection" for a charity. Thus, if the correct interpretation of the provision requires "natural love and affection" to exist for **all** of the trust's beneficiaries, and a charity is included as a beneficiary, it is unclear whether the trust will qualify under the exemption. Indeed, a draft Inland Revenue public ruling (PU0009) suggests that the ambit of the current exemption (section EH 4(6)) does not include trusts that include a charity as a primary beneficiary.

All the submitters share the concern that the lack of clarity in this area will result in a significant disincentive for people to include charities as beneficiaries of family trusts. This, it is argued, will lead to charities receiving less money from donations and gifts.

The "natural love and affection" exception is aimed at distributions that are genuine gifts. Debt forgiven to trusts that have charities as beneficiaries is as much a gift as debt forgiven to trusts that have family beneficiaries. Furthermore, charities are tax-exempt.

Therefore it is recommended that the general submission be accepted. However, the submitters suggest different approaches for achieving this aim in the legislation.

ICWPT and RNZFB suggest that the legislation clarify that a creditor can have "natural love and affection" for a charity. Indeed, RNZFB maintains that a creditor can name a charity as a beneficiary because of the “natural love and affection” that the creditor has “…for the group of people that the organisation cares for or for the cause [the organisation] supports”.

The problem with this approach is that it is the charitable organisation itself rather than the cause that is named in the trust deed. Thus, while it may be argued that a person can have “natural love and affection” for the cause, it is difficult to maintain that a person can have “natural love and affection” for the organisation itself.

Thus officials consider that, instead of deeming “natural love and affection” to exist for a charity, it is preferable to clarify that the inclusion of a charity as a beneficiary is an exception to the general rule that the creditor must have “natural love and affection” for the beneficiaries of the trust. (This is also the approach suggested by IHC and PS.)

RNZFB go on to suggest that the exception be extended to include not only charities but also non-profit bodies and organisations entitled to a rebate under section KC 5 (rebate in respect of gifts of money). During consultation ICANZ also expressed the view that the proposed exception for charities should be extended to include non-profit bodies.

However, officials consider that the exception should be limited to organisations and trusts carried on for “charitable purposes”. This limitation will ensure not only that the named beneficiary is an organisation or trust that is not carried on to benefit private individuals, but also that it exists for the benefit of an appreciably large section of the community. This public benefit requirement will ensure that settlors cannot receive a private advantage by naming a particular organisation in the trust deed.

Therefore it is proposed that section EH 49 be amended to make an exception for trusts that name charities as beneficiaries. In other words, the fact that a trust includes a charity as a beneficiary would not, in itself, be sufficient to deny the trust the benefit of the exemption.

Recommendation

Officials consider that the general recommendation of submitters be accepted. That is, the legislation should clarify that the fact that a trust includes a charity as a beneficiary would not, in itself, be sufficient to deny the trust the benefit of the “natural love and affection” exemption. However, the recommendation of RNZFB and ICANZ that the exception be extended to include non-profit bodies and (in the case of RNZFB) organisations entitled to a rebate under section KC 5 should be declined.

***Clause 21		Section EH 49***

Submissions

(4W - Denham Martin and Associates (DM); 7 - W M Patterson; 12 - ICANZ; 13 - New Zealand Law Society (NZLS))

The concern that the proposed section EH 49 does not clarify those family trusts that are within the ambit of the exemption. While submitters suggest various solutions, they all request legislative clarification of this rule.

Comment

As the proposed section EH 49 is currently worded, it will apply if the creditor of a trust forgives a debt to the trust because of the "natural love and affection" that the creditor has for the "beneficiaries of the trust". The submitters consider that it is arguable that the use of the words "beneficiaries of the trust" will require the creditor to have "natural love and affection" not only for all specified beneficiaries but also all future beneficiaries that may be added either by a power of appointment or the exercise of a discretion. Given that virtually all current trusts have either a specific or statutory power of appointment, the submitters argue that the proposed section EH 49 potentially removes most current family trusts from the ambit of the exemption.

The policy underlying the exemption is to remove proximate family arrangements from the ambit of the debt forgiveness rules. While officials agree that the proposed section EH 49 requires clarification, the problem in this area is to draft a rule that, in all the different situations that can arise, correctly distinguishes between proximate family and commercial arrangements.

Solutions suggested by submitters

NZLS suggests that the provision could be clarified by allowing a trust to take advantage of the exemption provided that the creditor forgives the debt because of the "natural love and affection" that the creditor has "for one or more of the beneficiaries of the trust".

Officials consider that this proposal does not correctly distinguish between proximate family and commercial arrangements. That is, it is conceivable that an exemption drafted in this way could include within its ambit a trust the primary focus of which was commercial.

Both ICANZ and DM suggest that the exemption should apply provided that, at the time the forgiveness is effected, the creditor has "natural love and affection" for the "primary beneficiaries" of the trust. DM considers that the "primary beneficiaries" of a trust would be determined by reference to criteria such as past distributions. In addition, DM suggests that the provision should clarify that a trust that includes a company as a "primary beneficiary" should not be able to take advantage of the exemption.

Officials are of the view that the suggested "primary beneficiary" test will not bring the required certainty to this area. That is, it will always be arguable whether or not a beneficiary is a "primary beneficiary".

Officials agree, however, that the provision should clarify that a trust that names a company as a beneficiary should not qualify under the exemption. While settlors may have "natural love and affection" for a company's shareholders, they cannot have "natural love and affection" for the company itself, which is a separate legal entity distinct from its shareholders.

DM offers an alternative solution that would include "debts owed in infra family circumstances, including debts owed by family trusts" within the definition of "excepted financial arrangement" and thereby outside the scope of the accrual rules.

The problem that officials see with this approach is that it does not address the issue of what is meant by either "infra family circumstances" or "family trust". Indeed, as discussed above, the challenge in this area is to draft a rule that, in all the different situations that can arise, correctly distinguishes between a proximate family and a commercial arrangement.

Mr Patterson considers that the lack of clarity in this area arises not only from the scope of the words "beneficiaries of the trust" but also from the use of the term "natural love and affection", which he considers imprecise and incapable of definition. He suggests that all remission of debt by a natural person that is, in effect, a gift should be subject to gift duty under the Estate and Gift Duties Act 1968 rather than income tax under the accrual rules. According to the proposed definition of "gift"[1] it would not matter whether the recipient of the benefit was a natural person, a trust or a company. This, he suggests, would remove the need for the "natural love and affection" exception.

Officials consider that this approach would undermine the policy underlying both the debt remission rules and, indeed, the accrual rules. An amount forgiven under a debt, being an economic gain to the debtor, should be treated as income. Any deviation from this principle should take the form of a narrow exception aimed at genuine non-

[1] "…a release by a natural person of a debt owed to that natural person by another person or trust with intent thereby to diminish the value of his own estate and to increase the value of the assets of that other person or trust".

commercial situations. The proposed definition of "gift" would include commercial transfers as well as gifts within families and, therefore, represents a significant deviation from this principle.

"Natural love and affection" is a term used in deeds and other legal documents to denote the motive for a gift arising from a relationship. Although it is accepted that the term is incapable of precise definition, it is a phrase that is sufficiently flexible to distinguish appropriately between proximate family and commercial arrangements as society changes and develops. It is envisaged that its meaning in specific circumstances will be clarified both by case law and Inland Revenue rulings.

Proposed solution

Officials agree with the general theme of the submissions and accept that the proposed section EH 49 should clarify those trusts that are within the ambit of the exemption. It is considered that the main problem with the provision as it is currently drafted is that the scope of the phrase "beneficiaries of the trust" is unclear.

Officials agree that this creates uncertainty for:

- trusts where the trustee has the power to appoint beneficiaries for whom the settlor does not have "natural love and affection";

- discretionary trusts with a class of discretionary beneficiaries amongst whom there is an entity for whom the settlor could not have natural love and affection; and

- trusts that name a charity as beneficiary.

The solution officials propose is that the amended section EH 49 should require "natural love and affection" to exist between the settlor and **all** of the trust's specified beneficiaries.

Power of appointment

The rule would also provide that the fact that a trustee had the power to appoint beneficiaries (under the trust deed or the general law) for whom the creditor did not have "natural love and affection" would not, in itself, mean that the trust could not take advantage of the exception. However the trust would cease to qualify under the exemption at the point at which a trustee exercised the power of appointment and appointed a beneficiary for whom the creditor did not have "natural love and affection".

Discretionary trusts

This rule would apply in the same way to a discretionary trust. That is, the trust would cease to qualify under the exemption at the point at which the trustees specify a discretionary beneficiary for whom the creditor did not have "natural love and affection".

Ordering rule

At the point at which a beneficiary for whom the creditor did not have natural love and affection was specified the trust would be taxed on future debt forgiveness. Under this scenario the trust would also be taxed on the aggregate of past debt forgiveness to the extent that it had not already been distributed to beneficiaries. This is necessary in order to counter a situation whereby a beneficiary for whom the creditor does not have "natural love and affection" (such as a company) is appointed after the debt forgiveness programme is complete and receives the benefit of an asset created from tax-free debt forgiveness.

There would also need to be a mechanism to determine whether the amounts that the trust has received from debt forgiveness are still contained in its funds and assets. This is because the trust may have already made a number of distributions to its beneficiaries, and the trustee could argue that these distributions have been made from amounts of forgiven debt. Officials, therefore, propose a rule that deems the order in which past distributions to beneficiaries are made. The rule would provide that, when the beneficiary is specified or appointed, all past distributions are deemed to be made: first, out of funds and assets other than debt forgiveness; and second, out of amounts received from debt forgiveness.

Charities

For the reasons outlined on pages 5-6 officials consider that a trust should not fail to qualify for the exemption because it specifies a charity as a beneficiary.

Companies

For the reasons outlined above officials consider that the provision should clarify that a trust cannot take advantage of the exemption if it specifies a company as one of the trust's beneficiaries.

Consultation

Officials have consulted with ICANZ and NZLS on this approach.

ICANZ support the solution proposed by officials with the exception that, in its view, the exception for charities should be extended to non-profit bodies (discussed on page 6).

NZLS considered that officials should give some thought to a solution based on a $27,000 exemption for remission income received by any entity, whether or not "natural love and affection" exists between the creditor and the debtor. This is similar in substance to Mr Patterson's submission and, for the same reasons outlined above, officials do not favour its adoption.

NZLS were also concerned that the solution proposed did not attempt to clarify the meaning of "natural love and affection". Officials accepted that this was a concern but explained that it would be practically impossible to define accurately all the situations where "natural love and affection" can exist.

On the specifics of the proposed rule, NZLS gave its qualified support to the approach taken by officials. However, NZLS did express concern that the proposed ordering rule may give rise to compliance costs.

In addition, NZLS considered that the trigger for a trust failing to qualify under the exemption should be the point at which the beneficiary for whom the settlor does not have "natural love and affection" received a distribution rather than the point at which the beneficiary was named. Officials do not consider that this proposal should be accepted because it could result in a timing advantage to some taxpayers and, therefore, a loss of revenue for the Government. This would occur in a situation where a settlor forgave debt to a commercial trust and that trust made no distributions for a number of years. While the trust would be taxed on the aggregate of past debt forgiveness when it eventually made a distribution, the amount would not take account of the time that the trust has had the advantage of the non-taxed remission income.

Officials and NZLS recommend that NZLS should be involved in the final drafting of the proposed rule.

Recommendation

That the general submission be accepted so that the provision clarifies those family trusts that are within the ambit of the debt forgiveness exception.

Clause 21 Section EH 49

Submissions
(*12 - ICANZ; 13 - New Zealand Law Society (NZLS)*)

The proposed section EH 49 should be extended to Division 1 financial arrangements.

Comment

The Taxation (Accrual Rules and Other Remedial Matters) Act 1998 will introduce a new set of accrual rules (Division 2) into the Income Tax Act. The Division 2 rules will apply to financial arrangements entered into on or after the Act receives Royal assent.[2]

The proposed section EH 49 clarifies the scope of the exception for debt forgiven out of "natural love and affection" and is contained in Division 2. It confirms that the exemption is available to a trust provided that the creditor has "natural love and affection" for the beneficiaries of the trust. After considering a number of submissions officials have recommended that this rule be further amended so that it clarifies how it applies to trusts where the trustee has the power to appoint, discretionary trusts, and trusts that include a charity as a beneficiary. Given its placement in Division 2, the new rule (as currently drafted) will not apply to existing (Division 1) debt forgiveness programmes.

However, if the new rule applies only to Division 2 financial arrangements it will mean that a trustee wanting to take advantage of its added certainty will be required to make an election under the proposed section EH 14 and apply the Division 2 rules to all its financial arrangements. Under the proposed section EH 14(5) this would require the calculation of a transitional adjustment for all the trustee's financial arrangements.

ICANZ argues that this will put an unnecessary burden on a large number of smaller less sophisticated taxpayers. Officials agree with this submission.

Therefore, it is considered that the new rule should also apply to trusts that forgive an amount owing under an existing financial arrangement on or after the date upon which the Act receives Royal assent.

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[2] Clause 21, proposed section EH 16

Recommendation

That the new debt forgiveness exception apply to creditors that forgive an amount owing under an existing financial arrangement on or after the date upon which the Act receives Royal assent.

OTHER POLICY ISSUES

EXCEPTED FINANCIAL ARRANGEMENTS

Issue: Application date for the excepted financial arrangement exclusion for "hire purchase agreement for livestock or bloodstock"

Clauses 20 and 108 Section EH 11

Submission
(Matter raised by officials)

The exclusion from the accrual rules of hire purchases of livestock or bloodstock should be backdated to 1 April 1993.

Comment

Hire purchase agreements entered into after 1 April 1993 are subject to the accrual rules. However, it is clear from the definition of "hire purchase agreement" and section FC 9 that hire purchase agreements of bloodstock or livestock were to remain outside the scope of the accrual rules. This is consistent with the treatment of leases of bloodstock or livestock under the specified lease and the finance lease rules.

The bill inserts in the definition of "excepted financial arrangement" in Division 2 an exclusion for "hire purchase agreement for livestock or bloodstock".

An amendment should be made to the definition of "excepted financial arrangement" in Division 1 to exclude "hire purchase agreements for livestock or bloodstock" from the accrual rules. The amendment should apply from 1 April 1993 (the date hire purchase agreements were removed from the "excepted financial arrangement" definition), unless a taxpayer has treated the hire purchase as a financial arrangement in a return of income already filed.

Recommendation

That the submission be accepted.

Issue: Election for new Division 1 excepted financial arrangements

Clause 20 Section EH 11(1) "excepted financial arrangement"

Submission
(12 – ICANZ)

Taxpayers should be able to elect that Division 1 financial arrangements entered into before enactment of this bill that are added to the list of excepted financial arrangements can continue to be treated as financial arrangements.

Comment

Certain additions to the list of excepted financial arrangements will apply from 1986, when the accrual rules came into effect, unless a taxpayer has taken a contrary position in tax returns already filed. The additions to the list are:

- an interest-free loan repayable on demand and denominated in New Zealand dollars;
- an employment contract;
- an interest in a group investment fund;
- an interest in a partnership or joint venture;
- travellers' cheques; and
- a warranty for goods or services.

The additions to the list were made retrospective because many of these arrangements were not intended to be accounted for under the accrual rules.

However, if taxpayers have entered into transactions between the date the last return of income was filed and prior to enactment of this legislation on the basis that the accrual rules apply it is fair to allow the parties to account for the transaction under the accrual rules. This ensures that business decisions are not compromised by the change.

Recommendation

That the submission be accepted.

Issue: Election to treat classes of excepted financial arrangements as financial arrangements

Clause 21 Sections EH 21 and EH 22

Submission
(12 - ICANZ)

Taxpayers should be entitled to treat classes of "listed" excepted financial arrangements as financial arrangements.

Comment

Section EH 21(1)(b), (p), (q), (t) and (u) exclude small prepayments, short-term agreements for the sale and purchase of property or services, short-term options, travellers' cheques and small variable principal debt instruments, respectively, from the accrual rules. These exclusions are provided for compliance cost reasons. A person holding only these financial instruments need not apply the accrual rules.

However, there are circumstances under which the exclusion may, in practice, impose high compliance costs on taxpayers. This is the case where a person has other similar types of financial instruments that are subject to the accrual rules. For example, where a person has to apply the accrual rules for some agreements for the sale and purchase of property or services, the requirement to isolate agreements with small amounts of prepayments could impose additional compliance costs.

To cater for this situation the bill allows a person to elect to treat all excepted financial arrangements under section EH 21(1)(b), (p), (q), (t) or (u) as financial arrangements.

The submission requests that taxpayers have the option to treat a class of excepted financial arrangements as financial arrangements. This would enable taxpayers to treat different classes of the same type of excepted financial arrangement differently - whether on the basis of currency, term or both. For example, taxpayers could elect to treat travellers' cheques denominated in US dollars as a financial arrangement, and those in other currencies as an excepted financial arrangement. This classification would be inconsistent with the policy objective of reducing compliance costs.

Taxpayers might also engage in tax minimisation behaviour by electing to apply accrual rules to certain classes of excepted financial arrangements to their advantage.

Recommendation

That the submission be declined.

Issue: Guarantees and definition of excepted financial arrangement

Clause 21 Section EH 21

Submission
(12 - ICANZ)

An additional excepted financial arrangement should be included in the definition of excepted financial arrangement to relieve a guarantee for private and domestic purposes.

Comment

ICANZ propose that a guarantee of an excepted financial arrangement also be an excepted financial arrangement.

The bill does not introduce any policy changes in relation to guarantees or security arrangements. Policy work is continuing in this area to determine the best method of accounting for such arrangements. This submission would best be considered as part of that project.

Recommendation

That the submission be declined.

