Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill

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

21 August 2000

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CONTENTS

GST

OVERVIEW OF SUBMISSIONS

The bill contains proposals for reform of the Goods and Services Tax Act 1985 contained in the discussion document on the GST review. It also contains other issues raised in submissions on the discussion document or identified by officials.

In 1997 the then Government agreed that officials should undertake a post-implementation review of GST in accordance with the Generic Tax Policy Process. The Government discussion document *GST: A Review* was released in March 1999.

The objectives of the GST review were to:

- reduce compliance and administrative difficulties in the practical application of GST;
- limit the scope for obtaining unintended GST advantages.

The GST proposals are wide-ranging and include extensive base maintenance, compliance cost and remedial measures. This bill does not, however, address every single GST issue that may need to be addressed. The review of GST continues, and the Government's tax policy work programme already contains further specific areas for review, particularly in the financial and imported services areas.

Submissions on the GST proposals in the bill covered a wide range of issues. The main recommendations following submissions are as follows:

- ***Input tax credits for changes in use of imported goods***

  A significant number of submissions opposed the retrospective application of the proposed legislation to remove the ability of a taxpayer to claim a one-off input tax credit in relation to assets introduced into the GST base from overseas. Officials are not recommending any changes to the proposal because of the revenue risk involved and the aggressive nature of the arrangements.

  The proposed legislation contains a savings provision from the retrospective nature of the proposal. The savings provision requires that the taxpayer must have agreed with the Commissioner, in writing, to the claim. Some concerns have been expressed about the uncertainty of this requirement, and officials are therefore recommending clarification and are discussing the wording with submissioners.

- ***Associated persons***

  Some submissions expressed concern at the breadth of the proposed definition of "associated persons". Officials consider that the general scope of the proposed definition is appropriate but are recommending some minor amendments to clarify the application of the definition.

- ***Second-hand goods***

  The bill proposes to limit the input tax credit for second-hand goods to the GST cost initially paid by the vendor in relation to sales of appreciating assets (such as land) by a non-registered person to a registered associate.

The proposal addresses a base maintenance issue involving associates entering into transactions primarily to claim an input tax credit where there is no output tax liability on the other side. The issue could be addressed in several ways but we consider the solution proposed is the simplest and best-targeted option.

- ***Deferred settlements***

  The proposed legislation addresses a revenue risk caused by the difference between the time at which GST is returned (if the vendor accounts for GST on a payments basis) and an input tax credit claimed. (If the purchaser is on the invoice basis this will be immediately.) The bill is drafted to exclude transactions when settlement is required within 93 days. Submissioners commented on whether there was a need for amendments to target deferred settlements and also noted that the 93-day grace period would not be sufficient for some business transactions. While officials are convinced that reform is required to prevent the growing number of deferral arrangements, it is acknowledged that the proposal could be narrowed in its focus and thereby ensure that genuine transactions are not caught. Officials therefore recommend that the time period in which a deferred settlement will not be subject to the proposed amendments be extended from 93 days to 365 days.

- ***Last day of taxable period***

  The proposed legislation limits the extent to which taxpayers are able to use an alternative day as the last day of their taxable period. The proposal was recommended as some taxpayers have been able to use the existing right to choose an alternative last day of taxable period to obtain sizeable tax timing advantages.

  Officials have met with representatives from the Corporate Taxpayer Group to discuss their submission on this proposal. From these discussions, and the written submissions, new issues have been raised concerning the ability of exporters to mitigate the cash flow disadvantages of GST. In officials' view, these issues require further analysis, and we recommend that the relevant clauses be removed from the bill. Officials will report to the Government after further consideration of the cash flow impacts of GST on exporters.

- ***One-off adjustments for changes from exempt to taxable use***

  There is currently some doubt as to whether it is possible to make one-off, rather than periodic, adjustments for assets with a value in excess of $10,000. For revenue protection reasons, for assets shifting from non-taxable to taxable use the bill did not extend the ability to make on-off claims beyond a proposed threshold of $18,000.

  A submission has been made on behalf of Community Housing Limited that significant compliance costs would arise from this limitation where assets regularly undergo a 100 percent change in use. To address this concern, and at the same time reduce the revenue risk in providing one-off adjustments, officials recommend that taxpayers be required to apply to the Commissioner when claiming a one-off input tax credit in relation to 100 percent change in use from making exempt supplies to taxable supplies. The taxpayer will have to satisfy a number of criteria, including that one-off adjustments are also made for taxable

to non-taxable changes in use, before the Commissioner will approve such an adjustment.

- ***General insurance***

  Officials recommend that amendments affecting the treatment of interest included in subrogation payments be removed and the issue deferred for further consideration as part of the planned review of the GST treatment of financial services. This change has been agreed with the Insurance Council.

  To address other concerns expressed by the Insurance Council, officials recommend the following changes to the proposed legislation affecting the treatment of general insurance:

  - The clause that would impose a GST liability on an insured person in relation to an insurance payment to a third party (if registered for GST) should be amended to place the liability instead on the third party where the third party receives the payment. This change is recommended after the Insurance Council indicated that the existing proposal would impose significant compliance costs on the industry.
  - The inclusion of further amendments to clarify the treatment of subrogation payments and the availability of an input tax credit for such payments.

- ***Definition of "input tax"***

  Submissions were received that suggested that the proposed reform did not go far enough to resolve inconsistencies that existed between the application of the Goods and Services Tax Act 1985 and the Customs and Excise Act 1996. Officials recommend further legislative amendment should be made to make the reforms more effective. These reforms will make it easier for agents of non-resident principals (who are selling the non-resident's goods in New Zealand) to claim an input tax credit for GST levied at the border.

- ***Remedial and drafting matters***

  Officials have made a number of other recommendations to clarify the proposals contained in the bill and make minor drafting changes.

- ***Tax-free shopping***

  Although not related to any of the matters contained in the bill, an extensive submission was received from Global Refund, with support from the Retail Merchants Association, concerning the introduction in New Zealand of GST refund scheme for tourists. Submissions note that such a scheme in New Zealand would compare favourably with the refund scheme recently introduced in Australia. Officials recommend that at this stage the submission be declined. Officials will report to the Government at a later date on the likely benefits and costs associated with tax-free shopping.

TAX-FREE SHOPPING

Clause: N/A

Submissions
(4 – Retail Merchants Association of New Zealand Inc, 18 – Global Refund)

A GST refund scheme on purchases by tourists should be introduced in New Zealand by January 2001 to promote retailing, tourism and exports, thus providing significant economic benefits. The introduction of an effective refund system in New Zealand would compare favourably with the refund scheme recently introduced in Australia.

Such a scheme is preferable to any expansion of the current sealed bag system as it is administratively simpler, is easily accessible, would facilitate refunds being spent at the airport prior to departure, is consistent with similar systems operated offshore, would minimise concerns about fraud, and would apply to both domestically produced and imported merchandise.

Global Refund seeks approval to work closely with government officials on the implementation of a refund scheme.

Comment

Under the current legislation goods supplied in New Zealand to a tourist may be zero-rated either if they are exported by the supplier (for example, delivered directly to their overseas address) or exported under the "sealed bag" system. The sealed bag system may either involve goods being sent from the retail store to an international terminal and collected by the tourist at the border, or goods purchased by the tourist being placed in a sealed bag which can only be opened when the tourist has left New Zealand.

If a refund scheme were introduced in New Zealand along the lines of that advocated in submissions, tourists would purchase goods from a participating retailer for the GST inclusive price. The retailer would give the tourist a "tax-free shopping cheque" which documents the details of the purchase. On the tourist's departure from New Zealand, the New Zealand Customs Service (Customs) would be able to verify the export by inspecting the goods documented in the tax-free shopping cheque. The tourist would then present the validated cheque at an airport refund counter for their cash refund, comprising the GST paid less the operator's commission.

The operator would recover the refund as a GST input tax credit from Inland Revenue. (For GST purposes the operator would be exporting the goods and therefore would be entitled to the input tax credit.)

As well as making cash refunds, the operator would undertake marketing and reporting activities for various purposes such as increasing retail sales and minimising the risk of fraudulent exporting.

Since 1 July 2000 a similar scheme for GST refunds has been operating in Australia. However, the Australian Customs Services, rather than a private operator, administer the scheme. To collect a refund tourists must buy goods worth $300 or more from a single business no more than 30 days before departure. Tourists may purchase several lower-priced items from the one business, either at the one time or over several occasions within the 30-day period, provided the total purchases amount to $300 or more and only one tax invoice is issued for the goods purchased. The goods can be used in Australia before departure, although the refund applies only to goods which tourists take with them as hand luggage. All retailers who are registered for Australian GST purposes can participate in the scheme. No change has been made to Australia's existing sealed bag or airport duty free shop sales. Officials understand that the Australian system will be reviewed in 12 months' time.

Officials note the comments made about the potential economic benefits of a GST refund scheme arising from increased retail sales and promotion of exports in comparison with the current sealed bag system, which retailers find costly to comply with.

We consider that making any decision on the desirability of introducing a GST refund scheme for tourists will require detailed consultation with Customs and retailers, and that the following issues will need to be addressed:

- *Administrative costs*: Customs consider that a tax-free shopping system in New Zealand may not be viable because of high administrative costs, regardless of whether or not Customs operated the system. Costs would be incurred in relation to export verification at all international airports and seaports.
- *Benefits to tourists*: The progressive removal of tariffs and a GST rate of 12.5 percent in New Zealand (compared with 17.5 percent in the United Kingdom) mean that tourists would not receive a significant saving. High minimum purchase amounts and commission fees would also limit the benefits of a GST refund scheme to tourists. In addition, departing passengers might experience delays at refund counters and risk missing their flights.
- *Fraud*: There is a risk that input tax credits may be paid in relation to false exports or goods that have been exported but are re-imported free of GST. International experience has also shown that some operators fail to refund monies due to their customers, yet claim input tax credits from the revenue authorities.
- *Tax revenue costs*: Tax-free shopping would reduce the current tax base. The amount of revenue that is collected from tourism is approximately $473 million per annum. In addition to retail spending, this figure includes GST on supplies of services such as accommodation, domestic travel and entertainment.
- *Policy intent of taxing supplies to tourists*: The current sealed bag system is consistent with a tax system based on whether or not consumers have access to the goods supplied. If tourists have access to goods they can theoretically be "consumed" in New Zealand and GST should apply. This is consistent with the taxation of services provided to tourists in New Zealand. Any change to allow GST refunds in relation to goods to which tourists have access in New Zealand would alter the current tax boundary.

- *Impact on the criteria for zero-rating other supplies*: The broad GST policy is to tax consumption in New Zealand (including consumption by tourists). However, temporary imports and certain goods held in New Zealand prior to export (such as bloodstock) are zero-rated. These policy considerations would need to be re-evaluated in the light of any proposal to zero-rate goods purchased by tourists under a GST refund scheme.

Recommendation

Officials recommend that a GST refund scheme not be considered for introduction in this bill, but that officials report to the Government again on the overall economic, revenue, and compliance and administrative implications of such a scheme.

DEDUCTIONS FOR GST IN CALCULATING TAX DUE ON GROSS INCOME

Clause: N/A

Submission
(8 – Mr C G Duff)

Allow the payment of GST to the Government as a deduction for income tax purposes.

Comment

Deductions from income tax are allowed where expenditure is incurred in producing taxable income. For example, a business may incur advertising expenditure in order to promote its products and generate sales. As there is a link between the advertising expenditure and income, it is appropriate that the business should be able to deduct the advertising expenditure from its income. This is in sharp contrast to the payment of GST to the Government. As GST is a tax that is charged on behalf of the Government by registered persons on the supply of their goods and services, it does not form part of business income nor can it be said to be a cost incurred in producing income.

This is reflected in the Income Tax Act 1994 (section ED 4), which excludes GST charged on the supply of goods and services from the term "gross income". The section goes on to provide that any GST paid by a registered person on their purchases is not allowed as a deduction for income tax purposes. Section ED 4 therefore keeps the income tax and GST systems separate.

This approach is also consistent with standard accounting practices, as set out in Financial Reporting Standard (FRS) 19. The standard is very clear that registered persons act as collectors of GST in respect of their taxable activities, and therefore the reportable income earned and expenditure incurred by a business is, in general, exclusive of GST.

The method by which GST is collected further illustrates that paying GST is not an expense that is incurred in producing income. The GST that is remitted to the Government is the net difference between the GST charged in supplying goods and services less the GST that is paid on purchases. To this end, the collection and remittance of GST to the Government is, in general, outside the principles ordinarily associated with calculating the tax that is payable on income.

For the reasons above, officials consider that under the ordinary principles that allow deductions for income tax, a deduction for the amount of GST remitted to the Government should not be allowed. Officials also note that if the amount of GST remitted to the Government were deducted from income tax, this would result in a significant revenue loss. In the period from May 1999 to June 2000 Inland Revenue received payments of GST amounting to approximately $5,900 million. If this submission were accepted, a revenue loss of approximately one-third of this amount would result.

Recommendation

That the submission be declined.

THE SPECIFIC ANTI-AVOIDANCE PROVISIONS

Clauses 69, 73(6), 82 and 84

Submission
(20 – KPMG)

The large number of amendments of an anti-avoidance nature should be tested and considered in the light of the scheme and purpose of the GST Act. In particular, consideration should be given to whether the changes proposed can be structured and targeted more clearly as anti-avoidance measures with more limited application and therefore a lower compliance cost.

Comment

The bill contains a number of important base maintenance measures which are designed to limit the scope for obtaining unintended GST advantages. The bill also contains a large number of compliance cost saving and remedial measures.

The base maintenance measures include:

- restricting the second-hand goods input tax credit in transactions between associated persons;
- requiring GST to be paid in respect of assets held on deregistration on the basis of their market value;
- removing avoidance opportunities in relation to deferred settlements; and
- preventing GST refunds for goods imported and subject to a "change in use".

Maintaining the GST tax base is crucial to meeting the Government's revenue requirements.

The base maintenance measures in the bill have been subject to the generic tax policy process and, therefore, to extensive consultation. In particular, they were considered as part of the discussion document *GST: A Review*, which was published in March 1999. As a result of those consultations significant modifications have been made in some areas to narrow the scope of the measures. These measures are consistent with the scheme and purpose of the GST Act.

Recommendation

That the submission be declined.

DEFINITION OF "ASSOCIATED PERSONS"

Clause 67

Issue: Implications of the definition

Submissions
(12 – ICANZ, 20 – KPMG)

There should be a thorough review of the practical implications of the proposed new definition of "associated persons" before any changes are made to the current legislation.

Comment

The definition of "associated persons" is an important one in the GST Act because it is used in a number of specific anti-avoidance provisions. For example, it appears in the rule in section 10(3) countering the supply of goods and services to associated persons at an under-value to minimise output tax, and the proposed rule limiting input tax credits for sales of second-hand goods between associated persons. These anti-avoidance provisions recognise that transactions between related persons are more likely than in the case of transactions between other persons to be influenced by non-arm's length considerations.