Issue: Revocation of election to treat excepted financial arrangements as financial arrangements

Clause 21 Section EH 22

Submission
(12 - ICANZ)

A new subsection should be added to section EH 22 which permits a person who has made an election to treat an excepted financial arrangement as a financial arrangement to revoke that election.

Comment

Under Division 1 a person can revoke an election to treat a short-term trade credit as a financial arrangement. The right to revoke elections has not been reflected in the Division 2 legislation.

An ability to revoke elections should be available to cater for changing business or accounting practice.

Recommendation

That the submission be accepted.

Issue: Excepted financial arrangements that are used for private or domestic purposes

Clause 21

Submission
(12 - ICANZ)

A new subsection should be added to the accrual rules so that no income or expenditure should arise under the Income Tax Act if a taxpayer uses an excepted financial arrangement for private or domestic purposes.

Comment

A number of financial arrangements that were previously within the ambit of the rules are now to be treated as excepted financial arrangements for example, travellers' cheques, foreign currency loans by cash basis persons for private and domestic purposes. These arrangements have been excluded from the accrual rules as they impose heavy compliance costs, for example, in record keeping and applying the accrual methods.

The arrangements were not excluded on the basis of whether or not income or expenditure should be deductible or assessable. This is a much wider issue. The intention is that the non-accrual provisions applying to income and expenditure will also apply to excepted financial arrangements. The Income Tax Act already has restrictions in deductions for expenditure or loss to the extent that it is of a private or domestic nature. Whether or not a gain constitutes income should be determined using the rules set down in case law over many years or by consideration of the specific items to be included in gross income set out in Part C of the Act.

Recommendation

That the submission be declined.

Issue: Partial assignments and defeasances of financial arrangements

Clause 21 Section EH 19(2)

Submission
(12 – ICANZ, 23W – Rudd Watts & Stone)

Apportionment should be contemplated under section EH 19(2) to prevent the whole financial arrangement becoming excluded as a result of a partial transfer of rights and obligations under a financial arrangement. (ICANZ)

Section EH 19(2) can be read to provide that a financial arrangement which under its terms contemplates from day 1 that certain rights will be disposed of absolutely will not be a financial arrangement. (Rudd Watts & Stone)

Comment

The submissions indicate that section EH 19(2) can be interpreted in different ways. Officials suggest the legislation be clarified to more accurately reflect its purpose.

The provision contemplates a situation where there are two arrangements. The first is a financial arrangement or an excepted financial arrangement and the other is the assignment or defeasance that transfers some or all of the rights or obligations to a third party.

The intended effect of the provision is to ensure the person disposing of the rights or obligations should not, as a result of entering into the arrangement to transfer those rights or obligations, become a party to a new financial arrangement.

The submissions suggest that in some cases where there is a partial transfer of rights or obligations or where the assignment is contemplated at the outset of the arrangement the new rules will exclude the underlying financial arrangement from the accrual rules. The ICANZ submission gives an example of a bond issue under which a person assigns the coupon payment rights while retaining the principle repayment rights. In this case, the submission suggests the whole "arrangement" is excluded from the accrual rules.

This is not the intention of the legislation and could result in financial arrangements that should be within the accrual rules being excluded.

With a partial transfer, the underlying transaction should still be subject to the accrual rules. The accrual method used may be the yield to maturity method or, if this cannot be applied because the consideration has been varied, a method prescribed by the Commissioner of Inland Revenue. In this case the relevant determination is *Determination G25: Variations in the Terms of a Financial Arrangement*.

Recommendation

That the submissions be declined, but the provision be drafted more clearly to better reflect the policy intent.

Issue: Assignments and defeasances with deferred consideration

Clause 21 Section EH 19

Submission
(Matter raised by officials)

An absolute assignment or legal defeasance with deferred settlement should not be excluded from creating a financial arrangement. There should be a provision to capture the deferred settlement part within the accrual rules.

Comment

Arrangements that transfer rights to income or obligations under a debt but allow the consideration to be deferred may contain a time value of money component. Such arrangements should be subject to the accrual rules.

Absolute assignments with deferred settlement

An absolute assignment is an arrangement where the assignor has completely transferred all of its rights in relation to the underlying financial arrangement. For an assignment to be absolute, the entire interest of the assignor and the income transferred has to be completely and unconditionally under the control of the assignee.

The submission contemplates an assignment where the assignor assigns an income stream to the assignee but the assignee does not settle immediately. An assignment with a deferred settlement is unlikely to be unconditional until the assignor has received the full settlement for the assignment. This type of arrangement, therefore, may not qualify as an absolute assignment. It should be made clear.

Legal defeasance

Under the bill, a legal defeasance is defined as a defeasance in which the release of a party to the financial arrangement from the primary obligation of the financial arrangement is either –

(a) acknowledged formally by the creditor; or

(b) acknowledged formally by a duly appointed trustee or agent of the creditor; or

(c) established by legal judgement.

Under the proposed definition a legal defeasance need not be settled immediately so long as the original creditor acknowledges that the debt has been transferred. For example, the original debtor (the defeasor) could enter into a defeasance agreement with a counterparty to defease the debtor's obligations but the agreement may provide for a settlement of the defeasance agreement at a later date. If the creditor duly acknowledges the release of the debtor (defeasor) from obligations under the original debt, the defeasance becomes a legal defeasance.

This type of arrangement, while qualifying as a legal defeasance, does in fact create a financial arrangement. A defeasance arrangement with deferred settlement possesses all the characteristics of a financial arrangement as set out in the proposed definition of financial arrangement (see section EH 19) and should be treated as such.

Recommendation

That the legislation be amended to ensure that assignments or defeasances where settlement is deferred are subject to the accrual rules for both parties to the agreement.

Issue: Exemption from performing a base price adjustment where there is an absolute assignment

Clause 21 Section EH 43(3)

Submission

(22W – Arthur Andersen)

For certainty it would be desirable to have a provision exempting a person who has an obligation to pay amounts under a financial arrangement that has been absolutely assigned from calculating a base price adjustment.

Comment

The bill treats the creditor in a defeasance situation as a party to a continuing arrangement. The approach accords with the substance of the transaction because, from the creditor's point of view, the only change is in the party making the payments.

A specific provision is necessary because legal defeasances are executed by way of novation. Under a novation the original arrangement between a debtor and a creditor is extinguished and a new arrangement entered into. The agreement of all three parties to the arrangement is necessary.

Assignments of income, on the other hand, are not normally entered into by way of novation. A parallel provision to that applying to defeasances is not, therefore, required.

Recommendation

That the submission be declined.

Issue: Exemption for original creditor to perform a base price adjustment when the debt is legally defeased by the debtor

Clause 21 Section EH 43(3)

Submission 1
(Matter raised by officials)

The original creditor to a debt should be exempt from calculating a base price adjustment only when a debt is transferred by defeasance if the terms of the new arrangement are substantially similar to the terms of the arrangement defeased.

Comment

Section EH 43(3) provides that the original creditor of a debt which has been legally defeased does not perform a base price adjustment at the time the original creditor acknowledges that the debtor has been released from the obligations under the original arrangement. This is because the original creditor, while providing the necessary acknowledgement to release the debtor from the obligations, may not be an active party to the legal defeasance arrangement. It assumes that the creditor's right to income are not amended materially.

Under a legal defeasance the creditor will remain entitled to the consideration under the same terms as provided by the original arrangement but payment is from the defeasance counterparty. Section EH 43(3) is needed to ensure that the creditor's position is not affected by the action of the debtor who has legally defeased a debt.

The definition of legal defeasance does not preclude the creditor having a significant involvement in the defeasance arrangement. At law, a legal defeasance by the debtor creates a new financial arrangement for the creditor. For tax purposes, if the creditor is an active participant in the process and the only modification to the terms, other than the party responsible for meeting the obligations, of the new arrangement is a change to the party responsible for meeting the obligation, then the base price adjustment should apply.

Recommendation

That section EH 43(3) apply if the only change, as a result of a defeasance, is to the party obliged to repay the debt.

Submission 2
(Matter raised by officials)

Section EH 43(3) provides that the original party to an arrangement which is defeased does not do a base price adjustment at the time of the defeasance. The party will still perform a base price adjustment eventually but it is unclear what the consideration to be taken into account in that base price adjustment should be.

Comment

Section EH 43(3), while ensuring that the creditor does not perform a base price adjustment at the time a debt has been legally defeased by the debtor, does not go far enough. At law, the effect of a defeasance is to bring the debt between the parties to an end. It is replaced by a new debt. The legislation, however, for the reasons stated above, says that no base price adjustment is required for the defeased debt, as the creditor's involvement in the legal defeasance is a passive one. Nevertheless, the original arrangement has ceased to exist.

Therefore a provision that states that the creditor must continue to account for the original debt as if it had not been defeased is required. In addition, the legislation must ensure that the creditor takes into account all the consideration under the arrangements when the base price adjustment is eventually calculated.

Recommendation

That section EH 43(3) be amended to ensure that when the creditor does a base price adjustment of a debt that has been legally defeased, the debt is treated as if the defeasance had not occurred and the cashflows under both the original and new debt are included in the base price adjustment.

Issue: Application date for rules associated with assignments and defeasances

Clauses 20 and 21

Submission
(22W - Arthur Andersen; 23W – Rudd Watts & Stone)

The proposed treatment for Division 2 financial arrangements regarding the consequences of legal defeasances and absolute assignments should apply to Division 1 financial arrangements if the assignment or defeasance occurs after the date of Royal assent. (Arthur Andersen)

Holders of financial arrangements should not have to perform a base price adjustment on the legal defeasance of a Division 1 financial arrangement. (Rudd Watts & Stone)

Comment

The application dates associated with the accrual rules are intended to give flexibility to taxpayers.

The “new” accrual rules as set out in Division 2 apply to arrangements entered into on or after the date this bill receives the Royal assent. The general application date is therefore determined by the date of entry into an arrangement. The rule is prospective so that arrangements entered into on the basis of the existing provisions are not disturbed. Taxpayers do, however, have the option of moving all financial arrangements onto the new rules if they perform a transitional calculation under section EH 14.

The submissions request that all or some of the rules in Division 2 relating to assignments and defeasances also apply to Division 1 financial arrangements. One reason given is that there is no policy reason for this not to occur. The other reason is that the debt parking anti-avoidance provision is applied on this basis and therefore the generally pro-taxpayer defeasance rules should be similarly applied.

These reasons are not compelling. First, taxpayers can use the rules set out in Division 2 if they choose to make a transitional adjustment for all financial arrangements. This will mean that there is a trade-off between any compliance costs associated with the transition and the tax costs or benefits associated with applying the new rules generally.

Second, the debt parking rules are an exception to the general application provision. Other changes to legislation in Division 2, some of which may have unfavourable effects on taxpayers, will not apply to transactions already entered into.

Third, the amendments for assignments and defeasances are linked with other key aspects of Division 2, in particular the definition of financial arrangement and the base price adjustment. Enabling the rules to apply to Division 1 arrangements without also amending related sections may be impractical.

Recommendation

That the submission be declined.

Issue: Bad debts occurring between associated parties

Clauses 20 and 21 Sections EH 5 and EH 51

Submission
(13 - New Zealand Law Society)

A lender whose loan to an associated person goes bad should be entitled to a deduction if either:

- the bad debt loss is deductible on ordinary capital/revenue principles; or
- at the time the associated person has assessable income as a result of debt remission.

Comment

The review of the accrual rules did not specifically address issues associated with the treatment of bad debts arising from financial arrangements. Bad debt deductions were recently reviewed. The Income Tax Amendment Act (No 3) 1993 confirmed that the accrual rules operate as a code for deduction of bad debts arising from financial arrangements and confirmed that deductions between associates were inappropriate.

The prohibition against the deduction of associated person bad debts was part of the accrual rules when they were first enacted. At that time it was considered that the non-arm’s length relationship between the borrower and the lender could create avoidance opportunities if bad debt deductions were permitted.

In 1992, the Valabh Committee recommended that the accrual rules be modified to allow persons in the business of lending money deductions for losses of principal in respect of loans to associated persons. The Government did not accept the proposals of the Valabh Committee that the accrual rules be modified because:

- It would make it easier for business lenders to capitalise their subsidiaries with debt instead of equity, thereby allowing any losses from the investment to be deductible while gains would not be included in income.
- The common law test as to whether a loan that goes bad was on revenue account (that is, a bad debt deduction would be allowed) or on capital account (that is, no bad debt deduction would be allowed) is difficult to apply in practice.

- A change could also provide scope for taxpayers to claim double deductions.

Recommendation

That the submission be declined.

Issue: Allowable deductions – bad debts

Clauses 20 and 21 Sections EH 5 and EH 51

Submission
(12 - ICANZ)

The reference to "the person" in section EH 5(2)(a) should be removed as it inappropriately restricts bad debt deductions in certain circumstances.

Comment

The effect of this submission would be to allow a recipient of a financial arrangement to claim a deduction for a bad debt where the income from the financial arrangement was accrued by an earlier holder. This would apply in particular to a financial arrangement held by an executor or administrator of a deceased estate.

The provisions in this bill treat a financial arrangement as being transferred on the date of death of a party to a financial arrangement and on distribution of a financial arrangement to a beneficiary under a will.

Crystallisation of tax at death recognises that there has been a real transfer of ownership from a deceased taxpayer to the estate. The transfer ensures that any gain or loss associated with the financial arrangement is calculated from the market price at the time of transfer, not the original cost to the transferor.

Allowing a provision to be enacted which enables an executor to take a bad debt deduction because a previous holder returned income from an asset during the period it is held is inconsistent with these amendments.

Recommendation

That the submission be declined.

FINANCE LEASES

Issue: Application of sections FC 8A to FC 8G

Clause 28 Sections FC 8A to FC 8G

Submission
(12 - ICANZ)

It is unclear whether sections FC 8A to FC 8G apply to all leases or only to finance leases. If the sections apply only to finance leases they should be clarified with a specific reference to finance leases, or they should be prefaced with the comment that the sections apply only to finance leases.

Comment

Sections FC 8A to FC 8G apply only to finance leases. Leases entered into after the implementation date that are not finance leases (that is, operating leases) are dealt with under section EO 2A. Leases entered into before the implementation date are dealt with under the specified lease rules or under section EO 2. To ensure it is clear that sections FC 8A to FC 8G apply only to finance leases, sections FC 8B, FC 8C(2) and FC 8E should be amended with specific references to finance leases. (The remaining sections already contain references to finance leases.)

Recommendation

That the submission be accepted.

Issue: Finance leases

Clause 28

Submission
(13 - New Zealand Law Society)

In some cases it is only with the benefit of hindsight that it can be ascertained whether a lease is a finance lease. If a lease is a finance lease and this is determined part-way through the lease term, when should the necessary adjustments be made?

Comment

The Law Society asks when adjustments should be made if a taxpayer determines that a lease is a finance lease during the lease term. It gives the example of a lease for which, when entered into, there is no expectation by the parties that the lease asset will be transferred to the lessee at the end of the lease term. Therefore the lease is not treated as a finance lease but as an operating lease. Circumstances then change and the lease is terminated and the lease asset is acquired by the lessee. The Society considers that it is then clear that the lease is a finance lease under paragraph (a). Therefore adjustments to the expenditure and income for prior years are necessary.

We disagree with the example given. Paragraph (a) is only intended to include leases under which the lease asset transfers to the lessee at the end of the lease term. If at the beginning of the lease it is not contemplated that the lease asset will transfer to the lessee at the end of the lease the lease does not meet the test in paragraph (a).

One of the aims of the finance lease definition is certainty. When taxpayers enter into a lease they should generally be able to ascertain whether the lease is a finance lease or an operating lease. Paragraphs (a) and (b) of the finance lease definition are drafted so that it is clear from the outset whether these factors will be characteristics of the lease.

However, under paragraph (c) it is possible that with the benefit of hindsight that a taxpayer could determine that a lease is a finance lease. For example, if there are two or more consecutive or successive leases of the same lease asset to the same lessee and the Commissioner treats those leases as one lease, the lease is for 75% or more of the asset's estimated useful life, and the second, or subsequent lease, was not contemplated when the first lease was entered into, it is only with the benefit of hindsight that the taxpayer can determine that the lease is a finance lease.

If a taxpayer determines that a lease is a finance lease during the lease term, we consider that rather than re-assessing prior year returns any necessary adjustment should be made in the income year that the taxpayer determines that the lease is a finance lease. Accordingly, we recommend that a provision targeted at such leases be inserted into the finance lease rules to allow taxpayers to make adjustments in the income year in which they determine that their lease is a finance lease.

Recommendation

An amendment is necessary allowing taxpayers to make adjustments in the income year they determine that their lease is a finance lease.

Issue: Definition of “finance lease”

Clause 47(2)

Submission 1
(6W – Tranz Rail; 11W – KPMG)

Taxpayers should have the option to elect into the new finance lease regime where a lease has financing characteristics, in particular if a lessee has the option to purchase the lease asset at the end of the lease term for market value.

Comment

Under paragraph (b) of the proposed “finance lease” definition, a lease is a finance lease if under the lease the lessee or an associate of the lessee has the option of acquiring the lease asset for an amount that is likely to be substantially lower than the lease asset’s market value on the date of acquisition.

The submissions propose that if the lessee has the option to acquire the lease asset at market value at the end of the lease term the lease should also be a finance lease.

We disagree. The finance lease definition is based on the definition *in Statement of Standard Accounting Practice 18*. In that definition a lease is classified as a finance lease if the lease transfers substantially all the risks and rewards incident to ownership to the lessee. The accounting standard then goes to list characteristics of a lease that could classify it as a finance lease. The proposed definition of finance lease in section OB 1 is based on some of those characteristics. We have removed ambiguities and attempted to make the definition as certain as possible for people entering into leases.

The discussion document *Taxation of Financial Arrangements* noted that “… [l]eases that are financing arrangements are essentially similar to deferred property settlements and, therefore, should be within the accrual rules.” If the lessee has the option of acquiring the lease asset for market value at the end of the lease term the lessee is not “financing” the purchase of the lease asset through the lease. Lessees get no financial benefit from leasing the asset if they purchase the lease asset at the end of the lease term, so the lease should not be a finance lease.

However, if one of the conditions of the lease was that the lease asset transferred to the lessee (as opposed to the lessee having the option to purchase the lease asset) at the end of the lease for market value the lease would fall within paragraph (a) of the finance lease definition.

If a lease does not fall within the finance lease definition lease it is an operating lease. Section EO 2A deals with the deductions available to a lessee under an operating lease. Over the term of the lease the deductions under the finance lease rules and under section EO 2A are the same, but under the finance lease rules the deductions for the lessee are accelerated. This is because the lessee can deduct interest on a yield to maturity basis, and because the lessee, not the lessor, is treated as owning the lease asset the lessee is entitled to a deduction for depreciation.

Even if the lessee has the option of purchasing the lease asset for market value at the end of the lease there is no guarantee that the lessee will purchase the lease asset. Suppose the lessee treats the lease as a finance lease and then does not purchase the lease asset. The deductions available to the lessee over time are the same except the timing of those deductions has been accelerated under the finance lease rules.

We are opposed to taxpayers having the option to treat what we consider are non-financing transactions as finance leases. In their submission KPMG note that the elective process has worked successfully elsewhere in the accrual rules. They give the example in section EH 10 which allows taxpayers to elect to treat short-term trade credits as financial arrangements. However, short term trade credits are excluded from the accrual rules for compliance cost reasons, while operating leases are excluded from the accrual rules because they are not a financing transactions and are not similar to deferred property settlements.

Recommendation

That the submission be declined.

Submission 2
(5W – Toyota Finance New Zealand Limited)

The finance lease definition should be based on an asset's "estimated useful life", rather than its "remaining estimated useful life".

Comment

Paragraph (c) of the proposed "finance lease" definition requires the lease term to be for 75% or more of the lease asset's remaining estimated useful life.

In its report *Operational Aspects of the Accruals Regime* the Valabh Committee recommended that leases with financing characteristics be included within the scope of the accrual rules. This draft of the finance lease definition referred to "remaining useful life of the lease asset", and in turn we adopted similar words.

"Estimated useful life" is used in the depreciation rules. An asset's depreciation rate is based on the asset's estimated useful life. The estimated useful life of an asset is the period over which the asset might reasonably be expected to be useful in deriving gross income or used in carrying on a business in New Zealand.

"Remaining estimated useful life" would introduce a new concept that is inconsistent with the depreciation rules. It would be difficult to determine when an asset was first depreciated, and the use of the term would also potentially widen the scope of the "finance lease" definition to include the lease of an asset if the asset is older than its estimated useful life.

If the asset was already as old as its estimated useful life, any lease would be treated as a finance lease, even if the lease was for a single day. This is an absurd result.

Identical leases of the same types of assets would be treated in different ways, depending on the age of the leased assets. This would be difficult to comply with for lessors who are entering into leasing transactions on a daily basis.

For the compliance cost reasons set out above we recommend that the definition refer to "estimated useful life" rather than "remaining useful life".

We also recommend that "estimated useful life" be linked to the estimated useful life as determined by the Commissioner when setting depreciation rates. Otherwise taxpayers could inappropriately determine their own "estimated useful life" for leased assets under the finance lease rules.

Recommendation

That the submission be accepted.

Submission 3
(5W - Toyota Finance New Zealand Limited)

The finance lease definition should apply if the lease term is more than 75% of the estimated useful life, not 75% or more.

Comment

Paragraph (c) of the "finance lease" definition applies if a taxpayer leases an asset for 75% or more of the asset's estimated useful life.

75% of an estimated useful life is usually a round figure. For example, if an asset's estimated useful life is four years, 75% of the estimated useful life is three years. Lease terms are usually for standard periods. Therefore it is more practical for the finance lease definition to apply to leases of more than 75% of the asset's estimated useful life.

Recommendation

That the submission be accepted.

Issue: Outstanding balance

Clause 47

Submission
(Matter raised by officials)

A definition of "outstanding balance" should be inserted in section OB 1 for the purpose of section FC 8C.

Comment

"Outstanding balance" is used in section FC 8C to describe the value for which a lease asset is treated as transferred when a lease terminates early. "Outstanding balance" is defined in section OB 1 for the specified lease rules. The definition should be amended to cover finance leases. For the purpose of the finance lease rules the term should refer to the amount of the loan outstanding, together with any interest or penalty provided for under the lease that is owing at the date the lease terminates.

Recommendation

That the submission be accepted.

TECHNICAL AND DRAFTING ISSUES

MISCELLANEOUS ISSUES

Issue: Branch equivalent income

Clause 11

Submission 1
(12 - ICANZ)

The proposed section CG 11(5) should be clarified so that the "consideration for a financial arrangement", as calculated under that provision, is used in the calculation of income and expenditure in relation to the financial arrangement in all subsequent years.

Comment

The purpose of section CG 11(5) is to calculate the consideration for a financial arrangement where a foreign company does not have attributed foreign income or loss in a preceding period. The consideration for the arrangement is relevant for calculating the amount of income or expenditure and the base price adjustment in all years that the company is a party to the arrangement (provided the company remains subject to the controlled foreign company rules).

Recommendation

That the submission be accepted.

Submission 2
(23W – Rudd Watts & Stone)

It is not apparent why section CG 11(5)(a) has been repealed but not replaced.

Comment

It was not intended that section CG 11(5)(a) be replaced.

As set out in the discussion document *Taxation of Financial Arrangements,* chapter 18, paragraph 18.16, the definition of "acquisition price" in section CG 11(5)(a) does not give the correct result when an arrangement matures or is transferred and a base price adjustment is calculated The current provision provides that the acquisition price is the value of that arrangement at the end of the immediately preceding period. This means the acquisition price will fluctuate from year to year.

If a person had attributed foreign income in a previous period the consideration for the financial arrangement should be that calculated under the accrual rules or the new section CG 11(5).

Recommendation

That the submission be declined.

Issue: Application date for section EH 4(9)(c)(iv)

Clause 20 Section EH 4(9)(c)(iv)

Submission
(23W – Rudd Watts & Stone)

The proposed section EH 4(9)(c)(iv) should only apply to debts sold at a discount on or after the date the bill receives the Royal assent.

Comment

Section EH 5A applies to debts sold at a discount on or after the date the bill receives the Royal assent. Under section EH 4(9)(c)(iv) a financial arrangement is deemed to be remitted where the financial arrangement is a debt that is sold at a discount to a person associated with the debtor under the circumstances described in section EH 5A.

The submitters recommend that section EH 4(9)(c)(iv) apply only to debts sold at a discount on or after the date of Royal assent. However, the section applies only under the circumstances described in section EH 5A. Under section EH 5A(1) the section applies to a financial arrangement that is a debt which is sold at discount to a person associated with the debtor on or after the date the bill receives the Royal assent. Section EH 4(9)(c)(iv) can only apply to debts sold at a discount on or after the date the bill receives the Royal assent. Therefore the legislation already provides for the outcome sought in the submission.

Recommendation

That the submission be declined.

Issue: Meaning of “holding or dealing”

Clause 21 Section EH 5(2)

Submission
(12 - ICANZ)

Section EH 5(2) refers to a person “holding or dealing” in financial arrangements. Clarification of what is meant by “holding or dealing” is required.

Comment

The words “holding” and “dealing” are used in many other provisions of the Income Tax Act 1994. For example, “holding” is used in section CF 2, which sets out the meaning of the term “dividends”, and “dealing” is used in section CD 1(2)(b), which applies to taxpayers who sell land and whose business is dealing in land. The words are not defined elsewhere in the Act, and we consider that defining these terms is not necessary.

Recommendation

That the submission be declined.

Issue: Purpose provision

Clause 21 Section EH 17

Submission
(23 - Rudd Watts & Stone)

The purpose provision should make reference to the fact that the accrual rules have removed the capital/revenue distinction in respect of financial arrangements.

Comment

Purpose provisions are concerned with why the law was enacted. They are intended to assist taxpayers appreciate the general intention of the particular part. There should be no conflict however between the purpose provision and a later specific provision.

The accrual rules did remove the capital/revenue distinction for financial arrangements but it has not been fully eradicated. It remains, for example, in relation to bad debts. It is not considered appropriate to include reference to the capital/revenue distinction in the purpose provision as it may conflict with later provisions.

Recommendation

That the submission be declined.

Issue: Application of accrual rules to non-resident trustees of a non-qualifying trust

Clause 21 Section EH 18(1)(c)

Submission
(23W – Rudd Watts & Stone)

Non-resident trustees of non-qualifying trusts are, as a matter of policy, outside the New Zealand tax net and therefore should not be subject to the accrual rules.

Comment

Non-residents are not subject to the accrual rules. However, under the trust rules a trust settled by a New Zealand resident is subject to tax on its world-wide income irrespective of the residency of the trustee of the trust. In order to ensure amounts *derived from outside New Zealand* are subject to the accrual rules section HH 4(3A) of the Income Tax Act 1994 specifically deems non-resident trustees to be resident in New Zealand for the purposes of the accrual rules.

There are exceptions to the general rules that non-resident trusts settled by a resident are subject to tax as if they were residents. These are set out in section HH 4(6).

The amendment in this bill is to ensure that the *New Zealand sourced income* of the non-resident trustee from financial arrangements is also treated as if the trustee were a resident where the settlor is a New Zealand resident, that is, the accrual rules should apply. This is consistent with the general scheme of the trust rules.

Section EH 18(1)(c), however, will apply to all non-resident trustees, so is too broad. The requirement for non-resident trustees to account for financial arrangements under the accrual rules should apply only if they are treated as if they were residents under the trust rules.

Recommendation

That the submission be accepted.

Issue: Composite financial arrangements

Clause 21 Section EH 20

Submission
(12 - ICANZ)

Section EH 20, which deals with composite financial arrangements, should be simplified by removal of the words “income” “gain” “loss” and “expenditure”.

Comment

Section EH 20 exists to enable any amounts solely attributable to an excepted financial arrangement that is part of a composite financial arrangement to be excluded from the accrual rules.

The submission suggests replacing the words “income” “gain” “loss” or “expenditure” with the words “any amount” in order to simplify the legislation.

The current provision replicates section EH 2 of the Income Tax Act 1994. The references to an amount of “income, gain, loss or expenditure” were reviewed as part of the core provisions and retained. They reflect the wording in the original accrual legislation. The words reflect both the “net” and “gross” concepts embodied in the Income Tax Act and enable the amounts solely attributable to an excepted financial arrangement to be calculated in a number of ways. This may be appropriate given the different types of composite financial arrangements that could be subject, in part, to the accrual rules.

Recommendation

That the submission be declined.

Issue: Cash basis concession

Clause 21 Section EH 24

Submission 1
(12 – ICANZ)

Expenditure should offset income in the cash basis person concession in section EH 24(1)(a).

Comment

As currently drafted, the cash basis concession applies to natural persons if the absolute value of income or expenditure from financial arrangements is $100,000 or less in an income year. The submission recommends that expenditure should offset income in the cash basis person concession.

The cash basis concession was intended to apply to small and, therefore, unsophisticated taxpayers who could not be expected to incur the costs of complying with the more complex aspects of the accrual rules. It was not intended that those taxpayers with large amounts of both income and expenditure should be exempt from the rules.

Recommendation

That the submission be declined.

Submission 2
(12 - ICANZ)

The meaning of the term "absolute value" should be clarified.

Comment

To determine whether they are cash basis persons, taxpayers must calculate the "absolute value" of their income and expenditure from financial arrangements under section EH 24.

"Absolute value" in sections CG 11(5) and EH 24(1) means the arithmetical sign of the result of the calculation or the components of the calculation, as the case may be, are ignored. The words "absolute value" are used to ensure that income does not offset the expenditure. The submission recommends that the term "absolute value" should be defined.

Recommendation

That the submission be accepted.

Submission 3
(9W - Deloitte Touche Tohmatsu)

The threshold for income and expenditure should be increased to $120,000, being 12% of $1,000,000. This would provide consistency with the current regime. Under the existing law the income threshold represents approximately 12% of the face value threshold.

Comment

Section EH 24 provides an exemption from the spreading provisions for cash basis persons. They do not have to apply the accrual rules if the absolute value of their income and expenditure from financial arrangements, calculated under the accrual rules, in an income year added together is $100,000 or less. The submission recommends that this threshold be increased to $120,000. When the accrual rules were introduced in 1986 a 12% nominal return on debt would have been the norm. We consider that in today's economic environment 10% is generous and therefore the threshold should remain at $100,000.

Recommendation

That the submission be declined.

Submission 4
(Matter raised by officials)

Section EH 24(1)(b) should refer to "absolute value" rather than "total value".

Comment

The cash basis person provision, section EH 24, refers to the "total value" of financial arrangements. To prevent taxpayers offsetting their financial arrangements the section should refer to "absolute value". If it is not amended a taxpayer with $10,000,000 of assets and $10,000,000 of liabilities might be able to account on a cash basis, which is not appropriate. The cash basis rules should apply to low dollar value financial arrangements only.

Recommendation

That the submission be accepted.

Submission 5
(Matter raised by officials)

The formula in section EH 24(3) should be amended so that accrual income refers to "income which would be derived under the accrual rules for the period….if the person were not a cash basis holder".

Comment

Section EH 24(3) sets out the formula to determine if a person's deferred income and expenditure exceeds the required threshold in section EH 24(2). One of the variables in the formula is accrual income. Currently the variable is defined as "income derived under the accrual rules for the period…" without any qualification as to the status of the person during that period.

The complication arises in the current wording because a person may not be required to apply the accrual rules during that period, so the term "accrual" income in that formula may be taken as zero. This would be the wrong result. The formula compares what would have been income under the accrual rules with the cash basis income regardless of the actual status of the person.

The same problem applies in the definition of accrual expenditure in the formula.

Recommendation

That the submission be accepted.

Issue: Meaning of purchase price

Clause 21 Section EH 23

Submission
(12 – ICANZ, 23W – Rudd Watts & Stone)

Under section EH 23 property transferred under a financial arrangement will be treated elsewhere in the Act as being transferred for its purchase price. Purchase price is not defined. It should be clarified what is meant by purchase price.

Comment

Proposed section EH 23 sets out the relationship between the accrual rules and the rest of the Act. In particular section EH 23(3) deals with property transferred under the accrual rules and the value of the property is treated as being transferred for under other provisions of the Act. As currently drafted the provision refers to purchase price. Purchase price is not defined. The provision should refer to the value of the property or services as determined under section EH 45(3).

Recommendation

That the submission be accepted.

Issue: Method of measuring accrual income and expenditure

Clause 21 Section EH 30-37

Submission
(12 - ICANZ)

Consideration should be given to removing the existing method of calculating accrual income and expenditure and replacing it with a different method which treats financial arrangements in a similar way to trading stock.

Comment

This proposal suggests an alternative way that income and expenditure from financial arrangements can be accrued. It suggests that this could reduce the number of determinations on issue and simplify this area of tax law.

The main methods of calculating income or expenditure from a financial arrangement are the yield to maturity method and straight line method. The legislation does not elaborate on how to calculate income or expenditure using these methods. The detail of the methods are set out in determinations.

Taxpayers can use other methods of accrual provided they are applied to all financial arrangements in a class, are consistent with methods used for financial reporting and the results are not materially different from those obtained using the methods required by legislation. The methodology suggested could therefore be applied under current rules if the results obtained are not materially different from those obtained using the yield to maturity method.

Officials agree that the accrual determinations need to be reviewed as a result of the amendments contained in this bill, the rewrite of the Income Tax Act and changes in the methods used to accrue financial arrangements denominated in a foreign currency. The methodology suggested by ICANZ would best be considered as part of the ongoing work undertaken by Inland Revenue on accrual determinations.

Recommendation

That the submission be considered in more detail as part of a review of the accrual determinations.

Issue: The relationship between the proposed sections EH 31(2) and EH 34-37 should be clarified

Clause 21 Sections EH 31 - 37

Submission
(23W – Rudd Watts & Stone)

Proposed section EH 31(1) provides that, subject to section EH 32 (straight line method) and EH 33 (market valuation method), a party must use the YTM method "unless the Commissioner accepts an alternative method." The requirements of an alternative method to yield to maturity are set out in section EH 31(2). Sections EH 34,35,36 and 37 then set out other possible methods, not all of which necessarily comply with the proposed section EH 31(2). The relationship between the provisions should be clarified.

Comment

Section EH 31(2) sets out the criteria taxpayers must consider if they want to use an alternative method to the yield to maturity method.

Sections EH 34 to EH 37 only apply if a person cannot use the yield to maturity method and cannot or does not choose to use the market valuation method. These methods are not required nor intended to meet the criteria in EH 31(2). Officials therefore do not consider that the relationship between the provisions needs clarification.

Recommendation

That the submission be declined.

Issue: Deemed transfers at market price

Clause 21 Section EH 42

Submission
(*Matters raised by officials*)

The bill has not provided for deemed consideration where a financial arrangement is transferred on the death of a taxpayer.

It is not necessary to provide that distribution *in specie* is an event that will trigger a base price adjustment. This is clearly a transfer.

Comment

Section EH 42 provides for the circumstances under which a base price adjustment should be performed. The base price adjustment is a wash-up calculation typically performed at the end of the term of a financial arrangement to ensure that all realised gains and losses under a financial arrangement are subject to tax. In performing the base price adjustment, a taxpayer will take into account the amount of consideration received and paid in relation to the financial arrangement. Under most of the circumstances provided for in section EH 42, the amount of consideration received and paid can be determined because an arm’s length transaction actually occur (i.e. a sale or transfer, or a financial arrangement matures).