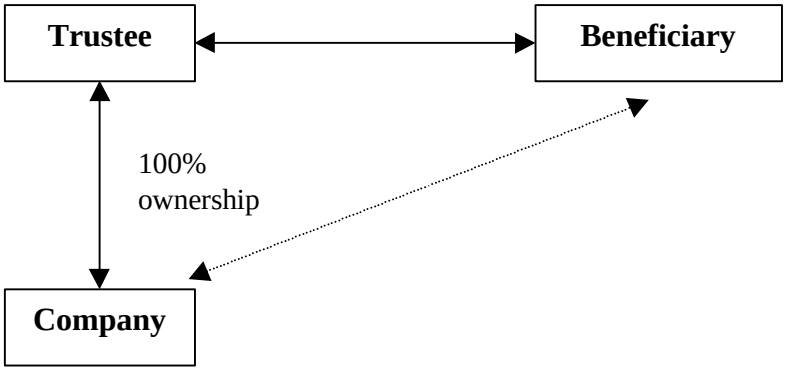
The existing definition in the GST Act is deficient because it does not treat as associated certain categories of persons between whom there is a significant degree of connection, for example, a trustee and a settlor of a trust.

Each of the tests in the new definition can be justified on the basis of it representing a sufficient degree of connection between the relevant persons.

The two submissioners who opposed strengthening the definition did not identify any reason, in principle, why it should not be strengthened in the manner proposed.

The universal tripartite test prevents the other tests of associated persons being circumvented by the interposition in arrangements of relatives, companies, and trusts which are under the influence or control of the main protagonists. An example would be a situation involving a trustee, a company wholly-owned by the trust and a beneficiary under the trust.

This is illustrated in the diagram below:



The trustee and the beneficiary are associated under the trustee-beneficiary test and the trustee is clearly associated with its wholly-owned company. There is a sufficient connection between the beneficiary of the trust and the company wholly-owned by the trust to justify treating these persons as associated.

Also, the existing associated persons definition in the GST Act already contains a version of the tripartite test, the only difference being that one of the three persons needs to be a company. This requirement is removed under the universal tripartite test in the bill, as there is no reason, in principle, why the tripartite test should apply only in relation to companies – its general concept should apply universally. For example, consider the settlor, trustee and the beneficiary of a trust, all of whom are individuals. The settlor is associated with the trustee under the new settlor-trustee test and the trustee is associated with the beneficiary under the trustee-beneficiary test. Accordingly, because of their common relationship with the trustee, there is a sufficient connection between the beneficiary and the settlor of the trust to justify treating them as associated under the universal tripartite test.

ICANZ submitted that it is not appropriate to base the GST definition of "associated persons" on the broader definition used in section OD 8(3) of the Income Tax Act 1994 because the latter definition applies only for a small selection of transactions and taxpayers where there is a special risk of avoidance. However, since its original enactment in 1988 as part of the international tax reforms, the section OD 8(3) definition of associated persons has been incorporated into a number of Income Tax Act provisions which have general application, such as the entire depreciation regime and section HK 11 (liability for tax of company left with insufficient assets). It is therefore not correct to describe the section OD 8(3) definition as being relevant only in a narrow range of provisions.

The section OD 8(3) definition was developed in 1988 after the enactment of the GST Act. If the section OD 8(3) definition had been available in 1986 it may well have been adopted at that time for the GST Act. Again, there is no reason, in principle, why the broader definition in section OD 8(3) should not be employed in the GST Act.

Also, not all of the broader features of the section OD 8(3) definition have been adopted in the new GST definition of associated persons. In particular, the new GST

definition does not include the test associating two persons habitually acting in concert. This test was not included because of its uncertain application.

It should be noted that the proposed definition is, in fact, narrower in some respects than the existing definition. First, the threshold for determining whether a company and any other person are associated is proposed in this bill to be raised from 10 percent to 25 percent. Second, the more narrow definition of "relatives" contained in paragraph (b) of the definition of "relative" in section OB 1 of the Income Tax Act 1994 is used for the purposes of the test for associating relatives. Generally, this definition of relative extends to the second degree of relationship rather than the fourth degree used in the existing associated persons test. The connection between "relatives" outside the paragraph (b) definition (for example, extending to great nephews under the fourth degree of relationship) is not sufficiently strong to justify treating them as associated persons. In contrast, there is a sufficiently strong relationship between de facto spouses to justify treating them as associated persons.

The KPMG submission refers to the difficulty that an independent contractor would face in knowing whether the recipients of its services were associated with each other, citing the example of different trading subsidiaries of a large group of companies. However, this submission seems to misconstrue the application of the operative provisions in the GST Act which utilise the definition of associated persons. This is because these provisions focus on whether the supplier and the recipient are associated, not whether the persons receiving supplies from a supplier are themselves associated.

The example in the KPMG submission is meant to illustrate how the new GST definition of associated persons is cast too widely. However, the relevant parties in this example are already associated under the existing definition, and there would seem to be a sufficient connection between the parties to justify so treating them.

Recommendation

That the submissions be declined.

Issue: Iterative universal tripartite test

Submission
(12 – ICANZ)

The tripartite test in proposed section 2A(1)(i) should not include a reference to itself, as this causes the test to operate iteratively.

Comment

Officials do not consider that the tripartite test in proposed section 2A(1)(i) operates in an iterative manner The test was intentionally drafted in the same manner as the tripartite test in section OD 8(3)(c), which, as the submission notes, was amended in 1991 to prevent it operating in an *ad infinitum* manner. To put the matter beyond

doubt, however, the reference to paragraph (i) in proposed section 2A(1)(i)(i) should be changed to paragraph (h).

Recommendation

That the reference to paragraph (i) in proposed section 2A(1)(i)(i) be changed to paragraph (h).

Issue: Defacto relationships

Submission
(12 – ICANZ)

The relationship of husband and wife included in the definition of associated persons should only be extended further to long-term de facto relationships (three years or longer).

Comment

The relatives test in the new definition of associated persons has been extended to include people in a relationship in the nature of marriage, that is, de facto spouses.

The current non-application of the GST definition of associated persons to de facto spouses is somewhat anomalous given that there would typically be a much closer relationship between de facto spouses than there would between first cousins or great nephews (which come within the existing definition of relatives for the purposes of the definition of associated persons in the GST Act).

De facto spouses are currently recognised for certain purposes of the Inland Revenue Acts, in particular, for calculating entitlement to family support tax credits and child support. The common statutory language used to describe a de facto relationship is a "relationship in the nature of marriage". This language has been employed in the new GST definition of associated persons.

Officials do not support restricting the de facto spouse test to relationships that have existed for three years or longer. A relationship is either a relationship in the nature of marriage or it is not. The other provisions of the Inland Revenue Acts which refer to de facto spouses are not restricted in this way. Various criteria can be used to determine in a particular case whether a relationship between a couple is such that they can be regarded as de facto spouses.

Recommendation

That the submission be declined.

Issue: Scope of the universal tripartite test

Submission

(Matter raised by officials)

The test in proposed section 2A(1)(i) which treats two persons as associated if they have a common relationship to another person should be amended to prevent it having the effect of associating relatives within the fourth degree of relationship even though the relatives associated persons test itself only extends to the second degree of relationship.

Comment

The definition of associated persons in proposed section 2A contains a more narrow test for associating relatives than the existing associated persons definition in the GST Act. The new relatives test extends only to the second degree of relationship rather than the fourth degree as under the existing test. This narrowing of the relatives test recognises that the connection between relatives outside the second degree of relationship (for example, extending to great nephews under the fourth degree of relationship) is not sufficiently strong to justify treating them as associated persons.

The test in proposed section 2A(1)(i) treats two persons as associated if they have a common relationship to another person. This test – referred to as the universal tripartite test – prevents the other associated persons tests being circumvented by the interposition in arrangements of relatives, companies and trusts which are under the influence or control of the main protagonists.

However, the universal tripartite test could have the inadvertent effect of effectively extending the relatives test to include persons within the fourth degree of relationship. This was not intended. This extension can be prevented by providing that the universal tripartite test does not treat two individuals as associated if they are both associated with the same other person under the relatives test.

Recommendation

That an amendment be made to provide that the universal tripartite test in proposed section 2A(1)(i) does not associate two individuals if they are both associated with the same other person under the relatives test in proposed section 2A(1)(c).

FINANCIAL SERVICES

Clause 68

Issue: Debt collection services

Submissions
(12 – ICANZ)

The reference to a "creditor's debt" should not be included. If that wording is retained a provision should be inserted to treat internalised debt collection activities carried out by businesses that are not principally providers of financial services as taxable.

(2W – NZ Post)

The amendment to treat third party debt collection services as taxable supplies should proceed.

Comment

It is accepted by submissioners that the provision of debt collection services should generally be treated as a taxable supply. The bill removes the existing exemption of debt collection services. The reference to a creditor's debt is intended to retain the current scope of the exemption for debt collection carried out by banks and other providers of financial services in relation to financial services they have provided themselves.

The provision of financial services (internalised debt collection services) is treated as an exempt supply regardless of whether or not the supplier is "principally" a provider of financial services – the definition of financial services and the exemption are activity based, not entity based.

Recommendation

That the submission be declined.

Issue: Financial options

Submission
(12 – ICANZ)

The term "financial option" should be defined.

Comment

The bill includes a financial option in the definition of financial services, therefore exempting their supply.

A term not defined in an enactment takes its ordinary meaning from the context in which it is used. A financial option is the right to buy or sell, at a specified price during a specified timeframe, specified financial assets, such as equity securities or currency. Officials consider that the ordinary meaning of the term "financial option" is sufficiently clear, and will be known, to those taxpayers who will be affected by this amendment, and therefore no definition is needed for this term.

Officials also note that the purpose of this amendment is to give legislative foundation to the current treatment of financial options in practice by taxpayers and Inland Revenue.

Officials further consider that it is desirable to retain flexibility in the meaning of the services listed as "financial services" in section 3 of the Act, and that defining a financial option would limit this flexibility.

Recommendation

That the submission be declined.

Issue: Deliverable and non-deliverable futures contracts

Submission
(12 – ICANZ)

The terms "futures contract", "deliverable futures contract", "defined market" and "arm's length" need to be defined or explained.

Comment

The bill includes within the definition of "financial services", and therefore gives exempt treatment to, the supply of a non-deliverable futures contract and supply of futures contracts that provide for the delivery of financial commodities.

A term not defined in an enactment takes its ordinary meaning from the context in which it is used. Officials consider that the ordinary meaning of the term "futures contract" is sufficiently clear, and will be known, to those taxpayers who will be affected by this amendment, and therefore no definition is needed for this term.

As with ICANZ's submission that "financial option" should be defined, officials consider that it is desirable to retain the current flexibility in the meaning of the term "futures contract" under the GST Act. Defining the term would limit this flexibility.

The Securities Amendment Act 1988 definition of "futures contract" is for the purposes of that Act, which regulates the raising of funds and is mainly directed towards the protection of the public. The purposes of the GST Act differ from those of the Securities Amendment Act 1988, and adopting definitions from that Act will unduly limit the scope of the GST Act.

The term "defined market" is intended to refer to a discernible or distinct market. It is not intended to refer to an "authorised futures exchange" under the Securities Amendment Act 1988, or any other specifically defined market, as many futures contracts, notably those utilised in the electricity supply market, are not in fact provided over a futures exchange or "traded" in any sense.

Recommendation

That the submission be declined.

Issue: Deliverable futures contracts for money

Submission
(Matter raised by officials)

The provision or assignment of a futures contract that provides for the delivery of money should be treated as an exempt supply.

Comment

The bill ensures that supplies of futures contracts that provide for the delivery of non-financial commodities are treated as taxable supplies. This is achieved by exempting the provision or assignment of futures contracts that provide for the delivery of a commodity if the supply of that commodity is itself an exempt supply.

The GST Act, however, deems money to be neither a good nor a service, and thus outside the scope of GST. Under the amendment the supply of a futures contract that provides for the delivery of money could, therefore, be subject to GST, contrary to the policy intent.

Officials therefore recommend that clause 68(1) be amended by inserting a reference to a futures contract that provides for the delivery of money.

Recommendation

That the submission be accepted.

DEFINITION OF "INPUT TAX"

Clause 69

Issue: Reform does not go far enough

Submissions
(12 –ICANZ, 21W – Denham Martin & Associates)

Denham Martin & Associates argue that the proposed amendment to the definition of "input tax" does not go far enough to resolve problems arising from the interaction between the Customs and Excise Act 1996 and the Goods and Services Tax Act 1985.

The situation outlined in the submission involves the importation of goods that are not acquired or applied for a purpose of making taxable supplies. In these circumstances GST will be levied and paid by the person importing the goods. Where the goods are supplied subject to approval and are found to be faulty the goods will not be "acquired" or "applied" as required by the amendment. As a consequence, a credit for the GST paid at the border will not be allowed. The submission recommends either inserting the word "imported" into the definition of "input tax" or, alternatively, amending section 12 of the GST Act to align it with the definition of input tax.

ICANZ supports the change to the definition of input tax to include the words "acquired" and "applied", but also suggests that the wording should be changed to "imported".

Comment

The bill allows importers acting as agents for principals outside New Zealand to claim input tax credits for GST paid on goods they import. Under the current legislation, if legal title to any goods does not pass to the importer, they may be denied an input tax credit even though they have paid GST on the importation of the goods.

Both submissioners recommend that an input tax credit should be allowed to registered persons if they import goods for the principal purpose of making taxable supplies. The intention is to mirror in the definition of "input tax" the wording in section 12, which allows the New Zealand Customs Service (Customs), by reference to the Customs and Excise Act 1996, the power to levy GST on the importation of goods to New Zealand. Although this has merit in policy terms, the word "imported" has broad application.

The Customs and Excise Act 1996 defines the term "importer" as a person by or for whom goods have been imported, including:

- persons to whom the goods are consigned; or
- persons that have ownership, possession or any beneficial interest in the goods on or at any time after their importation and the goods have left the control of Customs.

Using the word "imported" in the definition of "input tax" could allow an input tax credit where it is not appropriate to do so. Using the word "imported" could allow a final consumer to interpose an intermediary that is registered for GST in New Zealand to import the goods, claim a credit for any GST levied by Customs, and then pass the goods through to the final consumer.

> Example:
>
> A non-resident individual wishes to move to New Zealand. The individual would contract the services of a non-resident international moving company. The moving company would have arrangements with a New Zealand-based transport company to handle the goods once they reach New Zealand.
>
> The New Zealand transport company (acting as agent for the international moving company) could then claim a credit for the GST (if any) that is imposed on bringing the individual's goods into New Zealand.

Although the transport company has no proprietary interest in the goods, it may intrinsically form part of the taxable supply (transporting goods from A to B). Hence the import would arguably be for the principal purpose of making taxable supplies by the New Zealand transport company. Under these circumstances the handling of goods could be sufficient to entitle the transport company to claim an input tax credit for the GST levied by Customs on the imported goods.

In officials' view, it would be inappropriate for an input tax credit to be allowed in these circumstances. This is because the intention of GST to tax final consumption that occurs in New Zealand would be defeated.

Using the word "imported" in the definition of "input tax" will also create the expectation that a credit for GST levied by Customs will be available in most instances. For the reasons described above, a credit is not always appropriate and a number of exclusions to the meaning of the word "imported" would be required in order to protect the integrity of the GST base. This would create confusion and add another test to those of "acquired" and "applied" (which appear elsewhere in the GST Act) to determine when a registered person is entitled to claim an input tax credit.

Officials agree in principle with the proposal to amend section 12. Section 12(4)(c) permits a refund of GST imposed by Customs where there has been an error in calculating the tax. However, no refund is permitted if the registered person imported the goods for the purpose of carrying on their taxable activity. This prevents a taxpayer from claiming an input tax credit and claiming a refund from Customs (double dipping) if goods are faulty or tax has been levied in error. The exclusion could be disadvantageous to registered persons who import goods for the purpose of carrying on their taxable activity but (for example) because of faults in the goods never use them in their taxable activity. Officials recommend that the wording in section 12(4)(c) be amended so that the exclusion will only apply if the importer qualified for an input tax credit in relation to the imported goods.

Recommendation

That the submissions be accepted in part by making an amendment to section 12(4)(c).

Issue: Clarifying the application of the reform

Submission
(Matter raised by officials)

The amendment in clause 69 is intended to allow a refund of GST levied at the border when goods were entered for home consumption but were not acquired by the importer. This can occur in situations where the registered person may import the goods and apply them (through a New Zealand branch) or hold them as agent for the principal purpose of making taxable supplies. The reform, however, falls short of its objectives in relation to the activities of some agents.

Comment

The principal issue is whether an input tax credit should be allowed in all instances where GST is levied on goods that have been imported for the purpose of making taxable supplies. In most instances a credit should be available. However, if the goods are imported by a person who is an agent (that is, the goods are imported as part of the person's taxable activity, but not for the purpose of making taxable supplies) the position is less clear. In officials' view, if the goods are not imported for the principal purpose of making taxable supplies an input tax credit should not be allowed.

Under current legislation the availability of an input tax credit depends on whether the goods were acquired from the offshore supplier. Therefore:

- If the importer does not take possession or ownership of the goods, an input tax credit will not be available. In principle, the credit should be available to the non-resident as the supplier of the goods.
- If the importer takes possession or ownership of the goods a credit will be available to that person. The non-resident will not be entitled to the credit as that person is not the supplier of the goods.

The problem with this framework is in the assumption that the non-resident will register for GST so as to claim the credit for GST levied at the border. In general, it is undesirable to make non-residents comply with the tax rules of another tax jurisdiction in which they have limited involvement. The GST Act has two sections that attempt to keep offshore non-residents out of New Zealand's GST system.

One of these sections concerns the use of New Zealand agents. The Act currently provides input tax relief when supplies are made to an agent acting on behalf of a non-resident principal. It does not provide for the situation where the agent makes supplies on behalf of the principal.

The problem with this is the assumption that the non-resident will register for GST so as to claim the input tax credit for GST levied at the border.

> Example:
>
> A non-resident art gallery decides to sell several pieces of artwork that have some significance to New Zealand. Knowing that the artwork will get a better price in New Zealand, the art gallery arranges through an agent, who is resident in New Zealand, to sell the pieces in New Zealand. The value of the art and the activities of the non-resident art gallery would suggest that it should register for GST in New Zealand as it is selling the work in New Zealand.
>
> The agent, who is registered for GST, imports the pieces of art and arranges for their sale. As the agent does not acquire any proprietary rights to the artwork, it will not be entitled to an input tax credit for any GST levied at the border. The only party that would be entitled to an input tax credit is the art gallery. If, however, the art gallery did not register for GST, the input tax credit for the tax paid at the border would be unavailable.

Officials recommend the inclusion of another amendment that deals with supplies by resident agents made on behalf of a non-resident principal. The change will, in the case where a non-resident supplies goods in New Zealand through an agent, deem the supply to be made by the agent, provided the agent is registered for GST. The agent will then be responsible for charging GST and remitting it to the Government on the non-resident's behalf. In return, the agent will have the benefit of being able to claim a credit for any GST charged at the border.

A further technical amendment is also required as it is arguable that the word "applied" could (on a broad interpretation) go so far as to allow the handling of goods to be sufficient to entitle the handler an input tax credit for GST levied on the goods by Customs.

It is possible that the New Zealand business could actively participate in the import by acting as a freight forwarder. Goods could be bulk consigned to the freight forwarder, who would then break the goods down into the customer orders. The problem with this is that goods can be forwarded to a final consumer without attracting GST. This issue is similar to the concerns raised above in relation to the previous submissions to use the word "imported" in the definition of input tax.

Officials recommend that a technical amendment be made to limit the application of the word "applied" to instances where the importer will supply the imported goods rather than performing as its principal function the delivery of the goods or the facilitation of that delivery.

Recommendation

That the submission be accepted.

THE SECOND-HAND GOODS INPUT TAX CREDIT

Clause 69

Issue: Matching input tax credit claims and output tax paid on deregistration

Submission
(Matter raised by officials)

The bill should be amended to provide that an associated registered purchaser of goods from a deregistered supplier who acquired the goods before the introduction of GST is entitled to a second-hand goods input tax credit not exceeding the amount of output tax paid by the supplier on deregistration.

Clause 69 should also be amended to provide the second-hand goods input tax credit to an associated registered purchaser of goods from a deregistered supplier, who acquired the goods after the introduction of GST, does not exceed the amount of output tax paid by the supplier on deregistration.

Comment

The bill provides that if a person deregisters and pays output tax on the basis of the market value of assets acquired after the introduction of GST, the second-hand goods input tax credit allowed to an associated registered purchaser of the assets will be the lesser of the tax fraction of the purchase price or the open market value of the supply. This provision should be amended to ensure that the amount of the input tax credit the purchaser is entitled to does not exceed the amount of output tax paid by the supplier on deregistration. This achieves symmetry between the output tax paid by the supplier and the input tax credit allowed to the purchaser.

The bill should also be amended to provide symmetry in relation to the supply of an asset acquired by the supplier before the introduction of GST on which output tax had been paid on deregistration based on the cost of the asset. The amount of the input tax credit the associated registered purchaser is entitled to should not exceed the output tax paid by the supplier on deregistration.

Whether, therefore, the asset was acquired by the deregistered person before or after the introduction of GST, the amount of the input tax credit an associated registered purchaser of an asset receives should not exceed the output tax paid by the supplier on deregistration.

Recommendation

That the submission be accepted.

Issue: Whether the proposal should proceed

Submissions
(12 – ICANZ, 14 – PricewaterhouseCoopers, 19W – NZLS)

The revenue concern is exaggerated and the solution suggested is fundamentally inequitable.

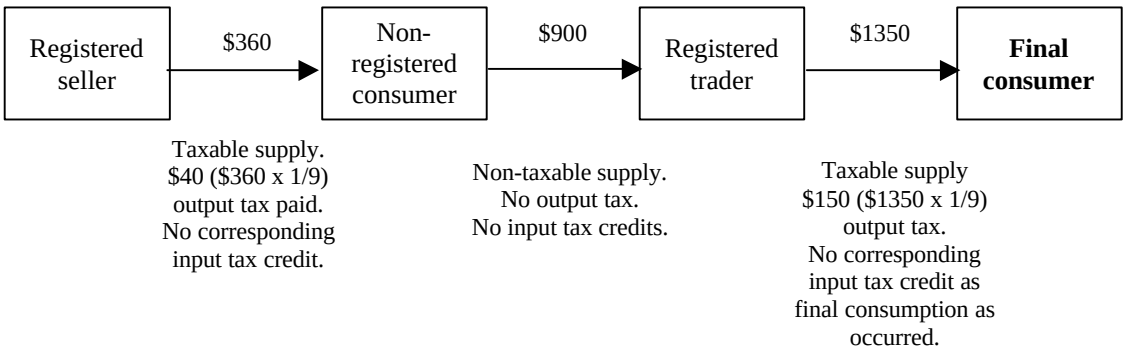
Therefore the proposal to limit the second-hand goods input tax credit in relation to supplies between associated persons should not proceed.

Comment

An input tax credit is allowed to a registered person who acquires second-hand goods from a non-registered supplier, even though no GST is charged on that supply. This is intended to recognise the GST paid when the non-registered supplier acquired the goods. Allowing a credit avoids the double taxation that would arise on the resale of goods on which GST was charged when acquired by the non-registered supplier.

For example, the following diagram illustrates a situation where an appreciating asset has been purchased by a private consumer who subsequently on-sells the good to a registered trader who also on-sells the good. The total private consumption is $1350. Ideally, net GST (output tax payable less input tax claimable) should be returned on this amount.

If no offsetting input tax credit were allowed to the trader, the net GST returned would equal $190. Over-taxation of $40 therefore occurs.



Allowing an input tax credit to the trader equal to the output tax paid by the first consumer (and returned by the registered seller) in effect provides a matching GST effect until the ultimate final consumption.

If however the trader obtained an input tax credit in respect of the $900 (as currently allowed) rather than the $360, under-taxation of $60 would occur (i.e. the difference between $1/9^{th}$ of $900 and $1/9^{th}$ of $360).

The input tax credit for second-hand goods has resulted in registered purchasers claiming large GST refunds in relation to goods (particularly land) on which GST has not been paid by the seller (because, for example, the goods were acquired before the introduction of GST). Therefore the credits are windfall gains to the registered purchaser rather than refunds of tax previously paid. As a result, in some cases second-hand goods are sold to an associated person primarily to claim the input tax credit.

The ability to claim an input tax credit on the purchase of second-hand goods which are retained for a substantial period of time before being resold also provides a substantial timing advantage in that no offsetting output tax is payable until subsequent sale.

This tax advantage is addressed in the bill by limiting the second-hand goods input tax credit in relation to supplies between associated parties to the lesser of:

- the GST component (if any) of the original cost of the goods to the supplier; or
- one-ninth of the purchase price; or
- one-ninth of the open market value.

(The current treatment is based on the lesser of purchase price or open market value.)

This would treat the associated parties as, in effect, one entity and provide a similar treatment to that which applies if a person acquires an asset wholly for private purposes then subsequently uses it wholly as a business asset.

Officials consider that the second-hand goods input tax credit should be limited as proposed in the bill for the following reasons:

- *The ability to receive large windfall gains is not restricted to transactions involving pre-GST assets. A*ll non-taxable supplies of appreciating assets to associated persons will be affected, not just those relating to goods acquired before the introduction of GST. The introduction of this proposal will provide a clear cut-off point for arrangements involving second-hand goods input tax credits for land and other appreciating assets, providing certainty in the tax treatment for both taxpayers and the Government. The proposed change was first outlined in the March 1999 discussion document and has been subject to lengthy consultation under the generic tax policy process.
- *The proposal is consistent with the policy of taxing final consumers. T*he proposal clarifies that registered persons are entitled to input tax credits to ensure that only the final consumer of goods or services incurs the GST cost. Allowing input tax credits in relation to goods that have not previously been subject to GST merely subsidises the purchase price and creates an unintended GST advantage. Retaining the current scheme of allowing a credit on acquisition for GST actually paid is consistent with the treatment of supplies of new goods.
- *The treatment is the same as if the asset was applied for taxable purposes rather than sold. T*he proposed approach means that the GST treatment is the same as if the supplier, having acquired the goods for non-taxable purposes, had applied the goods in a taxable activity instead of selling them to an associated person.

In these circumstances an input tax credit for the change in use would be allowed under current section 21(5) based on the cost of the asset.

- *Commercial transactions would be unaffected. T*ransactions occurring with an associated person for good commercial reasons will still go ahead as the commercial benefits arise irrespective of any windfall input tax credit.
- *Compliance difficulties should not be widespread. O*nly transactions between associated parties involving high value appreciating assets are affected. Purchasers should be able to acquire the necessary information from the vendor if they do not already have the information themselves. The proposal is therefore simpler and better targeted than alternative options for reform.

Officials note that to address the base maintenance issue inherent in allowing second-hand goods input tax credits Australia and the United Kingdom operate margin schemes. Under these schemes, a credit of tax is either deferred until the registered person sells the good, or GST is calculated on the difference between the purchase and sale price of the good. Canada does not allow any input tax credit for acquisitions of second-hand goods unless GST has actually been paid.

Recommendation

That the submissions be declined.

Issue: Alternative options for reform

Submission
(12 – ICANZ)

The policy should be more clearly directed to genuinely attack the benefit derived in inappropriate circumstances. For example, deny a credit if the asset is a pre-GST asset.

Comment

ICANZ consider that one option to target the inappropriate payment of credits is to deny a credit only if the asset is a pre-GST asset.

Officials note that the effect of the proposal in the bill would be to deny an input tax credit in these circumstances but consider that the proposal should also apply in relation to other supplies of second-hand goods between associated persons. This is because, as previously noted, the ability to receive large windfall gains is not restricted to transactions involving pre-GST assets. This approach will provide a consistent principle that in transactions involving associated persons an input tax credit should only be allowed for GST previously paid.

Recommendation

That the submission be declined.

Submissions
(12 – ICANZ, 14 – PricewaterhouseCoopers, 19W –NZLS)

The proposal creates an anomaly between supplies of second-hand goods to associated persons and supplies to non-associated persons.

ICANZ submits that the change should apply to all supplies of second-hand goods between both associated and unassociated persons so that there is no unfair disadvantage in genuine commercial transactions.

Comment

Submissioners consider that the current proposal creates a distortion between supplies made by associated persons and supplies made by unassociated persons and is therefore inequitable. However, any extension of the proposal to supplies made by unassociated persons would be a tax cost to taxpayers, and significantly increase compliance costs, as its scope would be much greater than the proposal in the bill. A purchaser could face significant compliance costs in ascertaining the GST cost incurred by a non-associated vendor.

An alternative approach would be to extend the proposal to non-associates but to deny an input tax credit if the GST component of the cost price, in circumstances where the cost was lower than the market or purchase price, was unable to be ascertained.

This approach, however, would favour associates (who are in a better position to ascertain the amount of GST actually borne) and would therefore be inappropriately targeted.

An alternative solution would be, as in Canada, to deny second-hand goods input tax credits. A change of this nature, however, would need to be consulted on widely and officials would not, therefore, recommend its inclusion in this bill.

Recommendation

That the submissions be declined.

Submissions
(12 – ICANZ, 19W – NZLS)

In the alternative, the credit should be deferred until the goods are on-sold.

In relation to transfers of land between associated persons the credit should be delayed for 3 years if the value of the land is $300,000 or more. If the land is sold to a third party, before the end of three years, then the credit may be claimed at the time the land is sold.

Comment

Submissioners consider that the tax advantage could instead be addressed by deferring a second-hand goods input tax credit until a registered person sells the second-hand good. This option was included in the discussion document (described as a “margin

scheme"). The majority of submissioners on the discussion document did not, however, favour this option for compliance cost reasons. In particular, it was noted that compliance difficulties would arise in relation to record keeping and apportionment.