The current act deems a transfer to occur when a resident becomes a non-resident. The discussion document *Taxation of Financial Arrangements* proposed that a transfer of financial arrangement should also be deemed to have occurred, at market, in the following situations:

- at the time a financial arrangement is distributed *in specie*; or
- at the time of death of a party to the financial arrangement; or
- at the time the trustee to the deceased person’s estate distributes a financial arrangement to a beneficiary.

It was also proposed in the discussion document that deemed transfers are to occur at market value. Market value is preferred over other valuation methods because it is independently verifiable and represents the most reliable estimate of the value of the financial arrangement on the date of the deemed transfers.

This policy has not been reflected in the bill. This should be corrected.

In addition, section EH 42(3) which relates to in specie distributions can be deleted as it replicates section EH 42(1)(a).

Recommendation

That the submission be accepted.

Issue: Exceptions from performing a base price adjustment

Clause 21 Section EH 43

Submission 1
(12 – ICANZ, 9W - Deloitte Touche Tohmatsu)

The time limit for temporary residents who are cash basis persons and therefore exempt from performing a base price adjustment should be aligned with the time limit for temporary residents in the foreign investment fund (FIF) rules.

Comment

Proposed section EH 43(1) excludes temporary cash basis persons from the requirement to do a base price adjustment when they become non-resident if this occurs on or before three years of the date they became resident. For example, someone who becomes a resident of New Zealand for tax purposes on 1 November 1999 is not required to do a base price adjustment when they stop being resident, so long as this occurs before 1 November 2002.

Section CG 15(2)(f)(iv) is also an exemption for temporary residents. The section excludes from the foreign investment fund rules interests held by natural persons if they had an interest in the fund before becoming resident in New Zealand for the period that falls before the first day of the fourth income year succeeding the income year in which they first became a resident of New Zealand. For example, those who become resident on 1 November 1999 do not have to calculate their FIF income on any FIF they held from 1 November 1999 to 31 March 2003.

The submission recommends that the time limit test for the exemption from doing a base price adjustment if the taxpayer becomes non-resident should be aligned with the time limit for temporary residents in the FIF rules.

Recommendation

That the submission be accepted.

Submission 2
(9W - Deliotte Touche Tohmatsu)

Temporary residents should not be required to perform a base price adjustment for any financial arrangement that they are a party to on becoming resident and that matures while they are temporarily resident in New Zealand.

Comment

Taxpayers are subject to the accrual rules when they become a New Zealand resident. They must perform a base price adjustment when any of their financial arrangements mature, because any gain or loss from the financial arrangement is realised.

Also, if a financial arrangement matures within three years of someone becoming resident it is difficult to determine whether that person is a temporary resident until he or she becomes non-resident.

Recommendation

That the submission be declined.

Issue: Base price adjustment

Clauses 21 Section EH 44

Submission
(13 – New Zealand Law Society)

The proposed EH 44, the base price adjustment, includes reference to amounts remitted by law. The inclusion of the reference to remission by law represents a change from the existing position.

Comment

This change is intended. The current provision refers to “any amounts that have been remitted by the person”. If a debt has been forgiven by operation of statute it has not been forgiven “by the person”. This means the base price adjustment could give an allowable deduction to holders for what is effectively a bad debt. Bad debts should be subject to the bad debt provisions in section EH 51.

The change was noted in the discussion document *The Taxation of Financial Arrangements*, chapter 11, paragraph 11.27.

Recommendation

That it be noted that the reference to remission by operation of law is a deliberate change from the existing provision.

Issue: Deductibility of expenditure from financial arrangements

Clause 21 Section EH 44(2)

Submission
(12 – ICANZ, 16W – PricewaterhouseCoopers)

An automatic deduction for investors in a financial arrangement should be restored. (ICANZ, PWC)

Legislation should be enacted to confirm that a deduction can be claimed for a loss incurred on a financial arrangement where there was a possibility that a taxable gain could have arisen at the time the arrangement is entered into. (PWC)

Comment

The discussion document and the resulting legislation propose the removal of the holder/issuer distinction. This was proposed because the distinction is not relevant for many derivative arrangements such as forward contracts and options and it is not always certain or obvious which party to an arrangement is an issuer and which is a holder. It is acknowledged that removing the holder/issuer distinction will simplify the application of the accrual rules. The main area of concern arising from this change is the removal of the automatic deduction (a deduction not subject to a “nexus with income” or business test) available under the accrual rules for some parties to financial arrangements.

Submitters claim that extending the interest deductibility test to all parties to a financial arrangement to determine whether an expenditure or loss is deductible creates too much uncertainty particularly in the area of hedging contracts which are passive investments. This issue, however, relates to the nature of the interest deductibility test and the case law and interpretations that have developed around it. The ICANZ submission recognises that a deduction may be secured under the general provision using similar arguments to those accepted by the Court of Appeal in *Inglis* v *CIR (1992) 14 NZTC 9,180*.

The accrual rules calculate the quantum of gains and losses. The core provisions and the common law determine what is included in income and what costs are deductible. In most cases accrual expenditure will be deductible either under the general provisions because there is a nexus with the income earning process, the business test is satisfied or because of a special rule in the accrual rules which allows a deduction for losses associated with gains that have been taxed in earlier periods but are never realised. The business test was added in 1987 to coincide with the introduction of the accruals legislation. This was to deal with deductions for deemed interest where there were arrangements with no principal. The breadth of the interest deductibility test, in the context of derivatives (such as forward contracts), has not been tested in the courts.

Currently "issuers" are subject to the interest deductibility provisions. Issuers include purchasers of property where settlement is deferred, and persons entering into forward contracts, futures contracts or options. Some of these arrangements are substitutes for forward contracts for foreign exchange and can be used as hedging instruments. The proposal to apply the general deductibility rule builds on the current structure of the Income Tax Act.

While acknowledging concerns associated with the interest deductibility test, officials believe the uncertainty needs to be weighed up against the benefits of removing the automatic deduction for holders. The benefits include:

- Consistency with the rewrite of the Income Tax Act, which will separate the timing rules from issues of assessibility and deductibility.

- Both parties to a financial arrangement are treated in a consistent way.

- Reductions in incentives to structure transactions to take advantage of the right to an automatic deduction.

- Enables the holder/issuer distinction, which is complex and itself uncertain in its application, to be removed.

A review of the interest deductibility rules is a more appropriate forum for resolving any uncertainty in this area. That review is currently part of the Government's tax policy work programme.

Recommendation

That the submission be declined.

Issue: "Consideration" definition

Clause 20 Section EH 45

Submission
(Matter raised by officials)

The consideration definition in section EH 45 should be amended so that the "lowest price" paragraph appears before the "cash price" paragraph.

Comment

"Consideration" is defined in section EH 45. The paragraphs of the consideration definition must be applied in the order in which they appear, starting with the paragraph (a). As currently drafted, the cash price is the price to be used if property passes under a financial arrangement if there is a cash price under the Credit Contracts Act 1981, regardless of whether the parties have agreed a lowest price.

The definition of "consideration" would give odd results if the parties had agreed to a lowest price. For example, if there is a cash price for the property passing under the financial arrangement but the parties agree a lowest price before to entering into the financial arrangement the value of the property is the lowest price rather than the cash price. As currently drafted, the consideration definition in section EH 45 requires that the cash price be used.

Officials recommend that the paragraphs be reordered so the lowest price paragraph applies in cases where there is a lowest price, and if there is no lowest price then the cash price paragraph applies.

Recommendation

That the submission be accepted.

Issue: Lowest price clause in composite financial arrangements

Clause 21 Section EH 45(4)

Submission
(12 - ICANZ)

The parties to a financial arrangement should be entitled to use the "lowest price" clause in the proposed EH 45(3)(b) irrespective of whether the arrangement is part of another financial arrangement.

Comment

The legislation proposes to exclude the application of the "lowest price" provisions to agreements for the sale and purchase of property or services where the agreements are part of a composite financial arrangement. This is because a composite arrangement that includes an agreement for the sale and purchase of property cannot be accurately characterised as such an agreement.

Recommendation

That the submission be declined.

Issue: Debt parking

Clauses 20 and 21 Sections EH 5A and EH 50

Submission 1
(12 - ICANZ)

ICANZ questions the need for a specific provision to attribute income to debtors for all transfers of financial arrangements at 80% of the remaining amount payable under the arrangement. A more appropriate approach would be to amend or add to the anti-avoidance provisions to target instances of abuse.

Comment

The provisions on debt parking are aimed at specifically addressing structures that have been used to circumvent the debt remission provisions. Under present law, if an assignment of debt occurs and there is an intention to leave the debt outstanding questions could arise as to the application of the anti-avoidance provisions of the

Income Tax Act. Such arrangements could potentially be held to be an insubstance remission of debt. However, this would be very difficult to determine.

The specific provision, which has precedents in both Australia and Canada, will help ensure the policy objective - to tax income from debt remission - is maintained.

The breadth of the provision has been limited by the extent of common ownership between the borrower and the purchaser of the debt, the method used to value the debt (market value, as recommended by ICANZ) and the level of discount at which the debt is purchased. This will narrow its application.

Recommendation

That the submission be declined.

Submission 2
(12 - ICANZ)

- The market value and whether the associate of the debtor has acquired the debt at a predetermined discount to the market value should be used to determine whether or not a financial arrangement is subject to the debt parking rules.

- If the primary submission fails an exception will be needed to accommodate the acquisition of financial arrangements which are issued at a significant discount and to exclude debt arising between parties that are members of a group at the time of creation of the financial arrangement.

Comment

The submission notes that commercial transactions are driven by reference to the market value of a financial arrangement, not its face value or the amounts payable under the arrangement. It suggests use of market value as the reference point to determine whether a transaction is subject to the debt parking provisions.

Officials agree with the submission. The value of an arrangement should be its market value subject to the assumption that the debtor has the same capacity to repay the debt when it is assigned as it had when the loan was made. This will ensure that arrangements that trade at a substantial discount because of the payment structure, and not as a result of falling creditworthiness, are not caught by the rules.

As we agree with the submission, the secondary issues do not need to be addressed.

Recommendation

That the submission be accepted, but subject to the clarification proposed by officials.

Issue: Security arrangements

Clauses 21 Section EH 53

Submission
(12 - ICANZ)

Sureties who are associated with the principal debtor should be able to deduct losses arising from indemnification of the principal debtor, provided no effective double deduction arises.

Comment

The provision that denies deductions for amounts paid by guarantors in satisfaction of an associate's debt support the general restriction on bad debt deductions for associates.

As discussed in response to the Law Society submission on page 28, relaxation of this policy is not appropriate.

Recommendation

That the submission be declined.

Issue: Commercial bills

Clause 38 Section GC 14A

Submission
(12 – ICANZ, 23W – Rudd Watts & Stone)

- The proposed section GC 14 A should be deleted. (ICANZ)

- The proposed section GC 14A should apply only where the transaction has the "purpose and effect" of avoiding NRWT or AIL. (RWS)

- In the event that our primary submission is not accepted the words "derives gross income from the redemption payment" should be clarified. (ICANZ)

Comment

ICANZ recommends that the provision (which replaces the current section CE 3(1)(b) but is intended to be narrower in its application) be deleted. This is because it is not sufficiently targeted. It could, for example, result in taxation of a resident taxpayer that acquires a commercial bill from a non-resident regardless of whether the taxpayer was a party to an arrangement to avoid tax. Rudd Watts & Stone consider that the provision remains too broad and could apply where a resident buys a commercial bill in the market not knowing that it was previously owned by a non-resident.

Officials consider that the policy objectives of the original provision (to support the NRWT and AIL rules) are still relevant and that the provision should not be deleted. The provision should stop non-residents selling bonds to residents before interest or redemption payments are due to avoid NRWT.

The provision was intended to be limited to the parties to a sale where an arrangement exists to avoid non-resident withholding tax. We accept that the provision as drafted is too wide. The provision should apply only where there is a purpose of avoiding NRWT or AIL.

The provision, if applied, taxes the resident as a proxy for the non-resident holder of a commercial bill. The gain for a non-resident holder, assuming that person is the original holder, is the difference between the amount paid to the issuer and the amount paid on redemption of the bond. Redemption payment is defined in section OB 1. No further definition is required.

Recommendation

That the provision apply where there is a purpose of avoiding NRWT or AIL.

Issue: Accrual rules anti-avoidance provision

Clause 39

Submission
(12 – ICANZ)

The requirement under the current section GD 11 that there be a connection between the parties before a taxpayer is caught by the provision should be reflected in the redrafted provision.

Comment

The proposed amendment removes the requirement of a "connection between the parties" because these words could be construed as a requirement that there be an association between the parties. However, taxpayers, whether associated persons or not, may act in concert to manipulate their tax liabilities.

Removal of the requirement does not mean, as the submission claims, that Inland Revenue has discretion to substitute market values indiscriminately in financial arrangements. To apply the provision Inland Revenue must show that the intention of the accrual rules has been defeated. This was discussed in *Auckland Harbour Board* v *The Commissioner of Inland Revenue* (1998) 18 NZTC, where the judge said:

> "... s 64J is essentially an anti-avoidance provision. It applies to situations where a taxpayer can point to a specific provision in the legislation, apply its terms, and claim a benefit – a benefit that is, however, contrary to the intended effect of the statutory regime. ..."

Recommendation

That the submission be declined.

Issue: Application date for amendment to consolidation rules to ensure remission income is recognised

Clause 40

Submission
(Matter raised by officials)

The application date for the amendment to the consolidation rules (which ensure that a debt that has not been held by members of a consolidated group throughout the term of the arrangement results in remission income for a debtor) should be amended. The provision should apply to debt remissions on or after the date that the bill receives Royal assent.

Comment

Debts remitted between members of a consolidated group do not normally result in income for a debtor. This is because the consolidation rules treat a group of companies comprehensively as one economic entity and one taxpayer. However, because this treatment of remission income is a concession to the general remission rule, the consolidation rules could be used to avoid the remission provisions.

The amendment, like the debt parking rule, aims to close down avoidance opportunities. It does this by more tightly targeting the transactions which will not result in income for a debtor.

The legislation as drafted, however, applies only to debts entered into after the date of enactment of the new accrual rules. As this legislation is intended to close down avoidance opportunities it is desirable that the rules apply to *events or transfers* that occur after the date the legislation is enacted, irrespective of when the arrangement was entered into. This is consistent with the application date for the debt parking provisions in clauses 20, section EH 5A and clause 21, section EH 50.

Recommendation

That the submission be accepted.

Issue: Definitions of "agreement for the sale and purchase of property" and "forward contract"

Clause 47

Submission

(14W – Simpson Grierson)

- The definitions of "agreement for the sale and purchase of property or services" and "forward contract" are circular.
- It is not clear that the requirements of (i), (ii) & (iii) of the definition of "forward contract" are intended to be cumulative.
- If the requirements of the definition of "forward contract" are cumulative the reference to an excepted financial arrangement in paragraph (ii) of the definition of "forward contract" should be removed.

Comment

The policy objectives of the changes to the definitions are to:

- Extend the definition of agreement for the sale and purchase of property (ASAP) to trade credits and the provision of services.
- Ensure that only the interest component associated with an ASAP is accrued when property is transferred under the accrual rules.
- Ensure that agreements that are substitutable for debt or debt instruments or hedge debt or debt instruments are accounted for under the accrual rules. For such instruments the value of the property or commodity to which an arrangement is linked is taken into account.

Agreements covered by the last point include those that use commodities or the price of a tangible or intangible asset as a pricing index. With such arrangements all or part of the return is indexed to the movement in the price of an asset or other commodity. Also covered are forward contracts for foreign exchange or financial arrangements.

The definitions, as drafted, do not accurately reflect these objectives. As noted in the submission, the definitions mean all agreements for the sale and purchase of shares would be subject to the accrual rules as they would be forward contracts. This means both an interest component and any movement in the value of the shares would be brought to account on an accrual basis. This was not intended.

The definitions should be redrafted to better reflect the purpose, to avoid the problem of circularity and to indicate that the parts of the definition of "forward contract" are not cumulative.

Recommendation

That the submission be accepted.

Issue: Meaning of "conveys" in the definition of "lease"

Clause 47

Submission
(1W - Ernst & Young; 12 - ICANZ)

- The words contained in paragraph (f), subparagraph (i), of the proposed lease definition read:

  > "Means an agreement under which a lessor **conveys** to a lessee for a lease term a lease asset or the right to possess a lease asset in consideration for a lease payment."

- The proposed lease definition should apply only to new leases entered into on or after the bill receives Royal assent.

Comment

For the purpose of the "specified lease" definition, a lease was defined as

> "…any agreement entered into on or after 6 August 1982 under which a lessor **conveys** to a lessee for a lease term a lease asset or the right to possession of a lease asset in consideration for any lease payment...".

The bill proposed to redraft that part of the definition as

> "…an agreement under which a lessor **provides** to a lessee for a lease term a lease asset or the right to possess a lease asset in consideration for a lease payment…".

The term “provides”, which is the subject of this submission, was introduced as part of rewriting the Act in plain English. The submission points out that the use of the term “provides” may unduly expand the types of agreements that could be classified as a “specified lease”.

Officials do not necessarily agree with that submission. Whether an agreement is a lease depends on the legal nature of the rights granted under the agreement. The distinguishing feature between an agreement that is a lease and one that is not should not depend on the meaning of “conveys” or any other words that may be used in its place.

An agreement that confers only a “right to use” a property is typically not a lease under the common law. To constitute a lease, the agreement must confer a “right to possess” the property. This interpretation is consistent with the use of the term “right to possess” in the definition of “lease”. The submission also pointed out that, therefore, certain licences of intangible property do not constitute leases under the current definition of “lease”.