Under a margin scheme, a purchaser is entitled to an input tax credit when the asset is sold. However, transactions can be manufactured to remove the effect of the deferral. For example, a registered person could transfer property to an associated registered person, thereby receiving an input tax credit immediately. Consequently, any effective margin scheme would require assets subject to the scheme to be "locked in" and, therefore, all subsequent purchasers would also be required to defer the credit until sale. This would affect a significantly greater number of registered persons than those affected by the proposed limitation in the bill.

A margin scheme would also impose significant economic and compliance costs on those affected. In particular:

- Timing disadvantages from lost interest (or returns) from the GST component of a purchase for the period between acquisition and sale. These costs can be significant, particularly if a good is expensive or held for a long time.
- Increased bookkeeping and invoicing requirements. High-volume businesses with large and varying amounts of trading stock would incur significant costs in tracking the margin on all sales.
- The obligation for unrelated (non-associated) purchasers to ascertain the status of a good and its GST treatment.

As an input tax credit for previous tax paid would no longer be allowed on acquisition, this would itself create a distortion in the treatment between new and second-hand goods, particularly if the margin scheme were applied to all second-hand goods.

In relation to transfers of land between associated persons, ICANZ considers that the credit should be delayed for 3 years if the value of the land is $300,000 or more.

Officials consider that for certain assets (especially land) three years is a relatively short period of time for taxpayers to wait in order to claim a credit. This approach would not therefore address the current tax advantages.

Recommendation

That the submissions be declined.

Submission
(19W – NZLS)

The tax advantage should be addressed by applying the existing general anti-avoidance provision.

Comment

Officials' view is that specific anti-avoidance provisions are generally easier to interpret and apply than the general anti-avoidance provision. Their application is, therefore, more certain. For this reason they are usually preferable to reliance on the general provision (either as currently drafted or as proposed), which is primarily intended to perform a backstop role. The second-hand goods proposal seeks to remove the current weakness in the GST framework allowing large windfall gains to registered persons. This is unlikely to be achieved as effectively if the general anti-avoidance provision were relied upon instead.

Recommendation

That the submission be declined.

Issue: Consistency with the taxation of value added

Submissions
(12 – ICANZ, 19W – NZLS, 20 – KPMG)

The change moves from a true added value tax so that consumption in New Zealand will be overtaxed, with detrimental effects on the economy.

Disallowing an input tax credit but requiring the purchaser to account in full for output tax on any subsequent disposal is not in accordance with the principles of the GST legislation, which is intended to tax effectively (in net terms) only the margin.

Comment

As discussed earlier, an input tax credit is allowed to a registered person who acquires second-hand goods from a non-registered supplier, even though no GST is charged on that supply. The amendment proposes to limit the second-hand goods input tax credit allowed in relation to supplies between associated persons to the lesser of:

- the GST component (if any) of the original cost of the goods to the supplier; or
- one-ninth of the purchase price; or
- one-ninth of the open market value.

The submissioners consider that this treatment is inconsistent with general GST principles in that it could give rise to tax on a greater amount than the value that is added by the registered person. A fundamental principle underpinning GST is that registered persons pay output tax on supplies made and obtain input tax credits for GST paid. If input tax credits are provided to registered persons where no GST has been paid, they are receiving a subsidy through the tax system. That result was not intended when GST was introduced.

The second-hand goods input tax credit was introduced for reasons of compliance cost savings and the desirability of recognising the GST cost originally borne by the non-registered vendor. As a consequence, it should only be allowed to the extent that GST is actually incurred by the non-registered vendor (in the bill this limitation applies only to associated persons for compliance cost reasons). It was not intended to provide a means of calculating the value added by the registered person.

Recommendation

That the submissions be declined.

Issue: Effect of the proposed changes to the definition of "associated persons"

Submission
(20 – KPMG)

Because of the proposed changes to the definition of "associated persons" the proposal to limit the second-hand goods input tax credit is inappropriately broad.

Comment

Officials consider that the proposed scope of the associated persons definition, and therefore the application of the second-hand goods input tax proposal, is appropriate. The definition is used in certain provisions to recognise that transactions between related persons are more likely than transactions between other persons to be influenced by non-arm's length considerations.

As previously stated, the existing definition of associated persons in the GST Act is deficient because it does not treat as associated certain categories of persons between whom there is a significant degree of connection. Each of the tests in the new associated persons definition can be justified on the basis of it representing a sufficient degree of connection between the relevant persons.

Also, not all of the broader features of the section on which the new provision is based (section OD 8(3) of the Income Tax Act 1994) have been adopted in the new GST associated persons definition. In addition it should be noted that the proposed associated persons definition is in fact narrower in some respects that the existing GST associated persons definition.

Recommendation

That the submission be declined.

TOKENS, STAMPS AND VOUCHERS

Clauses 70(4) and 72(1)

Issue: The need for proposed section 5(11H)(b)

Submission
(12 – ICANZ)

The proposed section 5(11H)(b) is redundant and does not need to be enacted.

Comment

Officials consider that the proposed provision is not redundant because it replicates the effect of an existing provision for the purposes of the GST treatment of "exported" services such as education services provided in New Zealand to non-resident students. If such services are supplied in exchange for a token, stamp or voucher, the value of the supply will be recognised at the time the token, stamp or voucher is acquired, rather than at the time it is redeemed. Therefore if the supply cannot be zero-rated because it is reasonably foreseeable that the services will be performed in New Zealand, GST will be required to be returned at the time the voucher is sold. The GST treatment is, therefore, established when the voucher is sold on the basis of whether or not future services will be performed in New Zealand.

If a standard rated supply of "exported" services could be recognised on the redemption of a voucher, difficulties might arise in valuing the supply if the consideration paid for the voucher differed from the value of the services at the later time of redemption. For example, the price of accommodation supplied in a hotel may change between the time a voucher for the accommodation is sold and the time a tourist arrives in the hotel.

However, officials do consider that proposed section 5(11H) should be clarified further so that the option to recognise GST on redemption cannot apply in relation to the *supply* (rather than the *redemption*) of a postage stamp or "exported" services.

Recommendation

That the submission be declined, but that a minor drafting change be made to clarify that the option to recognise GST on redemption cannot apply in relation to the *supply* (rather than the *redemption*) of a postage stamp or "exported" services.

Issue: Scope of the terms "token", "stamp" and "voucher"

Submission
(12 – ICANZ)

Terms used such as "token, stamp or voucher" should be broadened to include more modern trade forms such as electronic debit cards.

Comment

The Oxford dictionary definition of a voucher is "a document which can be exchanged for goods or services as a token of payment made or promised by the holder or another". The submission considers that the term "voucher" is limited to the more traditional forms of vouchers such as vouchers physically exchanged for goods or services.

The requirement to present the document ensures that it cannot be used to receive goods and services in excess of the consideration paid for the voucher. Electronic cards such as phone cards need not be returned to the supplier as they expire automatically. Therefore the ordinary meaning of a token or voucher should apply whether or not the document was returned to the supplier.

The submission considers that a phone card is more equivalent to a concession pass used on public transport and would not, therefore, be considered to be a voucher. In officials' view a concession pass for public transport is not a voucher but is verification that the holder is eligible for a reduced rate. A ticket allowing transport of a set amount or for a certain period (for example, a 10-trip ticket or monthly pass) would, however, be a voucher as it is a "token of payment" redeemable for certain goods and services.

Officials consider that the ordinary meanings of the words "token, stamp and voucher" are sufficiently broad to include electronic cards such as phone cards.

Recommendation

That the submission be declined.

Issue: Options to recognise GST to be mutually exclusive

Submissions
(12 – ICANZ, 13W – Rudd Watts & Stone)

The proposed section 5(11G) should be redrafted to explicitly state that the option to treat the redemption of the token as the supply, and the treatment of the sale of the token as the supply, are mutually exclusive options. Section 5(11G) does not explicitly over-ride section 5(11E); therefore a supplier who elected to charge GST at

the time of redemption of a token would still also be required to charge GST when the token was sold.

Comment

A minor change to section 5(11G) should be made to clarify that the election to treat the redemption of the token as the supply, and the treatment of the sale of the token as the supply, are mutually exclusive options.

Recommendation

That the submissions be accepted.

Issue: Issuer election of redemption option

Submission
(12 – ICANZ)

Only the issuer of a token, stamp or voucher should be able to elect that the GST be payable on redemption.

Comment

The submission notes that it is unclear what would happen if a third party purchases a token, stamp or voucher and on-sells it to a customer. In this case the purchaser chooses to sell the voucher rather than redeem it.

The intention is that the specific rules in the bill affect the issue of a token, stamp or voucher and the supply of goods and services provided in exchange for that token, stamp or voucher. Other supplies (sales) of the token, stamp or voucher between registered persons will not be affected as the face value of the token, stamp or voucher will remain unchanged, and any GST charged will be offset by an input tax credit.

Officials agree that this treatment should be clarified in the bill.

Recommendation

That the submission be accepted.

Issue: Certainty of GST treatment

Submission
(12 – ICANZ)

The proposed section 5(11G) should require the supplier to identify on the face of the token, stamp or voucher whether there has been a supply for GST purposes to enable any person who receives the token, stamp or voucher to know whether GST has been accounted for.

Comment

Difficulties may arise if one person issues a voucher and another person provides goods or services on the redemption of the voucher. If GST were recognised by the first supplier there would be no GST implications when the voucher was redeemed. The second supplier might not, however, know that GST had already been accounted for.

Officials consider that if the goods and services to be supplied on the redemption of a voucher are supplied by a person other than the issuer of the voucher, GST should be recognised on redemption only by agreement between the issuer of a voucher and the supplier of the goods and services. For example, a gift voucher may be issued by one bookshop to be redeemable at an affiliated bookshop. The GST treatment of the issue of vouchers should be established by agreement between the bookshops.

Recommendation

That the submission be accepted and the bill be amended to clarify that the option to recognise GST on the redemption of a voucher applies by agreement between the issuer/s of a voucher and the supplier/s of the goods and services specified in the voucher.

Issue: Clarification of clause 70(4)

Submission
(13W – Rudd Watts & Stone)

The provisions in clause 70(4) should be redrafted to achieve the intended result and to clarify when input tax credits may be claimed in respect of supplies and redemptions of tokens, stamps and vouchers purchased for the principal purpose of making taxable supplies in the course of a taxable activity. Replacement draft legislation has been submitted.

In particular, the submission raises the following issues:

- The provision treating the sale of a token as a supply of goods and services is not necessary as a token is within the ordinary definition of a service. It also notes that if the purchaser of the token is using it in the course of a taxable activity it should be entitled to claim an input tax credit.
- The proposed legislation in subsections 5(11F) and (11G) should focus on the goods or services supplied on redemption, not the service of redemption.
- It should be clarified that the treatment adopted by the supplier of a voucher has no effect on the recipient.

Comment

Although treating the sale of a token as a supply of goods and services is not strictly necessary, officials consider that it significantly aids comprehension. Not explicitly deeming a supply to occur on the sale of a token and then providing that a supply does not occur on redemption (as proposed by the submissioners) may create confusion as to what supply has been made for GST purposes. This will be further explained in the *Tax Information Bulletin* item on the legislation, once enacted.

Officials consider that the current proposed legislation would allow the purchaser of a token to claim an input tax credit even though the token is acquired for the purpose of acquiring goods and services, and not for the immediate purpose of making taxable supplies. It is sufficient that the token is acquired for the principal purpose of making taxable supplies. For example, a voucher may be acquired as a promotional give-away and it is not necessary that the purchaser acquire the actual goods and services for which the voucher will be exchanged.

As noted above, the bill should be clarified to provide that the specific GST treatment affects only the issue of a voucher redeemable for goods and services and the subsequent supply of those goods and services on the redemption of a voucher. Therefore how the supplier elects to treat the transaction under 5(11G) would not have any effect on the recipient.

Recommendation

Officials recommend that the submission be accepted in part and that the bill be clarified to provide that the specific GST treatment affects only the issue of a voucher redeemable for goods and services and the subsequent supply of those goods and services on the redemption of a voucher.

Issue: Clarification of the redemption option

Submission
(Matter raised by officials)

The bill should be amended to clarify that the option to recognise GST on the redemption of a voucher would apply only when it is not practical to recognise GST on acquisition.

Comment

The proposal in the bill will provide that the supply in relation to a token, stamp or voucher redeemable for goods and services will be recognised both for suppliers and recipients when the token, stamp or voucher is acquired.

However, this rule may increase compliance costs in some instances and an exception to the proposed general rule will apply to vouchers with a face value so that the output tax is recognised on redemption at the supplier's option. The rationale for the exception should be clarified in the bill by only allowing a supplier to recognise GST on the redemption of a voucher when it is not practical to recognise GST on acquisition.

Recommendation

That the submission be accepted.

GENERAL INSURANCE

Clauses 70(5) and 83(2)

Issue: The proposal to clarify the scope of input tax and output tax in relation to payments under general insurance contracts

Submission
(12 – ICANZ)

The proposal to remove the words "indemnify" and "indemnity" in section 20(3)(d) and section 5(13) respectively should be introduced retrospectively, rather than with effect from the date of enactment.

Comment

The proposed changes are intended to clarify the scope for the claiming of input tax credits and the payment of output tax in relation to general insurance contracts. This is so as to remove any argument that contingency insurance policies (such as sickness and personal accident insurance policies) are excluded from the normal GST treatment of general insurance.

The issue has been discussed with the Insurance Council of New Zealand, which has not made a submission that the change should be retrospective. Officials understand that this is because Inland Revenue has given a private binding ruling that contingency insurance policies are within the ambit of section 20(3)(d) and section 5(13). Thus the changes in the bill are seen as putting the matter beyond doubt rather than changing the law.

Officials understand, based on information provided to us, that a retrospective change to section 20(3)(d) would not have a significant effect on the position taken by general insurers in relation to input tax in their GST returns. However, it is not certain that the same can be said about the implications of a retrospective change to section 5(13) and that such a change would not give rise to a retrospective GST liability for a registered recipient. As the types of insurance policies affected are likely to be those that involve non-registered recipients, these effects are possibly limited. However, in officials' view even a small risk of a retrospective GST liability would outweigh the benefit (if any) of a retrospective change.

Recommendation

That the submission be declined.

Issue: Treatment of payments under general insurance policies

Submission
(Matter raised by officials)

Clause 70 should be amended so that payments made to registered third parties are subject to output tax under section 5(13) in the hands of the third party, rather than in the hands of the insured person.

Comment

The commentary on the bill noted that under section 5(13), as currently drafted, there is an argument that, if under a contract of insurance an insurer makes a payment to a registered third party rather than to a registered insured, the insurer is entitled to an input tax credit but the third party does not incur a corresponding output tax liability.

Clause 70 addresses this argument by providing that in the situation described the registered insured is liable to output tax.

Officials have had discussions with the Insurance Council, which advised us that there would be significant compliance cost concerns for insurers if clause 70 proceeded in its current form. This is because if a third party suffers a loss at the hands of a person who is insured under a contract of insurance, the practice of insurers is to make payment under the contract to the third party directly. Clause 70 would require insurers to pay the GST portion of the payment to the insured.