It is arguable whether certain licences of intangible property do not constitute leases under the current definition of “lease”. This is not an issue that we can deal with here. Even if certain licences of intangible property do not constitute leases under the current definition, officials doubt if any significant weight should be put on the term “conveys”.

We do not accept, therefore, that the term “conveys” is irreplaceable because of its entrenched meaning. In order to simplify the language of the Act, the term “conveys” should be replaced with the word “transfers”. The word “convey” has been taken to mean “transfers”. In *Nicholson* v *Milne* (1989), 74 CBR (NS) 263 Virtue J stated that:

> “The term conveyance (like the term transfer) is itself wide enough to encompass every method of disposing of, or parting with, property or an interest therein, absolutely or conditionally. The word is of general meaning and, given a liberal interpretation, includes the transactions here which resulted in the transfer of entitlement….To ”make over property” or to “convey property” has, I believe, the same meaning as to “transfer property”….”

The use of “transfers” is consistent with the meaning of “conveys”.

As this change does not represent a policy shift, the definition of lease should apply on or after the date the Act receives Royal assent.

Recommendation

That the word "transfers" should be used in the definition of lease.

DRAFTING CHANGES

Issue: Branch equivalent income

Clause 11

Submission
(12 – ICANZ)

The section reference in section CG 11(3C)(a) to section EH 32(5) should be amended to section EH 32(6).

Comment

We agree.

Recommendation

That the submission be accepted.

Issue: Structure and layout of Part EH

Clauses 20 and 21

Submission 1
(12 - ICANZ)

Division 1 should be transferred to Part EZ.

Comment

Part EZ contains terminating provisions. It is a collection of provisions ranging in subject matter whose only commonality is that they are terminating.

The current rules apply to financial arrangements entered into before the date of the Act's Royal assent. These rules will continue to apply to such financial arrangements until they mature. Division 1 cannot be repealed until the last financial arrangement subject to the current rules matures.

We do not consider that Division 1's termination in time is a sensible reason to add a substantial part of the accrual rules to Part EZ. Rather, we consider that all provisions relating to financial arrangements should be found in one place. Close proximity is particularly favoured because Division 1 makes reference to Division 2. This way, the current rules can be read alongside the proposed rule.

If the current rules were moved to Part EZ, a person would, potentially, have to turn between parts until they worked out which Division they could or should apply.

The repeal of the current rules will not affect the proposed rules. This was achieved by creating Divisions. Not only is the subject matter together in one place, but it is clear and accessible to users.

Recommendation

That the submission be declined.

Clauses 20 and 21

Submission 2
(12 - ICANZ)

The first two sections in Division 1, sections EH A1 and EH A2, should be renumbered EH 1, EH 2 and the remaining sections, EH 1 to EH 56, be renumbered.

Comment

Division 1 contains the current rules with provisions retaining their current section numbers. Consequential amendments had to either:

- refer to two sets of section references (the current rules and the proposed rules, reflecting the current and proposed terminology), with the current section references being repealed when Division 1 is being repealed; or

- refer only to the proposed references and require financial arrangements to apply the provisions in other Parts as they stood prior to their (proposed) amendment.

The latter option was chosen and it is for this reason that provisions in the current rules retain their section numbers.

Therefore, sections EH A1 and EH A2 which were inserted to set out Divisions 1's application and provide the link between Division 1 and Division 2 had to be numbered as they have.

We note that ICANZ are happy with sections EH A1 and EH A2's placement in Division 1, it is merely numbering on which they comment.

Recommendation

That the submission be declined.

Issue: Structure and layout of Part EH

Clauses 20 and 21

Submission 3
(12 - ICANZ)

There should be no comma between "Part EH" and either "Division 1" or "Division 2".

Comment

We agree.

Recommendation

That the submission be accepted.

Issue: Confusion between "accrual rules" and "accruals rules"

Clauses 20 and 21

Submission
(12 – ICANZ, 23W – Rudd Watts & Stone)

When "accrual rules" has been used to cover income from Division 1 or and Division 2, a new term should be used that covers both "accrual rules" and "accruals rules", or alternatively "accruals rules" should be included as well.

Comment

The term "accrual rules" only refers to income arising under Division 2 and the transitional adjustment in Division 1; it has not been used to cover income from both Divisions 1 and 2.

References to “accruals rules” have not been omitted by accident. Rather, section EH 15 requires that provisions in other Parts that refer to financial arrangements must be applied as they stood prior to their (proposed) amendment. Taxpayers applying those provisions should read the term “accruals rules” or “qualified accruals rules” as appropriate.

Recommendation

That the submission be declined.

Issue: Definition of financial and excepted financial arrangement

Clauses 20 and 21

Submission
(12 - ICANZ)

These substantive definitions should be relocated to section OB 1 to preserve the standard format of the Act. If the substantive definitions are not relocated to section OB 1, they must be cross-referenced in section OB 1 in a meaningful way.

Comment

We consider that it is appropriate to place definitions among substantive provisions.

If a definition is fundamental to the application of a provision or subpart, it should be placed where it will be prominent. The definitions “financial arrangement” and “excepted financial arrangement” are good examples, because these definitions determine whether one must apply the accrual rules.

If a definition is only used in one section, the definition may be presented in that section and generally, it is best presented as the final subsection of the section.

If a definition is placed among substantive provisions, we consider that the definition should also be referred to in section OB 1. This ensures that there is a complete list of definitions for users, regardless of where the term is defined in the Act.

Recommendation

That the submission be declined.

Issue: Application dates of Division 2

Clause 20

Submission
(23W – Rudd Watts & Stone)

The application dates of Division 2 should be contained in one section.

Comment

Section EH 16 provides that financial arrangements entered into on or after the date that the Act receives the Royal assent are subject to Division 2. Section EH 18(1)(d) and EH 18(2)(c) deal with financial arrangements subject to binding contracts where the binding contracts are entered into before the enactment of the bill and the financial arrangement itself is entered into after the enactment of the bill.

We agree that section EH 18(1)(d) and EH 18(2)(c) more appropriately fit with the general application date in section EH 16 and should be moved to that section. We note that section EH 18(1)(e), which relies the test in section EH 18(1)(d), will need to be moved as well.

Recommendation

That the submission be accepted.

Issue: Transitional adjustment

Clause 20

Submission
(12 – ICANZ, 23 – Rudd Watts & Stone)

Section EH 14(9) does not make grammatical sense. ICANZ specifically submits that "where" should replace "if" in the opening body of section EH 14(9) and an "if" should be inserted at the beginning of paragraph (b).

Comment

Section EH 14(9) requires a person to calculate a base price adjustment if three requirements are met. ICANZ submit that "[i]f paragraph (b) is read without reference to the opening words, the paragraph is a nonsense."

The Law Commission's Report *Legislation Manual Structure and Style* (Report 35, May 1996) states, in paragraph 181, that "[e]ach paragraph must follow grammatically from the words introducing the series and must perform an equivalent function in the sentence."

As drafted, each paragraph meets this test, whereas the proposed changes would not.

Recommendation

That the submission be declined.

Issue: Section EH 15

Clause 20

Submission
(23W – Rudd Watts & Stone)

Section EH 15 is too broad. It requires taxpayers to apply particular provisions at a specific point in time, ignoring subsequent amendments to those provisions. Section EH 15 should therefore state that the provisions of the Act be read as being unaffected by the bill.

Comment

We agree that section EH 15, as drafted, requires taxpayers to apply particular provisions without regard to subsequent amendments to those provisions. If the amendment should be taken into account, a provision overriding section EH 15 would be required. An example discussed in this report (see page 58) is section HB 2(1)(a)(iv). The amendment made to that section in the bill is intended to close down avoidance opportunities and so should apply as amended to all financial arrangements, irrespective of when they were entered into. Section EH 15 is being amended to achieve this.

If section EH 15 were amended so that the provisions of the Act were read as being unaffected by the bill, amendments such as the debt parking rules would be of no consequence. This is unsatisfactory.

Recommendation

That the submission be declined.

Issue: Section EH 18(1)(d)

Clause 21

Submission
(23W – Rudd Watts & Stone)

Section EH 18(1)(d) should be amended because it is not helpful to refer to an advance of a financial arrangement.

Comment

Section EH 18(1)(d) which sets out the application date in relation to binding contracts refers to a rollover, extension or advance of a financial arrangement. A financial arrangement may be rolled-over or extended, but it is actually money or money's worth that is advanced under a financial arrangement, not the financial arrangement itself.

We agree that section EH 18(1)(d) be amended to refer to an advance "in relation to" a financial arrangement. This language is consistent with that of Division 1.

Recommendation

That the submission be accepted.

Issue: Section EH 21 list of defined terms

Clause 21

Submission
(23W – Rudd Watts and Stone)

The term "insurance" should be removed from the list of defined terms for the proposed section EH 21.

Comment

The term "insurance" is listed as a defined term for the purpose of proposed section EH 21. The term is not defined for the purposes of that proposed section. Therefore, the term "insurance" should be deleted from the list of defined terms for the proposed section EH 21.

Recommendation

That the submission be accepted.

Issue: Sections EH 24(2), EH 26(1)(b) and EH 26(2)

Clause 21

Submission
(23W – Rudd Watts & Stone)

The wording in sections EH 24(2), EH 26(1)(b) and EH 26(2) needs to be improved.

Comment

Section EH 24(2): The exception to the cash basis person definition does require a natural person to apply the formula to each financial arrangement. Section EH 24(2) will be redrafted to make this clearer.

Section EH 26(1)(b): Section EH 24 provides that only natural persons may be cash basis persons. As an estate is not a natural person it will never meet the test in section EH 24. However, despite the natural person requirement, under section EH 26(1)(b) an estate may be a cash basis person if the deceased was a cash basis person at the time of his or her death and the other requirements of section EH 24 are met. No amendment is required.

Section EH 26(2): Section EH 26(2) provides that the trustee (of a deceased person's estate) is treated as the same cash basis person as the deceased. This applies to the trustee in their capacity as a trustee, irrespective of whether the trustee personally qualifies as a cash basis person. As section EH 26(2) conflicts with the requirement that a trustee perform a base price adjustment on the date of a person's death, section EH 26(2) should be repealed and the relationship between the cash basis person test and the trustee should made clearer in the section EH 26(1).

Recommendation

That the submission be accepted in part.

Issue: Value of property or services in the "consideration" definition

Clause 21 Section EH 45

Submission
(12 – ICANZ)

The word "alphabetical" should be replaced by "sequential" or, alternatively, the words "alphabetical order" should be replaced by the word "sequence" or "seriatim".

Comment

As drafted the value of property or services is determined under the "consideration" definition by applying paragraphs (a) to (d) in alphabetical order until a paragraph applies.

The use of "seriatim" is at odds with plain language drafting.

We consider that the suggested terms "sequential" or "sequence" potentially give a taxpayer too much discretion. Firstly, the words do not designate a starting point. A taxpayer may apply paragraphs (b), (c) and (d) in that order and comply with the legislation because the taxpayer has applied a sequence.

Secondly, even if paragraph (a) is designated as a starting point, paragraph (a) and any order of paragraphs (b), (c) and (d) are a sequence. There is no requirement that a taxpayer must apply the sequence (a), (b), (c) and (d).

We consider that "alphabetical" is the correct term to use because it unambiguously requires taxpayers to apply the subsection in the order of the letters of the alphabet.

Recommendation

That the submission be declined.

MINOR CHANGES

The following are minor amendments that have been identified by either officials or raised informally by tax practitioners. The amendments improve the clarity of the legislation and do not involve matters of policy.

Income Tax Act 1994

Section EH 16	Clarify application date to ensure that secondary market transactions are included under Division 2.
Section EH 24(2)	Align the deferral test with current legislation.
Sections EH 30(2)(a) and (b)	Use of the word “for” is too restrictive; replace with “in relation to”.
Section EH 32(2)	Remove the word “equal” from the subsection heading.
Section EH 32(3)	Insert at the beginning of the subsection “if the straight line method can be applied to a financial arrangement,”.
Section EH 40(1)	Replace “section EH 32(2)”with “section EH 32(3)”.
Section EH 42(1)(b)	Remove “remitted, other than being written of as a bad debt”.
Section EH 42(1)(c)	Replace the words “a person” with the words “the person”.
Section EH 42(1)(g)	Replace the word “irrevocable” with “irrecoverable”.
Sections EH 43(1),(2) and (3)	Replace “does not have to” with “must not”.
Section EH 43(3)	Replace the reference to “income” with “money”.
Section EH 44(1)	In the explanation of the term “income” insert “(a)” after “is” and before “income”, replace the word “including” with “and”.
Section EH 45(1)	Insert the words “consideration means”.
Section EH 45(2)	Remove the words “if some or all”.

Section EH 51(2)(a)	Replace the reference to “income” with “gross income”.
Section FC 8B(2)	Insert the word “term” after the words “date that the lease”.
Section FC 8B(3)	Insert the word “term” after the words “end of the lease”.
Section FC 8C(1)	Insert the word “term” after the words “before the lease”.
Section FC 8E	Clarify that the gain is included in gross income in the year of sale.
Section OB 1 – definition of maturity	Replace the reference to “agreement” with “agreement for the sale and purchase of property or services”.

Tax Administration Act 1994

Section 22A	Amend section 22A so that taxpayers are only required to keep records to verify the market value if they are not using a method approved by the Commissioner.

Other Changes to the Income Tax Act 1994

SIGNIFICANT POLICY ISSUES

AVERAGING OF TAX-FREE ALLOWANCES

Issue: Use of the term "pay period"

Clause 5

Submission
(8 - New Zealand Employers' Federation (Inc))

The term "pay period" should be replaced by the term "relevant period".

Comment

As noted in the submission, the proposed amendment is intended to apply to "relevant periods", that is, the period to which estimated expenditure applies. However, it is accepted that the current wording may allow for a contrary interpretation to be taken. Officials agree, therefore, that the proposed amendment requires modification. This will necessitate slight, consequential changes to the current wording of the section.

Recommendation

That the submission be accepted.

Issue: Application date

Submission
(12 - ICANZ)

The application date should be backdated to the beginning of the current income year.

Comment

The proposed amendment applies from 1 April 1999 (the beginning of the next income year). This is because, as noted in the submission, the proposed amendment is merely designed to reflect existing practice, and Inland Revenue will not be applying a contrary application in the interim. Officials therefore believe that it is not necessary to backdate the application date.

Recommendation

That the submission be declined.

GST AS PART OF THE COST OF FRINGE BENEFITS

Issue: Inclusion of GST in the value of fringe benefits when the goods or services provided by the employer are subject to GST or when the cost includes GST

Clauses 12, 13, 47(16) and 47(32)

Submission
(8 - New Zealand Employers' Federation)

Fringe benefit tax may no longer be relevant, particularly following the reduction in marginal income tax rates in the late 1980s, the move towards providing remuneration in monetary form, and uncertainty as to its coverage.

Specifically, the proposal to include GST in the value of fringe benefits should be rejected. It is incorrect to assume that benefits should necessarily be valued at the market price individual employees would have paid had they purchased them directly, as employees would often prefer the market value of the goods or services in cash.

The inclusion of GST in the value of fringe benefits results in employers being required to pay business income tax on top of a consumption tax, GST, which is meant to be borne by the end user.

The proposal is also likely to involve significant compliance costs.

Comment

A general review of fringe benefit tax is outside the scope of this bill.

The underlying policy of fringe benefit tax is that benefits should, in general, be valued at the price that would have been paid by the employee had he or she purchased the benefit directly. The submission of the Employers' Federation, that employees would often prefer to receive market value of goods or services in cash, is focussed on the underlying policy of fringe benefit tax rather than the specific inclusion of GST in its value. To be consistent with this established policy, as the benefit to employees is the cost they would otherwise have paid, which would have included GST, it is necessary that the value of a fringe benefit also include GST. It was the intention at the time of the introduction of GST that all fringe benefits would be valued on a GST inclusive basis. Subsequent decisions of the courts have made legislative amendment necessary.

As the example on page 34 of the commentary on the bill illustrates, exclusion of GST from the value of fringe benefits effectively enables employers to reduce their overall tax bill by paying employees in the form of benefits rather than monetarily.

This creates a potential risk to the revenue base by encouraging employers to provide remuneration in kind rather than in money. The inclusion of GST is necessary to ensure equity in tax system by all forms of remuneration, including non-cash benefits being taxed consistently.

Compliance costs are likely to be of a transitional nature as employers update their systems in order to calculate the value of a fringe benefit on a GST inclusive basis when required. Compliance costs will be minimal.

Recommendation

That the submission be declined.

Issue: The application date for the proposed changes to definitions

Clause 47(47)

Submission
(12 - ICANZ)

The changes to the definitions of "input tax" and "registered person" should be 1 April 1999, being the application date of the substantive amendments.

Comment

Clauses 12 and 13, which amend sections CI 2 and CI 3, apply to all benefits provided on or after 1 April 1999. Officials agree that the effective date for the proposed changes to the definitions relevant to the inclusion of GST in the value of a fringe benefit should be amended from the date the Act receives Royal assent to 1 April 1999, so that the two are consistent.

Recommendation

That the submission be accepted.

TRADING STOCK VARIANCES

Issue: Application of variance provision

Clause 19

Submission
(12 - ICANZ)

The provisions relating to the deduction of a variance in the year following the year in which the variance is incurred in section EE 5(3A) should be made optional. Taxpayers who wish to include a variance in the value of stock (in which case the variance would become deductible at the time the associated trading stock is sold), should be able to do so.

Comment

In response to the proposed replacement section EE 5(3A) in the bill, ICANZ submits that if taxpayers have included previous year variances under Financial Reporting Standard No. 4 *Accounting for Inventories* (FRS-4), they should not be required to deduct the previous year variances for tax purposes. Officials agree. The submission highlights that there needs to be some flexibility in how taxpayers are to apply the variance provision.

Section EE 5(4) [referred to as EE 5(3A) in the submission, which was the numbering in the bill] was inserted in response to a previous submission by ICANZ at the Select Committee stage of the Taxation (Tax Credits, Trading Stock, and Other Remedial Matters) Act 1998. This previous submission sought to allow taxpayers to use 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. The submission was accepted and section EE 5(4) was enacted. Further issues were raised which led to the proposed replacement of that section in the bill now being considered by this Select Committee.

These difficulties indicate that it is preferable to include less detail in the legislation because of the widely varying situations which will occur in practice and different accounting systems of taxpayers. A clarification to section EE 5(3) can indicate that taxpayers are only required to calculate variances for the current income year, although it will not prevent taxpayers from carrying forward previous year variances as sought in the submission. Previous year variances that are not included for financial reporting purposes will not be required to be carried forward because they will be deducted as part of the opening stock allowable deduction under section EE 2(4).

Consultation with the submission-maker and with the Tax Education Office Limited has raised another issue with the variance provision. This additional submission is that the variance should be calculated with reference to actual production costs used for financial reporting purposes in accordance with FRS-4. Section EE 5(3) currently requires the variance to be calculated with reference to budgeted or standard costs. The budgeted production levels or costs may differ from the actual production levels or costs used for financial reporting purposes, so it is appropriate to use the latter. Officials consider that the calculation of the variance with reference to budgeted or standard costs in section EE 5(3) should be changed to actual production costs included in financial statements.

Recommendation

That the submission (and the additional submission raised in consultation) be accepted.

Issue: Drafting matter

Submission
(Matter raised by officials)

The reference to the income year in which taxpayers are required to have the same balance dates, should be reinstated in section EE 15.

Comment

Section EE 15 is a rewritten version of the previous sections EE 1(5) and EE 1(6). The section deals with trading stock transferred within a wholly-owned group of companies. There was an inadvertent change in drafting, with the effect that it is not clear from section EE 15(1) when the two companies concerned need to have income years that end with the same balance date.

Recommendation

That it be clarified that the income year is the year in which the trading stock is valued under the provision, and not the year in which the return is filed.

GUARANTEE FEES PAID TO NON-RESIDENTS

Issue: Definition of "insurance"

Clause 47(17)

Submission
(18 – New Zealand Bankers' Association)

The proposed definition of "insurance", which will determine the application of the section CN 4 withholding tax to guarantee fees, should be amended to ensure that it does not include fees paid on normal trade and commercial financing transactions.

Comment

The submission notes that the reference to "guarantee against risk" in paragraph (a)(ii) of the new definition of "insurance" to be inserted by clause 47(17) of the bill could include fees paid on normal trade and commercial financing transactions such as letters of credit and performance bonds.

The main targets of the proposed amendment are guarantee fees paid to non-resident associated parties and guarantee fees which are in substitution for interest that would otherwise be subject to non-resident withholding tax or the approved issuer levy.

Officials agree that it is not desirable for the amendment to apply to fees paid on normal trade and commercial financing transactions between parties acting at arm's length. In particular, the compliance costs of imposing the section CN 4 withholding tax on such transactions would probably outweigh the revenue gain.

Officials have discussed with the submission-maker a wording change to clause 47(17) which would ensure that the main targets of the amendment — guarantee fees paid to non-resident associates and guarantee fees paid in substitution for interest — are caught. The amendment would not catch fees paid on normal trade and commercial financing transactions between parties acting at arm's length.

Recommendation

That the submission be accepted.

Issue: Application date

Clause 47(48)

Submission
(18 – New Zealand Bankers' Association)

The application date of the new definition of "insurance" in clause 47(17) (amended as recommended above) should, in so far as it relates to unassociated party transactions, be the date of Royal assent.

Comment

The bill currently provides that all of the amendments relating to guarantee fees paid to non-residents will apply from 17 November 1998, being the date of introduction of the bill.

Officials consider that the amendments should continue to apply from the date of their introduction in relation to associated party transactions in order to protect the tax base. However, officials agree that because the wording of clause 47(17), amended as recommended above, in relation to unassociated party transactions differs from that used on the introduction of the bill and the lower risk to the tax base posed by unassociated party transactions, clause 47(17) should apply from the date of Royal assent in relation to unassociated party transactions.

Recommendation

That the submission be accepted.

Issue: Deductibility of withholding tax to New Zealand payer

Clause 14

Submission
(18 – New Zealand Bankers' Association)

It should be made perfectly clear that payments to the Commissioner of withholding tax under section CN 4 are tax deductible to the New Zealand payer.

Comment

Officials consider that the proposed amendment is unnecessary. It is the Inland Revenue Department's interpretation that payments of withholding tax to the Commissioner under section CN 4 are deductible to the New Zealand payer. The Inland Revenue Department agrees with the submission-maker's interpretation that a payment of tax under section CN 4 is made by the New Zealand payer as agent of the non-resident and not in the payer's own capacity. It therefore follows that the payment of tax under section CN 4 is not, in relation to the New Zealand payer, a payment of income tax for the purposes of section DB 1 of the Income Tax Act 1994 (which denies a deduction for payments of income tax). This interpretation is stated in the Inland Revenue Department's *Tax Information Bulletin*, Volume 5, No. 4 (October 1993) concerning section 209 of the Income Tax Act 1976 (the precursor to section CN 4).

Recommendation

That the submission be declined.

Issue: Allowing a single return by New Zealand payer

Clause 14

Submission
(18 – New Zealand Bankers' Association)

A New Zealand payer of premiums subject to the withholding tax under section CN 4 should be able to file a single return for each year in respect of all premiums paid to non-resident insurers.

Comment

The proposed amendment is unnecessary because Inland Revenue Department practice already allows a single return to be filed for each year by a New Zealand payer in respect of premiums paid to all non-resident insurers, and does not require the New Zealand payer to make a separate return in respect of each non-resident insurer. Inland Revenue intends to continue this practice.

Recommendation

That the submission be declined.

PROVISIONAL TAX AND USE-OF-MONEY INTEREST

Submission
(Matter raised by officials)

The application of use-of-money interest to provisional tax should be clarified, and it would be timely to do so in this bill. The subject has also been raised in the ICANZ submission, even though the issue is not in the bill.

At present the legislation appears to require interest to be overcharged. The proposal is to introduce a refund provision for the 1997-98 income year as an interim measure because of resource constraints. A full legislative and administrative solution is proposed for subsequent years to prevent overcharging interest.

Comment

Under the current use-of-money interest provisions, payments towards a provisional tax liability are first applied to meeting any accumulated interest, with any residual amount going towards the tax liability itself. This measure was intended to ensure that interest did not compound, which would increase the complexity of the calculations both for taxpayers and Inland Revenue and increasing the overall amount owed.

However, for provisional tax, which usually has three payments due in relation to one income tax return, the general statutory rule of applying payments to interest first in cases of underpayment actually causes compounding of interest. At present, the Tax Administration Act 1994 requires that payments made on the second and third provisional tax instalment dates are first applied to meet any outstanding interest, rather than the provisional tax due. The policy intent was that payments apply first to provisional tax, with the residual amount, if any, applying to interest outstanding.

This issue was identified when taxpayers and their agents received assessments different from what they expected.

Officials consider an amendment to the use-of-money interest legislation is required to ensure that interest on provisional tax payments does not compound. The importance of an amendment is increased as the current legislative and operational position increases the interest charged only to taxpayers who underpaid their provisional tax, compared with the intended policy position. Compounding interest does not occur when taxpayers overpay provisional tax. This means that the current legislative position may also be seen as unfair, as only those who underpay are affected.

Resource issue

Officials considered the option of using Inland Revenue's FIRST system to refund all interest overcharged to all affected taxpayers for the 1997-98 income year, when the issue first arises. However, the Government's tax simplification initiative requires substantial departmental resources on computer development. An integrated computer solution in the 1997-98 income year is likely to compromise Inland Revenue's ability to deliver:

- the employer monthly schedule; or
- the effective introduction of call centres.

In both cases failure to deliver would have a large impact on the revenue base and the integrity of the tax system and its administration. Further, this risk would not be balanced by resulting gains in more accurate calculation of interest for the 1997-98 income year, as the bulk of cases will be addressed through the manual process proposed below.

Owing to these resource constraints, officials recommend an interim solution: a manual correction to interest calculations for the 1997-98 income year for taxpayers who apply to Inland Revenue for a refund of overcharged interest. Inland Revenue's computer systems will be corrected for subsequent years.

Inland Revenue has consulted with ICANZ, which accepts the proposed compromise. ICANZ considers the long-term solution applying immediately to be the most desirable action, but acknowledges the resource constraints in Inland Revenue.

To ensure that the integrity of the tax system can be seen as being maintained for the 1997-98 income year, Inland Revenue will be writing to accountants and software developers and undertaking other publicity to ensure that affected taxpayers can apply for refunds for remission overcharged. This publicity has been discussed with ICANZ, who agrees.

Recommendations

- That the application of use-of-money interest to provisional tax be clarified to prevent compounding of interest.
- That an administrative refund provision be introduced for the 1997-98 income year, with a full legislative and FIRST system correction for subsequent years.
- That an amendment to the use-of-money interest rules as they apply to provisional tax be included in this bill.

TECHNICAL AND DRAFTING ISSUES

Issue: Amendments required as a result of Taxation (Tax Credits, Trading Stock, and Other Remedial Matters Act) 1998

Submission 1
(Matter raised by officials)

The punctuation in section KD 1(1)(a) should be corrected to refer to “CB 1(1)(c)”.

Comment

Section KD 1(1)(a) was amended by replacing an incorrect cross-reference. Inadvertently, the replacement was followed by “; and” as if the provision were part of a list. However, the “; and” should have been a comma.

Recommendation

That the submission be accepted.

Submission 2
(Matter raised by officials)

Cross-references in the definitions of “direct market value interest” and “direct voting interest” that appear twice should be amended so that they only appear once.

Comment

Two sets of cross-referencing amendments have been made to each of the definitions “direct market value interest” and “direct voting interest”. As a result, the same words appear twice. One set of amendments, therefore, needs to be repealed.

Recommendation

That the submission be accepted.

Issue: Amendments required as a result of Taxation (Simplification and Other Remedial Matters Act) 1998

Submission 1
(Matter raised by officials)

Section 33A should be amended to remove a reference to “attributed income”.

Comment

Section 33A refers to “attributed income” as that term was to be used in the TOLIS provisions that were contained in the Taxation (Tax Credits, Trading Stock and Other Remedial Matters) Bill. As the TOLIS provisions were not passed, the reference to “attributed income” needs to be removed.

Recommendation

That the submission be accepted.

Submission 2
(Matter raised by officials)

Section 82A should be amended to refer to “information about a beneficiary”.

Comment

Section 82A of the Tax Administration Act 1994 contains a definition of “beneficiary information” but the definition is not used in the section. The section refers to “information about a beneficiary”.

Recommendation

That the submission be accepted.

Submission 3
(Matter raised by officials)

Section NC 15(1)(b) should refer to “section 36B of the Tax Administration Act 1994” rather than just “section 36B”.

Recommendation

That the submission be accepted.

Submission 4
(Matter raised by officials)

Paragraph (i) of the definition of "employer monthly schedule" should refer to "Schedule 19, clause 8(b)" rather than "Schedule 19, clause 8B".

Recommendation

That the submission be accepted.

Issue: Amendments required as a result of Accident Insurance Act 1998

Submission 1
(Matter raised by officials)

One of the two paragraphs numbered (ia) in the definition of "salary and wages" should be renumbered as paragraph (ic).

Comment

Schedule 8 of the Accident Insurance Act 1998 amended section OB 1 by inserting new paragraphs (ia) and (ib) into the definition of "salary and wages". However, this amendment ignored an amendment made by the Taxation (Tax Credits, Trading Stock, and Other Remedial Matters) Act 1998 that already inserted a paragraph (ia) in that definition. As it is not intended that paragraph (ia) should be repealed and be substituted by the new paragraphs (ia) and (ib), paragraph (ia) should be renumbered as paragraph (ic).

Recommendation

That the submission be accepted.

Submission 2
(Matter raised by officials)

Section 46(5)(d) of the Tax Administration Act 1994 should be amended to refer to "compensation payable under the Accident Insurance Act 1998".

Comment

Section 46 relates to employer monthly schedules. Employers must include particulars of compensation paid to an employee under the Accident Rehabilitation and Compensation Insurance Act 1992. Compensation paid under the Accident Insurance Act 1998 should also be included in the list of particulars that employers must include in their monthly schedule.

Recommendation

That the submission be accepted.

Issue: Amendments required as a result of Taxation (Remedial Provisions) Act 1998

Submission
(Matter raised by officials)

The provisional tax rules should be amended to ensure that if a taxpayer has not filed last year's tax return, the provisional tax liability is calculated using the taxpayer's residual income tax for the previous year, plus a 10% uplift factor. Therefore section MB 1(1) should be amended to ensure that paragraph (b) continues to apply from the 1999-2000 income year.

Comment

Section 14 of the Taxation (Remedial Provisions) Act 1998 amended section MB 1(1) by replacing paragraph (b) with paragraphs (aa), (ab) and (b). The application date of paragraphs (aa) and (ab) should have been limited to the 1998-99 income year to provide relief as a result of the second round of tax reductions, and paragraph (b) should have continued to apply in subsequent years.

The application of the section has the effect of repealing the requirement for taxpayers who have not filed last year's return to calculate their provisional tax using the previous year's residual income tax, plus a 10% uplift factor from the 1999-2000 income year.

Given that the first provisional tax payments for the 1999-2000 income year were due in February 1999, we recommend that section MB 1(1) be amended to ensure paragraph (b)'s continued application. The proposed amendment is a continuation of existing policy.

Recommendation

That the submission be accepted.

Issue: Section HF 1

Submission
(Matter raised by officials)

Section HF 1 should be clarified so that it applies to mutual associations that purchase products from their members.

Comment

Section HF 1 allows mutual associations to deduct rebates paid to members for their transactions with the association to the extent that those rebates are not more than the profit attributable to member transactions.

Section HF 1 was redrafted as part of the Taxation (Core Provisions) Act 1996 to apply to mutual associations that sell products to members, not to mutual associations that purchase products from members. This was an oversight. The section previously applied to both mutual associations that sold products to members and those that purchased products from members.

Section HF 1 should be amended, therefore, to reflect its original intention and should apply from the 1997-98 income year, the application date of the Taxation (Core Provisions) Act 1996.

Recommendation

That the submission be accepted.

Issue: "Joint venture agreement" definition in section OB 1

Submission
(Matter raised by officials)

The definition of "joint venture agreement" should be updated in the light of the Civil Aviation Act 1990, to refer to the "Civil Aviation Act 1990" and the "Minister of Transport" with effect from 1 September 1990.

Comment

The definition of "joint venture agreement" refers to the Civil Aviation Act 1964 and to the Crown "acting by and through the Minister of Civil Aviation and Meterological Services". The Civil Aviation Act 1964 was consolidated into the Civil Aviation Act 1990. Accordingly, the Act references need to be updated, and the Crown reference should refer to the "Minister of Transport".

These amendments should apply from 1 September 1990, the date the Civil Aviation Act 1964 came into force. Corresponding amendments to the Income Tax Act 1976 will, therefore, be necessary as well.

Recommendation

That the submission be accepted.

Issue: "Timber" definition in section OB 1

Submission
(Matter raised by officials)

The reference to "cost price" in the definition of "timber" should be repealed.

Comment

"Timber" is defined for various terms in section OB 1, including the definition of "cost price". However, this reference is redundant as the definition of "cost price" does not contain the word "timber". Accordingly, the reference to "cost price" should be repealed, with effect from the date of Royal assent.

Recommendation

That the submission be accepted.

Issue: Limiting deductions under certain arrangements

Submission
(Matter raised by officials)

Drafting changes should be made to clarify the proposed amendments relating to arrangements involving expenditure on films and petroleum exploration.

Comment

The formulae in draft sections DM 1A(4) and EO 4A(4) do not operate to reduce deductions in the manner intended. The current wording suggests that deductions should be reduced **by** the amount given by the formula rather than **to** that amount. The term "in total by" in relation to the reduction of deductions should, therefore, be replaced with "so that the total of those deductions equal".

In addition, some minor presentational improvements are being proposed to:

- the draft sections DM 1A(2)(c) and EO 4A(2)(c), which exclude certain income from the consideration taken into account in the calculation of deductions allowed; and

- the draft sections DM1A(7) and EO 4A(7), describing the operation of the time bar.

Recommendation

That the submission be accepted.

Changes to the Tax Administration Act 1994

TIME BAR WAIVERS

TIME BAR WAIVERS

Issue: Date of application

Clause 91

Submissions

(12 - ICANZ; 13 - New Zealand Law Society; 3W - Christchurch City Council; 20 - Vela Fishing)

Three issues arise in relation to this clause:

- Whether the clause is inconsistent with the New Zealand Bill of Rights Act 1990. Vela Fishing raised this issue.

- Whether it is appropriate that the clause should have potential retrospective effect. This was raised in all the submissions above. In addition, in an opinion to Inland Revenue, Crown Law has suggested that it may be appropriate to suggest a savings provision directed towards excluding taxpayers who filed proceedings before 18 November 1998 and who have specifically raised the validity of a time bar waiver assessment.

- Drafting and technical issues identified by officials.

New Zealand Bill of Rights Act

We do not consider that clause 91 is inconsistent with the New Zealand Bill of Rights Act 1990. This view is supported by recent Crown Law advice to that effect, although Crown Law notes that in this area, as in many areas affecting the Act, the issue is not free from doubt.