Officials therefore consider that the proposed section 5(13) in clause 70 should be amended to ensure that a registered third party who receives a payment under a contract of insurance, rather than the insured under that contract, is liable to output tax under section 5(13).

Recommendation

That the submission be accepted.

SUBROGATION PAYMENTS

Clauses 70(5) and 73(9)

Issue: The relationship between section 5(13) and 5(13B)

Submission
(12 – ICANZ)

The drafting of section 5(13) should be clarified to exclude from the output tax liability subrogation payments received by insurers that are already subject to output tax by virtue of section 5(13B) relating specifically to subrogation payments.

Comment

There is a degree of overlap between the two provisions. Officials do not consider that it gives rise to any significant difficulty in interpretation. Nevertheless, the drafting clarification should be made if that aids interpretation.

Recommendation

That the submission be accepted.

Issue: Excluding as subject to output tax the interest component of a payment under a contract of insurance

Submission
(12 – ICANZ)

The interest component of a payment under an insurance contract should be excluded from the amount of output tax payable by virtue of section 5(13) by a registered recipient.

Comment

Officials consider that the submission raises an important wider issue of the extent to which the interest component of any transaction should be excluded from the GST net. Officials consider that this issue would be better dealt with in the Government's planned review of the GST treatment of financial services.

Recommendation

That the submission be declined.

Issue: The inability to obtain input tax credits in relation to subrogation payments

Submission

(10W – Deloitte Touche Tohmatsu)

Although subrogation payments are subject to output tax in the hands of the recipient under section 5(13B), there is no corresponding ability for the payer of the payment to obtain an input tax credit. An amendment should be made to section 20(3) to allow an input tax credit to the payer of a subrogation payment.

Comment

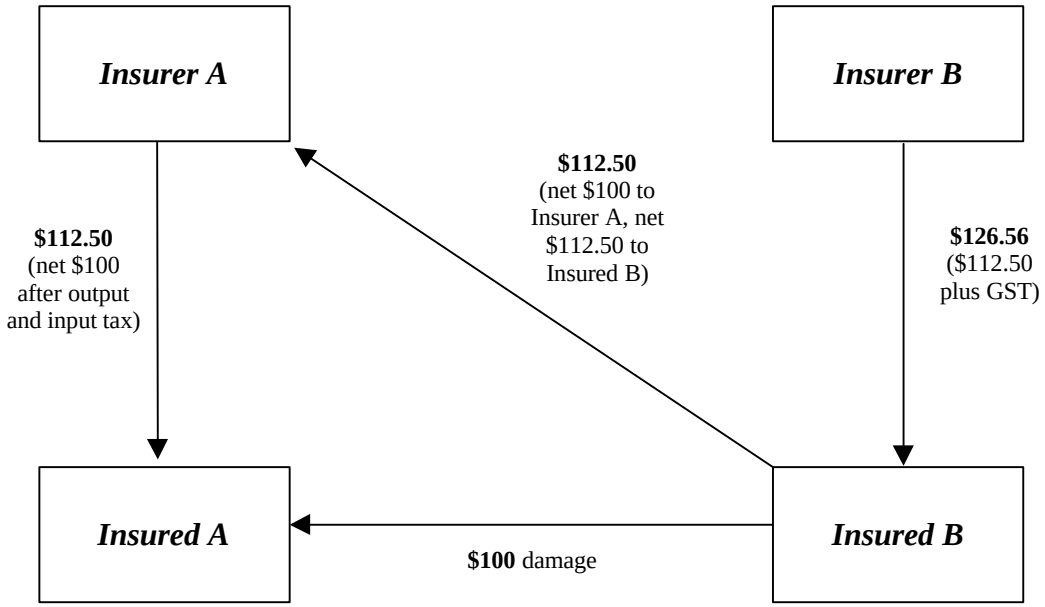
Before the introduction of section 5(13B) it was arguable that subrogation payments received by insurers in respect of payments that they made under contracts of insurance, and which qualified for input tax credits under section 20(3)(d), were not liable for output tax as they were not necessarily received under a contract of insurance.

This did not achieve the correct policy outcome, which is that general insurers' services are valued, and GST imposed, on the basis of cash received less cash disbursed (including by way of payments under policies).

The specific problem for insurers that has been identified arises in the situation where A (insured A) suffers a loss at the hands of B (insured B). A's insurer (insurer A) pays A the amount of the loss plus GST. The GST can be claimed by insurer A as an input tax credit and, assuming insured A is registered, will be paid as output tax by insured A. Insured B is required to make payment to insurer A equal to the payment made by insurer A to insured A. However, assuming insured B is a registered person, insured B does not appear to be entitled to an input tax credit for the payment. This means that when insured B makes a claim against its own insurer (insurer B) to recover its loss insurer B will have to gross up the payment to the amount paid by insured B plus GST.

To use a numerical example, insured A incurs a loss of $100 because of the actions of insured B. Insurer A pays insured A $112.50 (net $100 for both parties after input and output tax). Insured B pays insurer A $112.50 (net $112.50 to insured B because there is no input tax credit entitlement, net $100 to insurer A after output tax). Insurer B pays insured B $126.56 ($112.50 plus GST in order to fully reimburse insured B). Insurer B must, therefore, pay an additional amount of $14.06 because of the inability of insured B to claim an input tax credit for its payment to insurer A.

To further illustrate the point:



In summary, both insurers and other parties making subrogation payments are arguably disadvantaged under the current law. The Act should therefore be amended to allow registered persons making subrogation payments input tax credits for those payments.

Recommendation

That the submission be accepted.

Issue: Remedial amendment to section 5(13B)

Submission
(Matter raised by officials)

The drafting of section 5(13B) appears to state that subrogation payments are deemed to be consideration for a supply of services by the insurer if an input tax credit has been allowed for the subrogation payment.

The policy intent at the time the provision was enacted, however, was that subrogation payments should be deemed to be consideration for a supply of services by the insurer if an input tax credit has been allowed for the payment in respect of which the subrogation payment is made.

Officials consider that section 5(13B) should be amended to address this issue.

Recommendation

That the submission be accepted.

Issue: Application date of the amendment

Submission
(10W – Deloitte Touche Tohmatsu)

The submissioner's proposed change to section 20(3) to remove the disadvantage to insurers should apply from 1 October 1986, in accordance with the 1996 amendment that introduced section 5(13B).

Comment

Officials consider that it is not appropriate for this amendment to apply from the date from which section 5(13B) originally applied (1 October 1986) as the revenue consequences of doing so are unknown. In any event, there is some uncertainty in the interpretation of section 5(13B) itself (see matter raised by officials above) which requires an amendment. The section will be amended with effect from the date of enactment of the bill, and the change to section 20(3) should, therefore, also apply from this date to give a certain, symmetrical treatment of subrogation payments.

Recommendation

That the submission be declined.

Issue: The exclusion from output tax under proposed section 10(15C) of the interest component of a subrogation payment

Submission
(Matter raised by officials)

The proposed section 10(15C) should be deleted from the bill.

Comment

The proposed 10(15C), which excludes the interest component of a subrogation payment from GST, was included in the bill following a submission from ICANZ on the discussion document, *GST: A Review*.

Officials now have some concerns that the proposal is inconsistent with the mechanism for taxing general insurers, which is to require output tax to be paid on premiums and allows input tax credits for insurance payments. The possible inconsistency arises because this mechanism is based on cash flows rather than the

nature of the payments. In addition it is an open question whether interest should consistently be treated as exempt under the GST Act. Currently the exemption is largely confined to interest in relation to loans and similar instruments, and does not apply to interest generally.

Irrespective of the arguments for including or excluding the interest component of a subrogation payment, officials consider that the issue is part of the wider one of the extent to which the interest component of any transaction should be excluded from the GST net. As with the similar issue raised by ICANZ in relation to the interest component of general insurance payments, officials consider that this issue would be better dealt with in the Government's planned review of the GST treatment of financial services. Officials have consulted with the Insurance Council on this issue and the Council has agreed to this approach.

Officials note that, in any event, if the proposed section 10(15C) were retained, it would be necessary to make further amendments to the bill to provide that the interest component relates to an exempt supply and to exclude the interest component from any input tax credit claim in respect of the subrogation payment.

Recommendation

That the submission be accepted.

TIME OF SUPPLY FOR RATES

Clause 72(3)

Submission
(14 – PricewaterhouseCoopers)

The GST Act deems a supply of goods and services by a local authority to occur where any amount of rates is payable to the local authority. The bill proposes that the time of the supply be the earlier of:

- the date on which an instalment notice is issued if the instalment notice requires payment by a particular date;
- the date on which payment is required by the instalment notice;
- the date on which payment is received.

The term "instalment notice" should be clearly defined so as to remove any ambiguity regarding its meaning. The term should be defined so as to prevent routine "notices of levy" triggering the time of supply.

Comment

The automatic entitlement of local authorities to use the payments basis of accounting is proposed to be removed from 1 July 2001. Any local authority that exceeds the payments basis threshold will, therefore, be required to account for GST under the invoice basis from that date.

The bill also proposes to clarify the time of supply for rates payable to local authorities accounting for GST on the invoice basis. A GST liability will arise on the date an instalment notice is issued that requires payment of an instalment of rates by a particular date. This notice is akin to an invoice as it establishes an obligation to make a payment. In comparison, a "notice of levy" is notification of a resolution to strike a rate for a particular year. Although it advises the amount of rates payable in instalments and their due dates, it should not trigger a GST liability. The obligation to make a payment is established when a notice is issued for a particular instalment. A notice of levy may both notify as well as establish an obligation in relation to a particular instalment. For example, a notice issued at the beginning of a year could advise a ratepayer of their annual rates liability and set out the instalment payment pattern. That notice could also establish the obligation to make payment in relation to the first instalment.

Officials agree that notices of levy should not trigger a supply for GST purposes in relation to annual rates, and recommend that a minor amendment be made to the bill to ensure that a GST liability arises in relation to each separate instalment payment, rather than the total amount of rates payable for the year.

Recommendation

That the submission be accepted but dealt with by a minor drafting change rather than a definition of “instalment notice”.

UPLIFT TO MARKET VALUE RULES

Clause 73(1) and (2)

Submission
(18 – NZLS)

Section 10(3A) should be removed or a new paragraph be inserted in that provision providing that section 10(3) does not apply where the recipient "would have been entitled to a deduction under section 20(3) if the supplier had been a registered person and had complied with the requirements of this Act". In both cases, the deemed consideration under section 10(3) needs to be consistent with the approach to input tax under the proposed section 3A.

Comment

The relevant part of section 10(3) treats a supply made at an under-value between associated persons as being made at market value. Section 10(3A), however, prevents this rule applying if the recipient is a registered person who acquired that supply for the principal purpose of making taxable supplies and is entitled to an input tax deduction.

The first option suggested by the submission involves the repeal of section 10(3A). This would result in all supplies between associated persons being valued for GST purposes at their market value.

If transactions between registered persons were required to be transacted at market value any increase in output tax would be matched by an equivalent increase in input tax credits. Therefore requiring an uplift to market value would impose unnecessary compliance costs for no revenue gain. Sections 10(3) and 10(3A) are directed at supplies made to unregistered recipients at less than full value.

Officials consider, therefore, that the option of repealing section 10(3A) should not be followed.

The second option suggested by the submission involves inserting an additional paragraph in section 10(3A) providing that section 10(3) does not apply when the recipient would have been entitled to an input tax deduction if the supplier had been a registered person.

A modified version of this option is appropriate to cater for two situations where a registered recipient who acquired the supply for the principal purpose of making taxable supplies is not entitled to an input tax deduction. The first is when a supply not consisting of second-hand goods (for example, services or livestock) is made by an unregistered supplier to a registered recipient – no output tax is charged on the supply, so no input tax credit is available to the recipient. The second situation is when the application of the new restriction on second-hand good input tax credits (proposed section 3A(3)(a)) means that the registered recipient is not entitled to an input tax deduction – it is necessary, therefore, to "switch off" this restriction for the purpose of section 10(3A).

Recommendation

That the second part of the submission as modified above be accepted.

"CASH PRICE"

Clause 73(4)

Submission
(12 – ICANZ)

The amendment to deem the value of the supply to be the higher of the cash price or open market value should not proceed, as any price that is higher than the cash price would reflect a financing element which should be excluded from GST.

Comment

When a supply of goods or services is made under a credit contract, the value of that supply is deemed to be the "cash price" (under the Credit Contracts Act 1981) of the goods or services provided under the credit contract.

The "cash price" is either the lowest price for which anyone could have purchased the goods or services from that vendor on the basis of payment in full when the contract was entered into, or, if there is no such price, the fair market value of the goods or services at the time the contract was made. The use of "cash price" in the GST Act was meant to determine the consideration given by the purchaser for the non-credit portion of the credit contract (for the goods or services).

There are several problems with using the term "cash price" for GST purposes:

- There is uncertainty as to the boundary with respect to determining the vendor – for example, whether it extends to any branch of that vendor in New Zealand, or, depending on the price, branches overseas.
- The definition of "cash price" does not distinguish between classes of customers, such as retail and wholesale customers.
- Theoretical lowest prices could be used. For example, managers of retail outlets may have a discretion to give a maximum discount of, say, 30 percent. Even though managers may never in practice give this level of discount, it is theoretically the "lowest price."

Therefore any price higher than the "cash price" will not, as ICANZ submits, necessarily reflect a financing element. It may instead reflect that an inappropriately low value has been given to the "cash price" of a good or service, owing to any one or more of the factors outlined above.

However, officials do consider that the intended application of the provision should be clarified so that the value of goods and services supplied under a credit contract is equivalent to the consideration given by the purchaser for the non-credit portion of the credit contract (for the goods or services).

Recommendation

That the submission be declined, but the clause be clarified by referring to the price that purchaser would have paid for those goods and services from the supplier who provided them if the purchaser had made payment in full at the time that credit contract was entered into.

DEREGISTRATION

Clause 73(6) and (7)

Submission
(12 – ICANZ)

If the amendment proceeds, there should be an "amnesty" period (for example, six months) after enactment to deregister to allow the increased threshold to apply. Registered persons under the proposed $40,000 compulsory registration threshold should be able to make the deregistration adjustment based on the lower of cost and open market value.

Comment

The proposed requirement on deregistration to pay output tax based on the market value of assets retained rather than as currently, the lower of cost or market value, was contained in the GST discussion document released in March last year, and has been subject to lengthy consultation under the generic tax policy process. Any change will take effect from the enactment of the bill. Taxpayers will, therefore, have had at least 18 months to plan for any change. A further amnesty period would not be appropriate.

Officials do not consider that there should be any difference in the GST treatment of assets retained on deregistration by persons who voluntarily registered and those who were required to register. The anomaly in the GST treatment between assets retained and sold after deregistration and assets sold before deregistration applies in both instances and should be removed.

Recommendation

That the submission be declined.

EXPORTED GOODS AND SERVICES

Clause 74

Issue: Extending the zero-rating of exported information services

Submission
(12 – ICANZ)

The proposal to zero-rate certain exported information services should be extended to include the supply of information in relation to land.

Comment

The proposed amendment will zero-rate certain exported information services that are directly connected with moveable personal property situated inside New Zealand if the services are supplied to a non-resident who is outside New Zealand at the time the services are performed. In many cases, the connection with moveable personal property situated in New Zealand is incidental, such as when pharmaceutical samples are supplied from offshore by a non-resident to a New Zealand tester. In these cases the services provided by the New Zealand tester can be reasonably regarded as being consumed offshore and, therefore, should not be subject to New Zealand GST.

Officials do not consider that the amendment should be extended to exported information supplied in relation to land in New Zealand, such as the supply to a non-resident of a New Zealand architect's plan for building in New Zealand. In the case of such services there is a sufficiently substantive New Zealand connection to regard the services as being consumed in New Zealand and, therefore, subject to New Zealand GST.

Not zero-rating information services supplied in relation to land in New Zealand is consistent with the approach generally followed by other countries with a GST. For example, the European Union Sixth Directive on Value Added Tax specifically excludes services relating to land from the rule that the services of consultants involving the supply of information are taxable only in the country of the recipient of the information.

Recommendation

That the submission be declined.

Issue: The definition of "foreign-going ship"

Submission
(12 – ICANZ)

The term "foreign-going ship" should be redefined to include both trade boats and pleasure craft when the goods have been supplied as stores for consumption outside New Zealand.

Comment

The term "foreign-going ship" is used in proposed section 11(1)(l) to zero-rate goods supplied for use as stores for consumption outside New Zealand on aircraft or ships going to destinations outside New Zealand. The term is defined as a ship, other than a pleasure craft (as defined in the Maritime Transport Act 1994) or a fishing ship (as defined in the Maritime Transport Act 1994), going to a destination outside New Zealand.

The existing reference to "foreign-going ship" uses a definition in the now repealed Shipping and Seamen Act 1952. The new definition simply updates these references and does not change the effect of the existing law, which also excludes pleasure craft.

Officials do not consider that the existing law should be changed to zero-rate stores supplied for the purpose of consumption outside New Zealand in relation to pleasure craft. Pleasure craft are excluded for enforcement reasons. Although it is reasonably certain that stores supplied to overseas–bound ships engaged in the scheduled commercial transport of goods or passengers will, in fact, be consumed outside New Zealand, the same does not apply in the case of pleasure craft. It would be difficult in practice to verify that stores supplied for the purpose of consumption outside New Zealand on a pleasure craft were in fact consumed outside New Zealand.

Recommendation

That the submission be declined.

Issue: Goods supplied "free alongside ship" or "ex-factory"

Submission
(11 – Corporate Taxpayer Group)

Goods supplied "free alongside ship" or "ex-factory" should qualify for zero rating when they are entered for export, or deemed to have been entered for export, even if they are not exported by the supplier where it is clear the goods will be exported and the recipient is outside New Zealand at the time the goods are supplied.

Comment

The submission suggests defining the term "exported by the supplier" for the purposes of section 11(1)(a) to (ad) to include sales of goods to a place outside New Zealand when the recipient is outside New Zealand at the time the goods are supplied. Proposed section 11(1)(a) to (e) simply re-enacts without change the existing law on the zero-rating of exported goods.

Officials do not consider that this amendment should be made for several reasons. First, the requirement that goods be exported by the supplier was specifically inserted in existing section 11(1)(a) to (ad) to assist the enforcement of the zero rating provisions. The requirement is intended to ensure that the supplier takes sufficient measures to ensure that the goods will in fact be exported. Previously, the Act allowed the goods to be zero-rated when they were entered for export. The supplier would complete the Customs documentation. There was no requirement, however, for the supplier to ensure that the goods were actually exported. Significant practical difficulties existed in relation to the policing of these provisions because there was no efficient method to verify whether goods had been actually exported.

Second, the provisions focus on the physical exportation out of New Zealand of the relevant goods, and not the recipient of the goods as suggested by the submission. This approach is consistent with the destination principle under which GST applies only to goods and services consumed in New Zealand.

Third, referring to a recipient outside New Zealand is also problematic in the case of companies (both foreign and New Zealand) which have operations both in and outside New Zealand. If a non-resident company has a branch in New Zealand it is arguable that it is not outside New Zealand when goods are exported by the branch to its head office. Similarly, if goods are exported to an offshore branch of a New Zealand resident company the proposed requirement that the recipient be outside New Zealand may not be satisfied. In policy terms the goods in both cases should be zero-rated. These problems do not arise under the existing provisions, which simply focus on the physical exportation of the goods out of New Zealand.

It should be noted that the supply of goods on "free alongside ship" contractual terms may satisfy the requirement that the supplier export the goods if the conditions of the contract make it clear that the goods will, in fact, be exported. This could be the case if the seller has ensured that the goods have been delivered alongside the vessel or aircraft departing New Zealand in the manner usual in that harbour or airport.

Recommendation

That the submission be declined.

ZERO-RATING OF GOING CONCERNS

Clause 74

Issue: Time at which the status of a taxable activity as a going concern should be ascertained

Submissions
(11 – Corporate Taxpayer Group)

The change is inconsistent with a transaction tax that seeks to impose taxation at the time a transaction takes place and creates an environment of further confusion.

The going concern nomenclature suggests that the concept of going concern only exists at the time of transfer and not at the time of supply.

A two-prong test raises a potential issue, with taxpayers accounting for a transaction as a going concern at the time of supply where at the time of transfer there is no supply of a going concern.

The sale of a going concern should only be zero-rated at the time of supply if it is reasonably foreseeable that it would be operating as a going concern at the time of transfer.

(12 – ICANZ)

The timing of the test of a going concern should only be considered once, either at the time when the supply occurs, or when the actual transfer occurs – not both of these.

If a requirement that the purchaser be able to continue the activity were included this would further restrict registered persons' ability to zero-rate as going concerns.

(19W – NZLS)

Under the proposed amendment the going concern test will clearly apply at the time of supply. However, the test will also have to be met at the time the assets are transferred.

(13W – Rudd Watts & Stone)

For clarification, the words "by the recipient" should be added to the end of proposed section 11(1)(m)(ii).

Comment

The transfer of a going concern between registered persons is zero-rated for a number of reasons. These include the objectives of eliminating cash flow problems for purchasers starting up new businesses and of reducing the risk of a vendor charging GST on a transaction but failing to pay the GST to Inland Revenue.

A supply qualifies for zero-rating only if the vendor and purchaser agree in writing that the supply is of a going concern. This precludes the possibility of a vendor not paying output tax on the basis that the supply is of a going concern and a purchaser claiming an input tax credit on the basis that the supply is not of a going concern.

The amendment seeks to clarify the time at which a going concern must exist to enable the parties to reach agreement. It provides that there must be a going concern at the "time of supply" (generally the earlier of invoice or payment). The amendment also, in effect, provides that the taxable activity must be capable of being carried on by the purchaser as a going concern at the time of transfer or settlement.

Neither the Corporate Taxpayer Group nor ICANZ have provided any examples of when the proposed "two tier" test might be problematic. However, there may be situations where an agreement is entered into for the transfer of a going concern but it transpires that something less than a going concern is in fact transferred. In that case, if the parties have agreed at the time of supply that the transfer is of a going concern, the transaction will have been zero-rated. The fact that a going concern is not then transferred will require the parties to reverse this treatment. This may be problematic, for example, if the vendor is unable to collect the GST from the purchaser.

Officials consider that any such potential issues can be removed by an amendment to the requirement in section 11 (1)(m)(ii) that there must be a going concern at the time of transfer. The amendment would be to the effect that the agreement between the parties must contemplate that the taxable activity be capable of being carried on by the purchaser as a going concern. This amendment would also incorporate the drafting suggestion made by Rudd Watts & Stone.

Officials do not agree with the second point made by ICANZ. The example given by ICANZ is that of a person with no farming ability purchasing a farm with the intention of turning it into a resort. In that situation officials consider that the ability to zero-rate the transaction would still exist. That is because the test is an objective one based on the state of what is transferred. The farming business is still capable of being carried on by the purchaser as a going concern, notwithstanding the purchaser's intention or particular skill base.

In addition, the inherent nature of a going concern is that it is capable of being operated by the purchaser in a similar manner to its operation by the vendor. If this requirement were removed the whole concept of a going concern would need to be revisited. Officials do not consider that there would be any benefit in doing this.

Recommendation

That the submissions be accepted in part by requiring that the agreement between the parties contemplate that the taxable activity be capable of being carried on as a going concern rather than adopting the stricter requirement that the capability exist at the time of transfer or settlement.

RESIDENTIAL ACCOMMODATION

Clause 76(3) and (5)

Submission
(12 – ICANZ)

Clarify the ambit of the proposed exemption for the supply of residential property under a head lease to ensure it applies if a company leases accommodation for an employee as a condition of the employment contract with the employee.

Comment

The proposed section provides that the exemption will not apply if the property will be used by a registered person in the course or furtherance of a taxable activity. Officials consider that the exemption would still apply if an employee uses property supplied as part of their employment contract as their private residence. It would not, however, apply if a person uses the property mainly for business purposes.

Recommendation

That the submission be declined as the legislation already provides an exemption for residential accommodation provided by an employer to an employee.

PENALTY INTEREST

Clause 76(5)

Submissions
(14 – PricewaterhouseCoopers)

The amendment should not proceed, as there is neither a supply of goods nor services when penalty interest is charged.

(12 – ICANZ)

The amendment should apply at the election of the supplier to lower any compliance costs arising from the need to apportion input tax credits.

Comment

The proposal to exempt all penalty or default interest will remove the current technical distinction perpetuated by provisions of the Credit Contracts Act 1981 between certain penalty interest charged under credit contracts (and interest generally) and other forms of penalty interest.

Officials do not consider that it can be said that penalty interest does not relate to any supply when it is charged in relation to a contract for the supply of goods and services, or at least in relation to money outstanding under such a contract. Treating the charging of penalty interest as a supply will not "erode" the concept of supply or the base upon which GST is founded. In many other situations under the GST Act, such as the supply of general insurance services, the GST Act deems there to be a supply. This is not so much because there is no supply but rather because the supply cannot always be easily defined.

Officials note that the threshold over which registered persons must make output tax adjustments for exempt use is proposed in this bill to be raised from the lesser of five percent of turnover or $48,000 per annum to the lesser of five percent of turnover or $90,000 per annum, and this should reduce any compliance cost concerns.

Recommendation

That the submissions be declined.

LAST DAY OF TAXABLE PERIOD

Clause 77(2)

Issue: Greater flexibility in allowing taxpayers to choose the last day of their taxable period

Submission
(11 – Corporate Taxpayer Group)

Registered persons should be given the option of adopting an alternative last day of taxable period beyond the current statutory limitation.

Comment

The last day of a registered person's taxable period is generally the last calendar day of the month. To promote some flexibility in choosing an alternative day as the last day of a registered person's taxable period the legislation allows a registered person to select as the last day of a taxable period a day seven days either side of the last calendar day in which the taxable period would normally end.

The policy reasons for the concession were to reduce compliance costs by allowing taxpayers to align the end of their taxable period with their internal reporting date for accounting (subject to the Commissioner's agreement). Some registered persons have used this measure to obtain sizeable timing advantages between groups of registered persons. Officials are concerned that widening the concession could allow more opportunities to create timing advantages.

Officials are also concerned at the impacts the submission will have on compliance costs. The legislation only allows taxpayers to alter the day on which their taxable period ends. The date on which GST must be paid to the Government is not affected and remains the last working day of the month following the last day of their normal taxable period. If a taxpayer elects a day significantly into the following month this shortens the time available for that taxpayer to calculate their GST and furnish a return.

Recommendation

That the submission be declined.

Issue: Impact on previously agreed positions with Inland Revenue – "sound commercial reason" and "tax timing advantage"

Submissions
(11 – Corporate Taxpayer Group, 12 – ICANZ)

The amendment should not impact on previously agreed positions with Inland Revenue to counter timing disadvantages that were expected to arise with certain exporters. The phrase "sound commercial reason" should include situations where exporters attempt to mitigate these tax-timing difficulties.

ICANZ broadly agrees with the proposal to allow the Commissioner the power to reverse an earlier decision that allows registered persons to change the last day of their taxable period. However, there should be tax avoidance and the absence of a sound commercial reason before the Commissioner can reverse the decision.

Whether there is a "tax timing advantage" should be able to be assessed with respect to individual registered persons or GST registered groups but should not encompass registered persons that are outside a group.

Comment

The bill gives the Commissioner the right to reverse an earlier decision to allow registered persons to determine a day in substitution for the last day of their taxable period if they cannot provide sound commercial reasons, other than a tax timing advantage, for maintaining the change.

Both submissioners note that in some instances registered persons have adopted an alternative last day of their taxable period and that this has been done in order to overcome tax timing disadvantages. The submissioners state that these changes have been made so as to prevent exporters from being disadvantaged by delays in refunding GST paid on their purchases. (Exporters will, in most instances, be in a refund position as most of their supplies are zero-rated, that is, they are taxed at the rate of zero percent.)

Officials have since met with representatives from the Corporate Taxpayer Group to discuss their submission. From these discussions, and the written submissions, new issues have been raised concerning the ability of exporters to mitigate the cash flow disadvantages of GST.

In officials' view these issues require further analysis. Officials recommend that the proposed amendment contained in clause 77(2) be removed from the bill and the issue deferred for further consideration until after officials have reported to the Government on the overall economic, revenue, compliance and administrative implications in relation to the cash flow impacts GST has for exporters.

Recommendation

That the submissions be declined but that the Committee agrees to remove clause 77(2).

THE SIX-MONTHLY RETURN FILING PERIOD

Clause 78

Issue: Increase the threshold

Submission
(12 – ICANZ)

The proposed amendment should not proceed and, instead, the threshold that determines a registered person's eligibility to account for GST on a six-monthly return filing basis should be increased from $250,000 to $300,000.

Comment

The bill gives the Commissioner the discretion to allow a registered person to remain a six-monthly filer if the turnover of that person exceeds $250,000. This is provided that the registered person can demonstrate:

- a good history of filing and paying tax;
- good record keeping practices;
- that they have previously accounted on a six-monthly filing basis; and
- the nature and volume of supplies suggests that six-monthly filing is appropriate.

The submission argues that the threshold should be adjusted for inflation rather than introducing a Commissioner discretion.

The six-monthly return filing period is primarily directed at small businesses and businesses with a seasonal turnover. For the year ending June 1999 the proportion of persons accounting for GST on a six-monthly basis out of all registered persons was approximately 30 percent. The large majority of registered persons that made up that 30 percent had turnovers of less than $150,000 and on this basis it was considered that increasing the threshold to $300,000 is unlikely to provide any substantial benefits. This suggests that the policy objectives of allowing six-monthly filing are still being met.

In some instances, however, the threshold may be too low, especially for businesses with seasonal fluctuations and those that have just reached the threshold. It is for this reason that it was proposed that the Commissioner be given the discretion to allow certain registered persons the ability to remain on a six-monthly filing basis.

The reason a Commissioner discretion is preferred over increasing the threshold generally is that it allows access to six-monthly filing based on the particular circumstances of the business.