Our responses to the arguments submitted by Vela Fishing for why the clause does breach the Act are:

- Clause 91 does not breach section 27(3) of the New Zealand Bill of Rights Act because the clause does not deprive the taxpayer of the right to bring civil proceedings against the Crown according to law and in the same way as civil proceedings between individuals. The taxpayer retains the right to have proceedings determined in the normal way and to any remedies that successful proceedings may give rise to. What the clause does is to remove an argument (that current section 108B has no application to return periods ending before 1 October 1996) that the taxpayer might advance in its proceedings.

- Clause 91 does not breach section 27(2) of the Act since it does not deny any person the right to apply for judicial review. The clause might affect the outcome of judicial review proceedings, but it is not a privative clause that purports to oust a person's right to judicial review.

- Clause 91 does not breach section 26(1) of the Act because it does not make a person liable to conviction for an offence for which the person could not be liable at the time it occurred. This is because no new offence is created by the clause.

If a clause is inconsistent with the New Zealand Bill of Rights Act 1990, the requirement is simply that the Attorney General should notify the House of such a view at the second reading.

Potential retrospective effect

Inland Revenue's view is that under current legislation, waivers of the four-year time bar on assessments for income years beginning before October 1996 are valid. The amendment proposed in clause 91 puts this interpretation beyond doubt. The clause is potentially retrospective because there is a reasonable alternative argument that the current legislation is flawed in that it does not apply to assessments for income years beginning before October 1996. If the law is not clarified by legislation the correct interpretation of current law will need to be determined through the court system at considerable expense to all parties. In the meantime, because of doubts about the validity of waivers, no new waivers will be entered into by Inland Revenue until post-October 1996 income years approach the four-year time bar – this is in the 2001 year at the earliest.

Submissions on this clause argue that the legislation should not apply retrospectively. The only way to ensure this would be to restrict the new clause to waivers entered into after the date of enactment. The effect of all past waivers would then be litigated through the courts.

In general, retrospective tax legislation is and should be avoided. Retrospective changes to tax rules undermine perceptions of the fairness of the tax system, and thus voluntary compliance, and have economic costs in that the effect of investment and other decisions become more uncertain. Nevertheless, it is recognised by the Legislative Advisory Committee and others that in the tax area, as in other areas, these considerations need to be balanced against other policy concerns on a case by case basis. In some cases it can be fairer and add to certainty for legislation to be retrospective. The classic example is the correction of an incorrect section cross-reference.

Considering concerns in this balanced way can sometimes lead to the conclusion that significant changes to the law should be retrospective. For example correcting major base maintenance concerns is often achieved by making remedial legislation effective from date of announcement, which is generally the date of introduction of the bill. In such cases the reasoning is that people are given notice of the change and, therefore, should not rely on the law that it is proposed to change.

On more rare occasions greater retrospectivity seems justified. This is where the policy intent of legislation is seen as being clear but the legislation does not achieve it, and the result is a significant hole in the tax base or a significant unintended tax impost on taxpayers. A recent example was the retrospective repeal of duty on credit card transactions enacted as part of the Taxation (Remedial Provisions) Act 1998 (No. 7). The rationale is that there is in such cases greater unfairness and uncertainty in not changing the law retrospectively than in doing so prospectively.

When retrospective legislation has an adverse effect on taxpayers, the general practice has been to protect those who have relied on the law that is being retrospectively changed. The change in law is not applied to those who have demonstrated that they have relied on the old law by taking some action such as filing a return on that basis.

In the case of waivers, both Inland Revenue and taxpayers have demonstrated that they understood the waivers to be valid by voluntarily entering into them in good faith. By putting beyond any doubt the validity of these voluntary agreements, certainty and fairness are enhanced. Moreover, there is no action undertaken by taxpayers in good faith that is subsequently made detrimental to them by the retrospective law change. They entered into a waiver on the basis it was valid, and this validity is retrospectively affirmed. The fact that a taxpayer has later challenged the validity of a waiver is not an action demonstrating the taxpayer's reliance on legislation under which the validity of the waiver may have been questionable.

The benign nature of the proposed clause is reflected in the submissions of the Law Society and ICANZ. The Law Society does not oppose the proposal but quite appropriately asks FEC to question whether retrospective legislation is appropriate in this case. ICANZ, in its letter of 26 February 1999 to the Minister of Revenue (referred to FEC), supports the proposal on the basis that affected taxpayers "will be treated as having given a time bar waiver of the same nature and quality which they entered into". In addition, the taxpayer, other than Vela Fishing, who filed proceedings before the date of introduction of this bill has said to Inland Revenue that it is "accepting and understanding" of the proposal.

We note that Crown Law, in its opinion to Inland Revenue on legal aspects of this waiver issue, has offered the view that it may be appropriate to consider a savings provision to make the clause non-retrospective. Consideration has been given to this but, for the reasons outlined above, the conclusion is that the clause should not be amended.

Recommendation

The clause should not be amended to remove potential retrospective effect.

Issue: Drafting issues

Submission
(Matters raised by officials)

In the course of their analysis of submissions officials identified as requiring amendments one technical and a number of drafting issues affecting clause 91.

Comment

A reference to the former section 31 of the GST Act 1985 should be inserted after paragraph (d) of the substituted section 108B(3). This will clearly confirm that the time bar affecting GST assessments for periods ending before 1 October 1996 comes within the scope of the clarified provision.

On page 153 of the bill, the expression "of the Income Tax Act 1994" appears in error in lines 16, 17, 20, 21, 26, 27, 37 and 38. Those words are inappropriate and should be omitted from the bill.

Recommendation

That the submission be accepted.

OTHER POLICY ISSUES

ARRANGEMENTS FOR EXTENSIONS OF TIME

Issue: The power of the Commissioner to cancel an agent's extension of time arrangement

Clause 58

Submission
(12 - ICANZ)

The bill's proposal that the Commissioner can cancel an agent's extension of time merely by notifying the agent is not supported. The current section 37(4A), which requires the Commissioner to notify each client of an agent that the agent's extension of time has been withdrawn because the agent has failed to meet his/her return filing percentage obligations, should be retained.

Comment

Under the current section 37(4), the Commissioner grants extension of time arrangements on a case by case basis. The rules surrounding an extension of time are negotiated annually with ICANZ. The Commissioner must be able to withdraw this extension of time if an agent does not meet the negotiated standard. The current section 37(4A) is difficult to apply because it requires the Commissioner to notify each client of an agent that the agent's extension of time has been withdrawn for non-compliance, which would create significant administrative cost. As a further complication, not all of the agent's clients would lose their extension of time; only those who had an outstanding return from a prior year would be affected. In summary, the current legislation does not allow Inland Revenue to monitor and sanction non-compliant agents effectively. The intention of this amendment is to state the Commissioner's authority and remove these restrictions.

Before removing an agent's extension of time the department warns the agent involved. Some leeway is built into the process, so that minor failures to meet percentages do not result in loss of extension of time. The process is flexible and involves consultation with the agent involved. Removal of an agent's extension of time is viewed as significant, so the department will warn the agent before taking action.

In response to the concern of ICANZ that individual taxpayers will be harmed by the proposed amendment, it should be noted that clients of agents who have had their extension of time withdrawn can change to another agent, under both current and proposed law. Alternatively, they may apply for an extension of time arrangement in their own right should they choose to file their own return.

Recommendation

That the submission be declined.

Issue: The definition of "linked to a tax agent"

Clause 47(26)

Submission 1
(12 - ICANZ)

The extended terminal tax date of 7 April should not only apply to taxpayers who are linked to an agent who have an extension of time arrangement, but to all taxpayers who have an extension of time.

Comment

The terminal tax date extension is granted to agents who have an extension of time arrangement in recognition of the significant number of tax returns agents file on behalf of their clients. The delay in the terminal tax date to 7 April should not be provided to those taxpayers who should be in a reasonable position to know their tax as at 7 February. Individual taxpayers with an extension of time who are not required to file their return until 31 March should be in such a position to know how much tax to pay by 7 February in any year. With individual taxpayers only one return is affected, whereas many of the returns filed by an agent may be affected.

When considering the submissions officials identified the need for a consequential amendment to sections MC 1, MC 2 and NC 17, which refer to individual tax returns rather than the agent's extension of time arrangement. We recommend that these sections be amended to provide that the 7 April date does not apply if the Commissioner has refused to grant an extension of time or has cancelled an existing extension of time under section 37(4A).

Officials recommend that the proposed section 37(4A) be amended to include the Commissioner's current power to cancel an extension of time in relation to an individual taxpayer who is a client of an agent. The proposed section 37(4A), by replacing the current 37(4A), effectively removes this authority.

Recommendation

That the submission be declined and a consequential amendment be made to sections MC 1, MC 2 and NC 17 to make them consistent with the proposed section 37(4A).

That the proposed section 37(4A) be amended to carry forward the Commissioner's current discretion to remove an agent's extension of time in relation to a specific individual.

Submission 2
(12 - ICANZ)

If agents lose their extension of time, the change in due date should be prospective only.

Comment

If agents do not meet their obligations for a certain year their extension of time arrangement should be withdrawn for that year, not a later year. Effectively ICANZ is suggesting that filing omissions should be addressed in a later year. A tax agent who has genuine reasons for not meeting his/her obligations, such as illness, is already catered for in terms of the annual agreement. Taxpayers can go to another agent to get an extension of time if it is withdrawn from their own agent. They can also apply for their own extension of time to file a return. If their terminal tax date reverted to 7 February because their agent's extension of time was removed after 7 February, the Commissioner would consider remission of penalties in these cases.

The submission also raises the issue of transfers to the "B List" of taxpayers who have not supplied necessary information. The negotiated agreement between ICANZ and Inland Revenue regards taxpayers placed on the B List as having had their extension of time removed. This makes their tax return, in effect, overdue, so the department takes action to ensure their return is filed. An agent can contact the department should a taxpayer subsequently provide the required information, in which event the taxpayer will again receive an extension of time by being moved from the B List. This merely involves a call to the department by the agent or his/her staff. The compliance costs of this action are not viewed as significant, especially once the department introduces a free phone 0800 number expressly for agents.

Recommendation

That the submission be declined.

TAX IN DISPUTE AND REMISSION PROVISIONS

Issue: The application of use-of-money interest rules to the 1995-96 or earlier income years

Clauses 92, 95 and 98

Submission
(12 - ICANZ)

If a dispute relates to the 1995-96 or an earlier income year and begins on or after 1 April 1997, the use-of-money interest rules, introduced as part of the compliance and penalties legislation, should not apply as proposed by this bill.

Comment

The submission considers that if a dispute relates to the 1995-96 or earlier income years and begins on or after 1 April 1997 that any interest payable on the tax dispute should be calculated using the provisions that existed before the introduction of the new use-of-money interest rules. The policy intention of the new interest rules is that they should be used to calculate all interest payable from 1 April 1997 onwards. If ICANZ's submission were accepted, the rate of interest payable on tax in dispute would depend on the income year to which the dispute relates. If the previous provisions were to continue to apply, the interest rate payable would have to be brought into line with current market rates. Because these provisions have been repealed, the interest rates cannot be changed.

The proposed changes would allow the old rules to apply if a taxpayer indicates that they should apply before the enactment of this legislation.

Officials have discussed this submission with ICANZ, which accepts the thrust of the proposed amendments, subject to a number of proposed amendments discussed below.

During the discussion ICANZ raised an additional concern that the predecessors to sections 120 and 139 should apply when the dispute relates to a period before the 1995-96 income year.

Based on that discussion officials recommend the following amendments:

- Amend section 120AA(1)(c) to replace the current requirement that the taxpayer's objection, appeal or case stated must maintain that section 120 applies, with the requirement that the taxpayer has simply informed the department of his/her view that section 120 applies, in the course of the disputes resolution process. It is accepted that taxpayers would not actually state in their objection that section 120 applies in relation to the tax in dispute.

- Amend section 120AA(2) to include the requirement that if subsection (1) applies, the Commissioner must apply section 120 or section 139 or their predecessors, whichever is appropriate, as they applied immediately before their repeal.

The effect of these amendments is first, that the taxpayer is not required to inform the department through any formal legal procedure that section 120 applies; notification by letter and as part of the disputes resolution process is sufficient. Second, to ensure that where interest is calculated under the rules that applied before the introduction of the new use-of-money interest rules that it is calculated in situations of both underpayment and overpayment when section 120AA(1) applies.

Recommendation

That section 120AA(1)(c) be amended so that it simply requires taxpayers to have informed the department in the course of the disputes resolution process that they consider that section 120 applies.

That section 120AA(2) be amended to include the requirement that the Commissioner apply section 139, and the predecessor provisions to section 120 or 139 where appropriate.

Issue: Amendments to Part VIIIA of the Tax Administration Act 1994

Clauses 93 and 97

Submission
(23W - Rudd Watts & Stone)

The amendments in clauses 93 and 97 do not operate so as to overcome the general commencement provision (section 1(2)) of the Tax Administration Act 1994.

As a consequence, Part VIIIA (Challenges to assessments) does not apply to income derived before the 1995-96 income year.

Comment

Officials agree that clause 93 should be amended so as to alter the reference to “1985” in section 124A (a) to “1995” and to omit the proposed new paragraph (b) from the new subsection (3) of section 124A.

Officials also agree that clause 97 should be redrafted so that the amendment to section 138A (1) mirrors the amendment to section 124A contained in clause 92.

Recommendation

That the submission be accepted.

OTHER ISSUES

Issue: Publication of public and product rulings

Clauses 68, 71, 72, 84, 86

Submission
(Matter raised by officials)

Notification that a public or product ruling has been made should continue to be published in the *Gazette*.

The notice that a public ruling is to be extended should continue to be published in the *Gazette*.

The notice that a public or product ruling is to be withdrawn should continue to be published in the *Gazette.*

Comment

After further consultation it has been requested that the *Gazette* be retained for the notification, extension and withdrawal of public and product rulings.

The need to retain the *Gazette* stems from section 91DE(3) and 91FJ of the Tax Administration Act, which stipulate that the date of withdrawal of a public or product ruling may not be sooner than the date on which the notice of withdrawal is made public. If the department were to use, for example, the *Tax Information Bulletin* to publish a withdrawal notice, it could potentially take up to a month before the notice was made public. In contrast, the *Gazette* is published weekly and so withdrawal can be effected much sooner.

The *Gazette* should also be retained for the publication of notifications and extensions. The wider distribution, reliability and regularity with which the *Gazette* is published makes it a more appropriate venue for the publication of notification and extension notices.

Clauses 68(2), 71(1), 72(1), 84(4) and 86(2) should be changed so as to refer to the *Gazette,* rather than "a publication of the Department".

Recommendation

That the submission be accepted.

Issue: Clarification of the term "audit"

Clause 73

Submission 1
(12 – ICANZ)

The proposed change to clarify the term "audit" to incorporate all verification activities undertaken by Inland Revenue should not proceed.

Comment

ICANZ has submitted that the inclusion of the word "investigation" in clause 73 section 91E(4)(g) extends the section too far and should be removed.

The original policy of the section was that Inland Revenue's Rulings unit should not rule on matters that were the subject of investigation by other divisions of Inland Revenue.

Extending "audit" to include all verification activities undertaken by the department helps clarify this policy and prevents different technical divisions of the department from committing resources to identical issues.

The definition is the same as that adopted for the penalties legislation.

Recommendation

That the submission be declined.

Submission 2
(12 – ICANZ)

The purpose of section 91E(4)(g) was to prevent taxpayers who are in the middle of a tax audit from playing one section of Inland Revenue against another. Inland Revenue should develop a reasonable procedure to ensure taxpayers know when they are notified of a tax audit or investigation for these purposes.

Comment

Inland Revenue is looking at this issue and preparing a paper for external consultation (including ICANZ.

Recommendation

That the submission be declined.

Issue: Application when tax is due and payable

Clause 73

Submission
(12 – ICANZ)

Clause 73 (Section 91E(4)(d)(i)) should be extended to include other forms of tax (such as PAYE) which are paid in advance as tax credits and are then assessable on an annual basis.

Comment

The potentially significant policy issue underlying this submission requires further work and consultation.

Recommendation

That the submission be declined.

Issue: Ruling before the receipt of a notice of assessment.

Clause 73

Submission
(23 – Rudd Watts & Stone)

The proposed section 91E(4)(f) has the potential to create a problem when there is a delay between the making of the assessment and the date the notice is issued, or a delay between the date the notice is issued and the taxpayer actually receiving the notice of assessment. The practical reality is that the taxpayer (and possibly the Rulings unit of Inland Revenue) will only know of the existence of a Commissioner assessment once the notice of assessment is received by the taxpayer.

Comment

The proposed amendment is simply a clarification of the current position that a taxpayer may not request a ruling after an assessment has been made. We appreciate the practical difficulties highlighted in the submission. Further consultation is required, especially since the most likely solution identified by officials represents a significant change in the time within which a taxpayer may request a ruling.

We therefore recommend that the proposed amendment not proceed pending further consultation.

Recommendation

That the submission be declined.

Issue: Arrangement not seriously contemplated

Clause 73

Submission 1
(Matter raised by officials)

An arrangement that is the subject of a binding ruling must be seriously contemplated not only at the time of application (as specified in clause 73(3)), but throughout the period following application to the date of issue of the ruling.

Comment

This amendment is needed to ensure that Rulings' time is used in the most effective manner and in a way that is consistent with the original policy.

If, after a taxpayer's application has been received it becomes apparent that the arrangement is no longer seriously contemplated, the Rulings unit needs to be able to stop work on that application and give priority to those rulings where the arrangement is seriously contemplated.

Therefore clause 73(3) should be extended to clarify that the arrangement that is the subject of a binding ruling must be seriously contemplated at the time of application through to the date of issue of the binding ruling.