Officials are also concerned that raising the threshold could increase compliance costs on taxpayers that are not suited to cope with the cash flow demands that are created by six-monthly return filing. This is because of the effect that paying six months of collected GST has on working capital. There is also evidence to suggest that the preparation of a GST return can be more difficult over longer periods unless bookkeeping systems are completely up to date. Longer filing periods mean that a registered person's recollection of past events may be less than complete.

Recommendation

That the submission be declined.

THE PAYMENTS BASIS OF ACCOUNTING FOR GST

Clause 80(2)

Issue: Access to accounting for GST on a payments basis

Submission
(12 – ICANZ)

Businesses that exceed the threshold that allows them to account for GST on a payments basis should be allowed to remain on that basis provided that they file monthly returns.

The main argument for the proposal is that small businesses are not sophisticated, and it is too hard for non-accountants to manage the inclusion of accounts receivable and accounts payable in their accounting systems.

The invoice basis poses difficulties for practitioners in terms of reconciling the GST account when applying professional accounting standards to the client's financial reports.

Comment

A basic GST principle is that a GST liability arises at the earlier of issue of an invoice or receipt of payment. Consistent with this principle, registered persons are generally required to account for GST on an invoice (or accruals) basis. As noted by the Court of Appeal, GST is a tax on supplies, not on receipts,[1] and is determined by the contractual relations between the supplier and the recipient.[2] The recognition of GST should also follow these principles.

The payments basis (otherwise known as the cash basis) permits a registered person to recognise a GST liability on the supply of goods and services when payment is received from the customer. Similarly, a registered person accounting for GST on the payments basis is only allowed an input tax credit on its purchases when the registered person makes payment.

The reason for the proposal to adjust the payment basis threshold was not to address concerns that accrual adjustments (as required under the invoice basis) are too difficult for many, but rather to reflect movements in purchasing power since 1990, when the threshold was last reviewed. The suggested increase to $1.3 million also includes an amount for expected inflation for the next five to ten years.

[1] *Commissioner of Inland Revenue* v *New Zealand Refining Company Limited* (1997) 18 NZTC 13,187.
[2] *Wilson & Horton Limited* v *Commissioner of Inland Revenue* (1995) 17 NZTC 12,325.

The submission argues that allowing greater access to the payments basis will significantly reduce compliance costs. These compliance costs are often associated with the invoice basis of accounting because that method requires the complex task of making accrual adjustments for debtors and creditors – an area of accounting where there is ample scope for errors that could entail penalties.

Officials do not agree with the submission for the following reasons:

1. If the recommendations put forward by the submissioners were accepted this would result in a fundamental shift in the time of supply rules (which are one of the key GST building blocks), if not in the nature of GST more generally.
2. Allowing more registered persons to use the payments basis would increase the amount of GST returned when cash was received for a supply of goods and services rather than when the goods and services were supplied. This could have a significant impact on revenue depending on the numbers of registered persons that elected either to remain on the payment basis (as they cross the threshold) or to switch from the invoice basis.
3. Allowing unrestricted access to the payments basis could also undermine specific anti-avoidance proposals, particularly in the areas of deferred settlements and debt factoring. This is unlikely to be ameliorated by monthly filing.
4. The present $1 million threshold allows 94 percent of all GST registered persons to account using a cash basis. The proposed increase to $1.3 million allows a further 6,000 registered persons access to the payments basis. This raises the availability of the payments basis to approximately 95 percent of registered persons. This suggests that the threshold is still meeting its policy objectives.
5. For registered persons that have a turnover that exceeds the proposed $1.3 million, the Act gives the Commissioner the discretion to direct a registered person to account for GST on a payments basis. In exercising the discretion the Commissioner must consider whether the nature, volume and value of the supplies made by the registered person and the nature of their accounting system suggests that it would be appropriate for that person to account for GST on the payments basis.

Officials consider that where there is a genuine need for a registered person to use the payments basis (but cannot because of the threshold) the Commissioner discretion is the preferred means of allowing extended access to the payments basis as the exercise of the discretion is based on the individual circumstances of the case.

Recommendation

That the submission be declined.

DEFERRED SETTLEMENTS

Clause 82

Issue: Whether the proposal is necessary

Submissions
(12 – ICANZ)

The proposal is not necessary because the term "payment" is sufficiently broad to address the perceived mischief.

The proposal to allow the Commissioner to aggregate two or more transactions with a low value if separate transactions have been entered into to avoid the $225,000 threshold makes a supposedly simple amendment more onerous and far-reaching.

(19W – NZLS)

The perceived mischief should be addressed through the application of section 76, the general anti-avoidance provision.

Comment

The proposal is necessary to address the often substantial discrepancy between the time at which GST is returned (if the vendor is on the payments basis this will not be until payment is received) and an input tax credit claimed (if the purchaser is on the invoice basis this will be immediately). Arrangements have been entered into between both associates and non-associates under which settlement is deferred for very long periods of up to 20-30 years. In some instances it appears that arrangements are entered into primarily to obtain the tax deferral advantage.

ICANZ has referred to extracts from Inland Revenue's *Tax Information Bulletins* and *Technical Rulings* manuals in support of a proposition that Inland Revenue adopts a wide definition of the term "payment", accepting such methods of payment as accounting journal entries, acknowledgement of debt and mortgage back and cheque swaps. The implication to be taken from this is that the range of circumstances in which a person may pay GST on a payments (or cash) basis in any transaction is narrow.

The extracts referred to, however, have, in officials' view been taken out of context. The context in question is an attempt by Inland Revenue to provide guidance as to "whether satisfaction of the obligation to pay imposed by the agreement for sale and purchase has occurred".[3] Clearly if the obligation to pay is not satisfied, payment has not occurred. Officials question, therefore, the conclusion that payment will generally have occurred in most of the transactions in question.

[3] IRD *Technical Rulings Manual*, para 109.22.5.1.

Officials consider that the proposal to require deferred transactions over $225,000 to be accounted for on an invoice basis would be easily circumvented if taxpayers were able to split a transaction into two or more transactions to fall under the threshold. Although officials agree that it does add some complexity, the provision to allow the Commissioner to require such transactions to be aggregated is clearly necessary.

In relation to the view expressed by the NZLS that Inland Revenue apply section 76, the general anti-avoidance provision, officials note that there is a preference in policy terms for specific anti-avoidance provisions because their application is more certain. Section 76 is primarily intended to perform a backstop role in relation to the specific anti-avoidance provisions.

The continuing prevalence of settlements that are deferred to obtain a tax advantage and the associated revenue risk provide, in officials' view, a clear need for a specific anti-avoidance rule.

As outlined below, officials do, however, consider that the scope of the specific rule can be narrowed in a manner that ensures that the main target is transactions involving a significant deferral and hence a significant GST advantage.

Recommendation

That the submissions be declined.

Issue: The 93-day exclusion period should be extended

Submissions
(19W – NZLS)

The exemption for shorter term agreements (93 days) may not be sufficient as the settlement period for the sale of commercial (and some residential) buildings may be longer than that for entirely legitimate reasons.

An alternative solution would be to amend the proposed section 19D so that it is more targeted to very long-term settlements where the abuse is.

(12 – ICANZ)

The proposed section 19D should be limited to supplies where payment is not required to be made until more than 365 days after the agreement is entered into. By changing the provision's application to affect transactions of over one year only, genuine transactions are likely to be protected, while the period will be too short to attract GST avoidance schemes.

Comment

Officials note the concern expressed by both submissioners that the 93-day exclusion period is too short for many genuine transactions. Officials also note that the arrangements that have necessitated the proposed section 19D involve deferral periods of more than one year.

Officials therefore agree that by extending the 93-day period to one year most genuine transactions will fall outside the scope of proposed section 19D and most transactions entered into to gain a GST timing advantage will be caught.

Recommendation

That the submissions be accepted.

Issue: Alternative solutions

Submissions
(19W – NZLS)

The Commissioner should have a discretion to require any person to register on an invoice basis if the Commissioner considers that a transaction would have the effect of avoiding GST.

(12 – ICANZ)

If the arrangements in question give rise to a significant base maintenance risk, this could be addressed by allowing input tax to be claimed only by the invoice basis person to the extent that payment has been made.

Comment

In officials' view, the suggestion that the Commissioner have a discretion to require registration on an invoice basis if there has been tax avoidance is inappropriate for dealing with the specific issue sought to be addressed by the proposed section 19D.

In particular, to address particular deferred settlement arrangements, the Commissioner would need the further discretion to place the taxpayer in question on an invoice basis retrospectively. This would create an unacceptable level of uncertainty in the operation of the GST legislation.

Another problem with the suggestion is that it would require taxpayers previously on the payments basis to account for all future supplies on an invoice basis. This could give rise to compliance difficulties for taxpayers with less sophisticated accounting systems. In contrast, the proposed section 19D will affect only supplies with a value of more than $225,000 GST inclusive.

Officials do not agree with the submission by ICANZ that it would be better to defer the input tax credit to the invoice basis purchaser until payment. This is because there will be a considerable number of taxpayers on an invoice basis who routinely enter into transactions above the $225,000 threshold. Changing the timing of input tax credits in relation to a specific type of arrangement for these taxpayers will involve mismatches in the treatment of input and output tax and compliance costs which could be greater than those borne by vendors affected by the existing proposal (as modified).

Recommendation

That the submissions be declined.

Issue: Whether, if the proposed section 19D is to be enacted, there should be some amendment to the timing of deduction of input tax credits associated with the transaction

Submission
(19W – NZLS)

If proposed section 19D is to be enacted, there should be some amendment to the input tax rules to allow the GST component of supplies associated with the invoice basis supply also to be deducted on an invoice basis.

Comment

Although there is some potential merit in the submission, it is unclear what would constitute a "supply associated with the invoice basis supply" and hence what supplies would qualify for the suggested accelerated input tax credit. In addition, the extent to which associated inputs would involve a significant delay between the time of invoice and payment is unknown. Officials do not, therefore, agree that the type of provision submitted for would be appropriate.

In any event, if the Committee agrees that the exclusion period under the proposed section 19D should be extended to one year, significantly fewer transactions would be affected by any potential mismatch between the timing of the payment of output tax and the timing of input tax credits for "associated" supplies.

Recommendation

That the submission be declined.

Issue: The proposal to allow the Commissioner to aggregate transactions with a low value

Submission
(19W – NZLS)

The current drafting of subsection 3(a) of the proposed section 19D is ambiguous and should be clarified.

Comment

In officials' view proposed subsection 3(a) is drafted clearly and there is no ambiguity requiring clarification. The NZLS now agrees with this view.

Recommendation

That the submission be declined.

Issue: Clarification as to whether the "$200,000" threshold is exclusive of GST

Submission
(12 – ICANZ)

Clarification is needed that the value of "$200,000" referred to is exclusive of GST. If the value were to be inclusive of GST, this could cause a push towards the zero-rating of property transactions as a going concern to fall below the threshold.

Comment

The threshold proposed in the bill is $225,000, and this is inclusive of GST. There is no reference in the bill to a $200,000 threshold, although this was suggested as the (GST exclusive) threshold in the March 1999 discussion document. In our view no clarification is needed, therefore.

Officials do not consider that any problems arise from a potential push to the zero-rating of property transactions as going concerns. Under the provisions relating to going concerns (as clarified in this bill) there is clear guidance as to the circumstances in which zero rating will or will not be available. Officials do not consider that these circumstances will alter depending on the level of the threshold under proposed section 19D.

Recommendation

That the submission be declined.

INPUT TAX CREDITS FOR GOODS IMPORTED AND SUBJECT TO A "CHANGE IN USE"

Clause 84

Issue: The retrospective application of the proposal from 1 October 1986 other than where the Commissioner has agreed in writing to a claim before 16 May 2000

Submissions
(12 – ICANZ, 20 – KPMG, 16 – Bradbury and Muir on behalf of its client SeaHunter Fishing Limited)

Taxpayers who have taken positions based on the legislation as it is written at the time must be entitled to have those positions tested against that legislation. There is a general understanding with successive governments that if a claim has been made before the announcement of remedial legislation or the introduction of the amending bill, the claim can continue to be considered under the existing rules through savings clauses. To do otherwise imposes commercial constraints on the investment of money and resources and introduces an element of uncertainty into the tax system.

Proposed sections 21D and 21E(1) should only apply from the date of assent, or, at the earliest, from the introduction of the legislation: not from 1 October 1986. In addition, at a minimum, the limitation on claims approved by Inland Revenue in writing prior to 16 May 2000 should be changed to claims or tax positions submitted to Inland Revenue by that date.

(12 – ICANZ)

This degree of retrospectivity encourages Inland Revenue to drag out its review process of refund claims that it disagrees with from a policy perspective until it introduces legislation to change the rules.

The comparatively small amount of revenue at stake compared to issues that have preceded this and the length of time this issue has been around are further reasons for not introducing this legislation retrospectively.

In addition, officials may not have addressed the associated Bill of Rights issue following the problems with the forgiveness of debt last year.

(16 – Bradbury and Muir on behalf of its client SeaHunter Fishing Limited)

Clause 84 will introduce retrospective legislation depriving taxpayers of rights which they currently enjoy and are legislatively guaranteed by the New Zealand Bill of Rights Act 1990, and is therefore unconstitutional.

In SeaHunter Fishing Limited's case a claim for a refund was lodged in the period ending 31 May 1997 and has not yet been paid or agreed to.

(11 – Corporate Taxpayer Group)

The retrospectivity is excessive in relation to the perceived abuses.

Comment

The input tax credits in question arise as a result of a loophole in the current section 21(5) of the GST Act that allows an input tax credit when an asset that is not used in making taxable supplies starts to be used in making taxable supplies.

Section 21(5) is intended to allow an input tax credit only where GST has been imposed, that is, on goods and services acquired after 1 October 1986. Limiting the subsection in this manner was a deliberate policy decision at the time GST was introduced. The subsection recognises that where GST has been paid and not deducted, an input tax credit should be available where the asset is applied in a registered purchaser's taxable activity. It would not be logical or equitable to allow an input tax credit where no GST had been charged.

A simple outline of the typical tax structure at which the proposal is aimed is as follows:

- A non-resident registers for GST purposes and imports a large asset (for example, a boat) for a short period.
- The asset is classified by New Zealand Customs Service as a temporary import and thus does not attract GST at the border.
- The asset is leased to a New Zealand company, the leasing activity constituting a "taxable activity" for GST purposes.
- On the basis that the asset was previously outside New Zealand, thus not used in making taxable supplies, but starts to be used, albeit temporarily, in making taxable supplies, the non-resident claims an input tax credit for the lesser of one-ninth of the cost of the asset or the open market value of the supply of the asset.

Against the policy background outlined above, officials consider that such structures are at the aggressive end of the scale and, without the change, pose a significant, albeit difficult to quantify, revenue risk.

The proposal was first raised by the previous Government in the discussion document *GST: A Review*, released in March 1999. As submissioners have noted, it was not suggested in the discussion document that the change would be retrospective. At that stage officials were aware of some activity involving use of the structures in question but this was not thought to pose a significant revenue risk.