Recommendation

That the submission be accepted.

Submission 2
(Matter raised by officials)

The requirement that an arrangement that is the subject of a binding ruling must be seriously contemplated at the time of application (clause 73(3)) should be extended to apply to product rulings also.

Comment

Section 91F(4) of the Income Tax Act gives the Commissioner power to decline to issue a product ruling if the arrangement to which the application is made is not seriously contemplated.

This section has been overlooked in the draft legislation, and should be amended in the same way as the provision relating to private rulings in clause 73(3).

Recommendation

That the submission be accepted.

Issue: Material assumptions

Clause 75

Submission 1
(23 – Rudd Watts & Stone)

Clause 75 is intended to ensure that a ruling will still be binding if the Commissioner's assumption is not material to the ruling. Our reading of the Act in its current form is that the Commissioner is only authorised to make assumptions that are material.

This change will lead to a "scatter gun" approach to the insertion of assumptions in rulings by Inland Revenue because it will argue that the insertion of additional assumptions should not concern the taxpayer. It could lead to disputes about whether an assumption is, or is not, material post-assessment. This outcome would be inconsistent with the primary aim of binding rulings – to provide taxpayers with prospective certainty of the tax effects of their transactions.

Comment

Although the Commissioner is required to state all material assumptions in the ruling, in theory there is no restriction on the inclusion of immaterial assumptions.

The decision to subject assumptions to a materiality threshold is necessary because the materiality of the assumption cannot always be determined when the ruling is issued. The approach taken in the bill has the advantage of maximising the number of situations in which rulings can be issued, while minimising the fiscal risk. It is a taxpayer-positive development.

Taxpayers' certainty as to the tax effect of their transactions is no more compromised under this proposal than it is currently. Taxpayers need to ensure that the assumptions they made to the Commissioner are correct. At present if an assumption (even an immaterial assumption) proves to be incorrect the whole ruling is invalidated. Under clause 75 the ruling will be invalidated only if it can be shown objectively that the assumption was material.

Officials disagree that this development will lead to a "scatter gun" approach. This change will not alter the way that Inland Revenue's Ruling's unit inserts assumptions. Assumptions are included only when the taxpayer is unable to provide information about future events or facts.

Recommendation

That the submission be declined.

Submission 2
(23 – Rudd Watts & Stone)

If an assumption proves to be materially incorrect it should not automatically invalidate the whole ruling – if the assumption is not material to the remainder of the ruling. (For example, an assumption may be material to the application of one taxation law to the arrangement but not material to another. In this case the ruling should only cease to be binding in respect of the first taxation law.)

Comment

Under this proposal, the Rulings unit would need to specify which part of the ruling each assumption applied to. This would be complicated and time consuming, and is unlikely to create certainty.

Recommendation

That the submission be declined.

Issue: Conditions in binding rulings

Clauses 77 and 84

Submission
(23 - Rudd Watts & Stone)

What types of conditions are contemplated by this amendment? Legislative guidance is necessary.

Comment

These clauses merely enact the current practise of Inland Revenue's Rulings unit, which is to identify key matters that must be assumed to be true for a ruling to be correct. Without the power to limit the application of a ruling through specifying key assumptions, the Commissioner would in many cases be unable to rule.

Recommendation

That the submission be declined.

Issue: What is meant by "consumer"?

Clause 83

Submission
(Matter raised by officials)

The word "consumer" used in clause 83 should be defined.

Comment

To alleviate any potential ambiguity the word "consumer" used in clause 83 should be defined to mean a party to an arrangement that is subject to a product ruling and who is not the applicant of the ruling.

Recommendation

That the submission be accepted.

Issue: Early publication of product rulings

Clause 84

Submission
(23 - Rudd Watts & Stone)

The legislation should be modified to enable the Commissioner to publish a product ruling before the end of the two-month period if the applicant requests that it be published and it is practicable for the Commissioner to do so.

Comment

As currently drafted, the proposed legislation allows two months from the date a product ruling is issued to the date the ruling is publicly released. The time delay is included so that the applicant may reap some commercial advantage from the ruling before the contents are made public.

It is acknowledged that there may be instances when applicants may wish to have their product ruling made public before the expiry of the two-month period. In these circumstances it should be possible for the applicant to apply in writing to the Commissioner requesting early publication.

The Commissioner would then issue a notification in the *Gazette* and seek to publish the ruling in full in a departmental publication as soon as possible.

Recommendation

That the submission be accepted.

Issue: Redraft of proposed section 91G

Clause 87

Submission
(23- Rudd Watts & Stone)

Proposed section 91G refers to taxation law that has been repealed, but not necessarily replaced. Consequently it makes no sense to refer to the repeal changing the way the [old] taxation law applies to the arrangement.

Comment

This change is not necessary. If a section is repealed, the way the taxation law applies to the ruling has clearly changed, in that it no longer applies.

Recommendation

That the submission be declined.

Issue: Notification provisions for binding rulings

Clause 88

Submission
(Matter raised by officials)

No notification provisions have been provided for "status" rulings.

Comment

Both private and product rulings contain a notification provision that requires the Commissioner to send a copy of the ruling to the applicant as soon as possible after the date on which the ruling was made. No provision has been made for this to occur for "status rulings".

Clause 88 should be amended to require that the Commissioner send a copy of the "status" ruling to the applicant as soon as practicable after the date on which the ruling is made.

Recommendation

That the submission be accepted.

Issue: Minor changes to the operation of “status” rulings

Clause 88

Submission
(Matter raised by officials)

The requirements for “status rulings” need to be specified in greater detail.

Comment

The requirements for “status” rulings provide only a broad outline of the process. Further discussions with those in Inland Revenue responsible for issuing these rulings has resulted in a few process-orientated recommendations for further refinement of the legislation.

- inclusion of an authority provision – giving the Commissioner express power to make a “status” ruling;

- inclusion of provisions where the Commissioner can refuse to make a “status” ruling – essentially mirroring the private and product ruling requirements;

- clarification that a “status” ruling is annulled when the private or product ruling on which it is based is withdrawn;

- including more comprehensive disclosure requirements - mirroring the private and product ruling requirements;

- giving the Commissioner power to request further information in relation to the “status” ruling; and

- requiring the Commissioner send a copy of the “status” ruling to the applicant as soon as possible.

Recommendation

That the submission be accepted.

Issue: Redraft of proposed section 91GD

Clause 88

Submission
(23 – Rudd Watts & Stone)

The section should be redrafted as follows:

> "The Commissioner does not have to withdraw and reissue a new ruling to correct a typographical or a minor error if the correction does not alter the ruling on how the taxation law applies to the person or the arrangement."

Comment

Officials agree that the section needs to be redrafted, and the validity of the ruling should be emphasised.

The section should be redrafted along the following lines:

> ***Effect of a minor error on binding ruling –****(1) The Commissioner does not have to withdraw and reissue a new ruling to correct a typographical or a minor error if the correction does not change the way the taxation law applies to the person or the arrangement.*
> *(2) In the circumstances outlined in (1) the ruling remains binding.*

Recommendation

That the submission be accepted.

Issue: Publication of product "status" rulings

Clause 88

Submission
(Matter raised by officials)

The proposed legislation should provide a mechanism for the publication of product "status" rulings.

Comment

The bill introduces a new variety of ruling – the "status" ruling. This ruling is issued in response to a law change to give applicants some certainty as to whether their original ruling still applies.

The bill does not provide for the publication of product "status" rulings.

It is officials' view that once a status ruling has been issued it should be notified in the *Gazette* and published in full in a departmental publication as soon as possible.

If the original ruling has not yet been publicly released, notification and publication of the status ruling must be withheld until the original ruling is published. The original ruling and the status ruling may be published together.

Recommendation

That the submission be accepted.

Issue: Outstanding debts

Clause 90

Submission 1
(Matter raised by officials)

Clause 90 needs to be amended to clarify that the outstanding debts must relate specifically to earlier binding ruling applications, not to outstanding debts generally.

Comment

As currently drafted, clause 90 is not specific enough in its reference to outstanding debts. The policy of the section is that if an applicant has outstanding debts in relation to previous binding ruling applications the Commissioner should be able to decline to issue further rulings until these debts are paid.

Recommendation

That the submission be accepted.

Submission 2
(Matter raised by officials)

The application date for this section should be changed to coincide with the introduction of new rates for binding rulings.

Comment

The application date for the section should be changed from the date of enactment to 1 June 1999.

Recommendation

That the submission be accepted.

Issue: Disputable decisions

Clause 99

Submission
(Matter raised by officials)

A decision by the Commissioner to decline to issue a ruling should be specifically excluded from the dispute resolution process.

Comment

As currently drafted, clause 99 removes from the ambit of the dispute resolution process decisions made by the Commissioner as part of a binding ruling or status ruling.

However, it is arguable that clause 99 does not remove from the disputes process decisions of the Commissioner not to issue a ruling.

The correct policy, as outlined in the discussion paper *Legislative Review of Binding Rulings,* is for such decisions to be excluded from the disputes process.

Taxpayers whose applications are declined would still be free to initiate judicial review proceedings to challenge the decision-making process.

Recommendation

That the submission be accepted.

Issue: Power to waive fees

Submission
(Matter raised by officials)

The regulations on private and product rulings state that the Commissioner may waive fees in exceptional circumstances. The legislation (section 91I) needs to be amended to make it clear that the Governor General has authority to regulate on this issue.

Comment

The proposed amendment of this issue, recently identified by officials, is merely a clarification.

Recommendation

That the submission be accepted.

TAX RECOVERY AGREEMENTS

Issue: Age limitations on assistance in recovery of tax

Clause 101

Submissions
(12 - ICANZ)

Any tax agreement that is entered into should only have prospective effect.

The maximum amount of time that a tax recovery agreement should apply is the length of time that a New Zealand taxpayer is required to keep business records seven years from the end of the year to which the assessment relates).

Comment

The proposed legislation does not sanction any action taken by the Commissioner before enactment, nor does it retrospectively impose a tax liability. It merely authorises the Commissioner to collect tax debt, following enactment. In this regard, therefore, the legislation is not retrospective.

Officials consider that it would be inappropriate to limit recovery action to debts that arise after the entry into force of each tax recovery agreement. This would be inconsistent with the international norm for such agreements. It would also be inconsistent with the tax recovery agreement that New Zealand has negotiated with the Netherlands.

When developing the proposed legislation officials did recognise, however, that there was merit to including a cap on the age of recoverable debt. It was recommended, therefore, that the proposed legislation provide that a debt must not have been outstanding as an uncontested tax liability longer than six years before the entry into force of the relevant tax recovery agreement.

Officials also recognised the desirability of a cap on the age of debt which, although it remains recoverable under the laws of the requesting country and meets the six-year rule described above, is still becoming old. In developing an appropriate provision, officials drew upon a model tax recovery agreement the OECD is currently developing. This provides that a state is not obliged to comply with a request for assistance that has been made after a period of 15 years from the date the debt first became recoverable.

The rationale for this provision is that a 15-year period provides a balance between providing sufficient time for disputes to be settled domestically before foreign assistance is required, and allowing a requested state to avoid the obligation to collect unacceptably old debt. It was, therefore, recommended that the proposed legislation contain a provision to this effect.

There is no need to limit the period to the length of time that a New Zealand taxpayer is required to keep business records, as the availability of taxpayer records will not be a material factor in collection under a tax recovery agreement. Any request for assistance in recovery of a foreign tax debt must be accompanied by written particulars of the amount of the tax claim; the extent, if any, to which the requesting country considers that the tax claim is uncontested; a declaration that the request meets the terms of the relevant tax recovery agreement; and a certified or notarized copy of the instrument permitting enforcement in the other country.

Recommendation

That the submissions be declined.

Issue: New Zealand's entry into tax recovery agreements

Clause 101

Submission
(23W - Rudd Watts & Stone)

New Zealand should only enter into tax recovery agreements once the boundaries of our domestic tax regime have been properly defined.

Comment

The supporting comments suggest that the submission is:

- concerned with the possibility that taxpayer rights will be undermined by New Zealand's entry into tax recovery agreements; and

- driven by the perception that due consideration has not been given to the issue.

The Government recognises that entry into tax recovery agreements by New Zealand will allow for extra-territorial enforcement of foreign revenue laws, in as much as New Zealand will assist in the collection of foreign tax debt, and foreign jurisdictions will assist in the collection of New Zealand tax debt. Careful consideration has, therefore, been given to the issue.

The proposed legislation has been developed in close consultation with the Ministry of Justice, and has been considered by the Legislation Advisory Committee. During this drafting process every effort has been made to ensure that the proposed legislation sets appropriate boundaries on the application of tax recovery agreements, thereby adequately safeguarding taxpayer rights.

The provisions are consistent with the main terms and conditions of New Zealand's first tax recovery agreement, negotiated with the Netherlands, which will provide a precedent for future agreements to be negotiated with other countries. This agreement has been derived from the Convention on Mutual Assistance in Tax Matters — the international model developed by the Council of Europe and the OECD. Throughout its development the model was subjected to extensive consideration by experts in international law and tax who carefully considered the issues concerning legal process and taxpayer rights.

International co-operation in tax administration has been recognised by the OECD as a necessary response to the deregulation of international commerce, and the ongoing removal of barriers to global investment and movement of capital.

Recommendation

That the submission be declined.

Issue: Rights of appeal

Clause 101

Submission
(Matter raised by officials)

That minor amendments be made to the proposed section 173I, to remove a redundant provision and correct imprecise drafting.

Comment

The proposed section 173I provides a taxpayer with a right of appeal on a question of fact or law that arises from the exercise of any authority, discretion, power, provision or right by the Commissioner or a competent authority under the legislation. Subsection (2) provides that the District Court may determine the reasonableness of such an exercise.

An appeal on a question of fact or law does not involve a determination of reasonableness. Officials recommend, therefore, that subsection (2) be omitted, on the basis that it is redundant.

The proposed section 173I(1) refers to a taxpayer who "claims to be affected" as having a right of appeal. It should simply provide that a taxpayer "may appeal".

The proposed section 173I(1) refers to "…the Commissioner or a competent authority…". This should be changed to "…the Commissioner or another competent authority…". The proposed section 173I(3) refers to "…the Commissioner or the competent authority", and should be changed to "…the Commissioner or the other competent authority". These changes are necessary because, as defined by the proposed legislation, the Commissioner *is* a competent authority.

Recommendation

That the submission be accepted.

DRAFTING ISSUES

Issue: Limiting deductions under certain arrangements

Clause 101

Submission
(Matter raised by officials)

Changes should be made to the proposed compliance and administrative requirements for reducing deductions under certain arrangements involving expenditure on films and petroleum exploration. A number of other minor presentational drafting changes are also required in this area.

Comment

Clause 59 of the bill requires taxpayers who have claimed deductions under an arrangement of the type in question to file an amended annual return for the income year in which consideration for the disposal of property is derived. The TAA does not generally require the filing of amended returns. Rather, in circumstances similar to these it requires the filing of special returns in a form prescribed by the Commissioner. The reference to “amended returns” should, therefore, be changed to “special returns”.

Recommendation

That the submission be accepted.

Changes To The GST Act

GST ON OVERSEAS MAIL DELIVERY IN NEW ZEALAND

Issue: Approval of the amending legislation

Clauses 109–110

Submission
(17W – Telecom New Zealand Limited)

Telecom wishes to note its support for the introduction of amending legislation to zero-rate the supply of postal services in relation to the delivery of overseas mail in New Zealand.

Recommendation

None.

Issue: Application date

Submission
(15W – New Zealand Post)

The amending legislation should apply from either:

- the date from which GST first applied to the supply of goods and services in New Zealand, namely 1 October 1986, or

- the first day of the month from which officials became aware of the anomaly the amending legislation seeks to correct, namely 1 July 1998.

Comment

The broad aim of goods and services tax (GST) is to tax all final consumption that occurs in New Zealand. Agreements between international postal authorities deem the consumption of the delivery of international mail to occur at the time the letter is posted. To tax the fees charged by New Zealand Post to overseas postal organisations for the delivery of international mail in New Zealand would be against the intention of the Goods and Services Tax Act 1985, since the consumption of these services occurs outside New Zealand. Other comparable services, such as international courier services, are not subject to GST, creating economic distortions through providing them with a tax-based price advantage.

The Act specifies an exclusion from zero-rating for exported services performed directly in connection with movable personal property situated in New Zealand. As mail is considered to be movable personal property, mail delivery services, even if provided to a non-resident who is outside New Zealand, are subject to GST.

The amendment seeks to align the treatment of overseas mail delivery services in New Zealand with the original policy intent with effect from the date the Act receives the royal assent.

The New Zealand Post argument for retrospectively applying the amendment from 1 October 1986 is based on the original policy intent that services rendered to non-residents who are outside New Zealand at the time of supply should not be subject to GST.

Officials consider that the amendment should apply prospectively as provided in the bill. While the amendment seeks to correct a situation in which the intended policy was not reflected in the legislation, officials do not believe that the amendment should be retrospective for the following reasons:

- As a general rule retrospective legislation creates legislative and taxpayer uncertainty.

- Retrospective legislation would not reduce any economic distortions as it will not alter purchasing decisions already made. It would merely result in a refund of $12 million of GST already paid by New Zealand Post.

- Making this amendment retrospective would give an unrealistic expectation to other taxpayers seeking corrective remedial legislation.

New Zealand Post has also suggested an alternative application date of 1 July 1998, the first day of the month in which the issue was brought to the attention of officials. Officials consider that there is also no justification for this date, for the reasons stated above.

Retrospective legislation could be appropriate where there are significant benefits that would justify an exception. Officials consider there are no significant benefits in this case that would justify an exception to this general rule.

Recommendation

That the submission be declined.