In March 2000, however, officials became aware that there was a growing proliferation of such structures. Two structures that officials were aware of together involved GST refund claims of about $10 million. It was also apparent that such structures were being actively marketed. The new Government, therefore, decided to accelerate the application date for the change.

The GST legislation currently imposes no time limitation within which taxpayers must claim input tax credits. Without making the change retrospective to 1 October 1986, there was thus a clear risk that the growing profile of such structures would cause an unquantifiable level of input tax credit claims in respect of past periods.

It is for these reasons that the Government has decided that the level of retrospectivity in this case is justified.

In relation to the point raised by ICANZ that retrospectivity of this kind might encourage Inland Revenue to "drag out" its review process, officials are not aware of any instance of Inland Revenue deliberately delaying the process to stall a GST refund until the introduction of the legislation.

Lastly, officials note that before the bill was referred to Cabinet, advice was received from the Ministry of Justice that there was no breach of the Bill of Rights in relation to this issue.

Recommendation

That the submissions be declined.

Issue: Application of shortfall penalties

Submission
(20 – KPMG)

Should the legislation be passed in its current form, an amendment to the current section 141B of the Tax Administration Act 1994 should be made to expressly exclude taxpayers from liability for shortfall penalties.

Comment

Officials consider that, should the legislation be passed in its current form, the suggested change to section 141B of the Tax Administration Act 1994 would be unnecessary for two reasons:

- Making the proposed change to section 21(5) would itself be an acknowledgement that the taxpayer's interpretation was at least arguable and on this basis that interpretation is unlikely to be regarded as "unacceptable" for the purposes of the shortfall penalty.
- Section 141B(6) provides that the interpretation to be considered is the position taken by the taxpayer in the relevant tax return.
- Section 141B(7) states that the matters that must be considered in determining whether there is an unacceptable interpretation include the actual or potential application of all the tax laws that are relevant. This would include the law at the time the taxpayer adopted the position in question as well as a later retrospective change.

Recommendation

That the submission be declined.

Issue: General provision to preserve taxpayers' rights whenever there is retrospective tax legislation

Submission
(20 – KPMG)

A provision should be inserted into the Tax Administration Act to preserve taxpayers' tax positions when legislation of a retrospective nature is introduced. The rule would also require the Government of the day to publicly announce any change in the law that is to be retrospective as soon as possible after the Government has taken the decision to change the law.

Comment

As the submissioners note, taxpayers are afforded some protection by processes that include consideration of Bill of Rights issues and by the ability of select committees to ensure that retrospective legislation is carefully considered in each case.

However, as noted in *Phillips* v *Eyre*,[4] for every guiding principle that retrospective legislation is of questionable policy, there are exceptions based on whether justice would otherwise be served. The suggested provision would remove the ability for appropriate exceptions to be made, as in this case.

It is also important to note that a fundamental constitutional principle is the legislative supremacy of Parliament, an example of which is that Parliament may not bind its successors, and no Parliament is bound by Acts of its predecessors. The suggested provision would be inconsistent with this principle.

Recommendation

That the submission be declined.

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[4] (1870) LR 6 QB 1.

Issue: Whether the proposal in any event produces the right policy outcome

Submission

(16 – Bradbury and Muir on behalf of its client SeaHunter Fishing Limited)

The better policy alternative would be to abandon the proposed sections 21D and 21E altogether. This is because by bringing an asset into the GST net the owner becomes liable to charge and account for GST on any subsequent disposal of the asset. Unless an input deduction is allowed the Government would, in effect, be paid GST on the entire value of the asset rather than the "added value". This is contrary to fundamental GST/VAT principles and undermines the integrity of GST. It is also inconsistent with the treatment given to other assets brought into a taxable activity.

New Zealand prides itself on having a broad-based GST with minimal exceptions. The amendment is contrary to that approach because it singles out one class of taxpayers for special treatment and creates an exception. As such, it is an undesirable precedent. There are no avoidance considerations that could justify it.

Comment

Input tax credits should generally be allowed only where the recipient of goods or services has borne a GST cost and where output tax is payable by the supplier. To do otherwise would provide taxpayers with windfall gains and give rise to a significant revenue loss.

As already noted, section 21(5) applies only to assets acquired after 1 October 1986, to ensure that the allowance of input tax credits is limited to cases where GST has actually been paid. Denying input tax credits for assets that have been used offshore and in respect of which GST has not been paid is therefore consistent with the current policy.

The problem addressed by the proposed sections 21D and 21E arises from the boundary between the tax base in New Zealand and those offshore. It is one of a number that arise from boundaries in the operation of GST. This bill addresses broadly similar issues in relation to second-hand goods (arising from the boundary between registered and non-registered persons) and deferred property settlements (arising from the boundary between payments and invoice GST accounting methods).

Recommendation

That the submission be declined.

Issue: The ambit of the proposal

Submission
(11 – Corporate Taxpayer Group)

The perceived abuse would be better targeted by allowing the input tax credit subject to the following:

- if the asset in question leaves New Zealand and there is no longer a taxable activity requiring GST to be paid on the market value of the asset at that time;
- if the asset is sold out of the New Zealand tax base, ensuring that the supply cannot be zero-rated.

If the asset does not leave the New Zealand tax base allowing the input tax credit is justified on the basis that the taxable activity will continue to produce an output that will be subject to GST.

Comment

As already noted, officials consider that input tax credits for changes in use should not be available in respect of assets that were previously offshore and bore no GST on their acquisition.

The alternative solution proposed does not, as alleged, address the problem. If a taxable activity ceases, GST is payable on deregistration (which can be forced by the Commissioner) in any event. While the suggested removal of zero-rating for assets that leave the New Zealand tax base might be an improvement on the current position, it addresses only a limited set of the circumstances at which the proposed sections 21D and 21E are aimed.

In addition, the suggested zero-rating "solution" assumes that the policy concern is one of timing, that is, output tax is not payable until some time after the input tax credit is claimed. However, the issue is not one of timing but whether the credit should be allowed at all. Consequently, officials do not agree with the third limb of the Corporate Taxpayer Group's proposal, which is to allow the credit when the asset continues to be used in a taxable activity in New Zealand.

Recommendation

That the submission be declined.

Issue: The meaning of "in writing"

Submission
(11 – Corporate Taxpayer Group)

The retrospective nature of the proposal combined with the requirement that to be excluded from its ambit the Commissioner must have agreed in writing to the claim can create an anomalous result for taxpayers who have claimed change in use adjustments on a periodic basis. The proposal applies adversely to a taxpayer that has, in a series of GST returns, consistently made an adjustment but received no specific written approval from the Commissioner.

Comment

GST is a self-assessed tax and, as the submission points out, specific written approval from the Commissioner to taxpayers for input tax credit claims would not normally be given. However, Inland Revenue does, following receipt of a return, provide the taxpayer with a computer generated notice confirming the taxpayer's calculation. This may later be followed up with an audit.

Officials consider that the computer generated notice would be sufficient to satisfy the criterion that the Commissioner has agreed in writing to the taxpayer's claim.

We also consider, however, that the "in writing" requirement should be clarified to remove the ambiguity perceived by submissioners. The intention is that where the Commissioner has not queried a claim in writing before the introduction of the bill, or where the Commissioner has made such a query but agreed to the claim before the introduction of the bill, the claim should not be affected by the proposed sections 21D and 21E. This should be reflected in the legislation.

Recommendation

That the submission be accepted.

ADJUSTMENTS FOR CHANGES IN USE

Clause 84

BACKGROUND

A registered person can claim input tax credits in relation to goods and services acquired principally for business purposes. Those goods and services may also be used for a private or exempt purpose. The Act deems such use to be a taxable supply by the registered person, and output tax is charged accordingly.

A registered person cannot claim input tax credits in relation to goods and services acquired principally for private or exempt purposes. If those goods or services are also used for business purposes, the Act allows an input tax credit to reflect that taxable use.

The principal objective of change in use adjustments is to ensure that input tax credits reflect the extent of the taxable use of goods and services. This is achieved by making adjustments to output tax or input tax if the original intended use of the goods and services changes or if the goods and services are acquired for both taxable and non-taxable purposes.

The requirement to make output tax adjustments ensures that tax is borne by the final consumer when there is private or exempt use of goods or services. For example, the private use of goods or services acquired by a registered person for the principal purpose of making taxable supplies represents a supply of goods or services to the registered person in his or her private capacity and, as such, should be subject to GST.

Inland Revenue requires adjustments to be made in each taxable period that the asset is owned to reflect the continuing changes in use. This can result in high compliance costs for small amounts of revenue.

An alternative to the "adjustments" approach is the "apportionment" approach, which is adopted in a number of other jurisdictions, including Australia. This limits the initial input tax credit to the estimated proportion of taxable use. Therefore in relation to an asset used, say, 60 percent for taxable purposes, an input tax credit of 60 percent of the GST component of the purchase price would be allowed. This amount would be further adjusted to reflect any changes in the asset's continuing taxable use.

The next stage of the GST review will consider the scope of the current rules and whether the current adjustment method should be replaced with an apportionment method, taking into account which of these is the preferable conceptual framework, which method provides the more accurate result and the relative compliance and administration costs of the two methods. In the meantime, the changes proposed in the bill will assist in reducing compliance costs.

Submissioners on the proposed changes to the GST treatment of changes in use raised a number of issues including:

- whether or not any changes should be made at this stage, given that officials will be undertaking a longer term review of the current adjustment approach;
- the need for a comprehensive explanation on enactment of the proposed changes;
- the timing of output tax adjustments and extending the one-off basis to input tax adjustments.

GENERAL ISSUES

Issue: Defer any changes until the general review

Submission
(12 – ICANZ)

No change should be made to the current change of use adjustments until a general review is undertaken. However, if change is necessary, adjustments should be allowed to be made annually.

The methods of allocation should only be changed once the full GST review on this area has been completed.

Comment

The discussion document on the GST review compared the apportionment approach used in other jurisdictions with the current adjustments approach in NZ. It noted that an apportionment approach has considerable complexities. First, the approach assumes that intended continuing use can be predicted. Second, the treatment on disposal may be complex as it is unclear whether the apportionment should be calculated on the respective amounts of taxable and non-taxable use on acquisition, on disposal, in the intervening period or at a combination of these times. Canada and the UK have detailed rules to make these calculations.

By not deeming a supply to occur when goods and services are used for non-taxable purposes, the apportionment rules do not reflect the principle that GST is borne by the final consumer. In the discussion document it was considered that this key principle should be retained but that the compliance costs imposed by the current requirements to make adjustments in each taxable period needed to be reduced.

The proposals to reduce compliance costs were generally supported by submissioners on the discussion document but some submissioners considered that the current scheme creates inequities and should be replaced with an approach that directly apportions input tax as adopted in a number of other jurisdictions including Australia.

Officials consider that the proposals to reduce compliance costs (including allowing taxpayers to make annual adjustments) should be enacted before the longer term review. Delaying the proposed changes to adjustments will only prolong the

difficulties taxpayers face in making input and output tax adjustments. Officials consider that these benefits would outweigh the costs of changing the legislation in the interim.

Recommendation

That the submission be declined.

Issue: Communication on the proposed changes

Submission
(12 – ICANZ)

In order to assist taxpayers in understanding the changes, the explanatory material published when the bill is passed into law should contain a comprehensive explanation of how these provisions apply in practice.

Comment

Officials will prepare a comprehensive *Tax Information Bulletin* on the changes in the bill. It will explain fully how the changes will apply in practice and will contain examples where necessary. Officials acknowledge the particular difficulties taxpayers have in making output tax adjustments. Therefore the *Tax Information Bulletin* will contain a detailed explanation of the new requirements.

Recommendation

That the submission be accepted.

Issue: Value of adjustments

Submission
(12 – ICANZ)

If a person uses goods or services that were acquired prior to the introduction of GST for a non-taxable purpose, the person should be able to make the adjustment based on the lower of the cost or market value of the asset.

Comment

Officials consider it is clear that the legislation proposed in the bill would allow an adjustment on the basis of the lower of cost or open market value. No amendment is, therefore, necessary.

Recommendation

That the submission be declined.

OUTPUT TAX ADJUSTMENTS

Issue: Scope of adjustments

Submission
(12 – ICANZ)

If a person acquires goods and services before 1 October 1986 and ceases using them for business purposes prior to 1 October 1986, the person should not be required to make output tax adjustments for any subsequent non-taxable use.

Comment

The intention of the legislation is to require an output tax adjustment for any non-taxable use of business assets irrespective of whether or not they were purchased after the introduction of GST. In the situation raised in the submission an output tax adjustment should not be made, as the asset was not used for business purposes when GST was introduced.

Recommendation

That the submission be accepted.

Issue: Extent of adjustments

Submission
(9 – Ernst and Young)

Output tax on deemed supplies from a change in use should never be higher than the input tax credit previously claimed on an earlier change of use.

Comment

A deemed supply arises from a change in use of goods and services from taxable to non-taxable purposes because the registered person is consuming the goods and services. Officials consider that the adjustment should not be related to the amount of the initial input tax credit, as the purchase of the goods and services and any non-taxable use are treated as, in effect, separate supplies. This approach achieves equity in the GST treatment of an asset used for private purposes by either a registered or non-registered person. For example, if a non-registered person rents a TV, that person

will pay GST on the rental cost and not receive an input tax credit. If a registered person acquires a TV for business purposes, that person would pay output tax but receive an equivalent input tax credit. If the person then uses the TV in their home output tax is charged on the value of that private use, being the market value of TV rentals.

The submission considers that adjustments are based on the original input tax credit claimed on acquisition. This is a feature of apportionment approaches used in other jurisdictions. These approaches will be compared with the current adjustments approach in a longer-term review.

Recommendation

That the submission be declined.

Issue: Timing of adjustments

Submission
(13W – Rudd Watts & Stone)

The timing of the proposed GST adjustment provisions in clause 84 needs to be clarified, as does the principle underlying periodic and annual adjustments. In particular:

- It is not appropriate for the Commissioner to approve a method (other than actual use), and that it is inconsistent with self-assessment for the Commissioner to do so.
- Some guidance is required as to the application of section 21C(1)(c) – annual output tax adjustments.
- Some guidance is also required on why output tax payable under an annual method takes into account output tax paid in previous periods, whereas the output tax payable under the periodic method does not.

Comment

The proposed requirement for the Commissioner's approval follows the current practice whereby taxpayers may use the direct attribution, turnover or a special method, with any special method being developed in consultation between the Commissioner and a taxpayer to ensure that it is appropriate. Officials do not consider that the requirement for Commissioner approval is inconsistent with self-assessment as it is expected that most taxpayers will be able to apply the actual use method in relation to determining the extent of private use or the turnover method in relation to exempt supplies. Other taxpayers who already have a special method will not need to reapply. Therefore the approval will only affect those taxpayers with new assets with mixed or changing use.

The *Tax Information Bulletin* and other supporting Inland Revenue publications will provide more detail on the timing of the annual adjustment. Generally, this would be

expected to be in the taxable period in which a calculation of taxable and non-taxable use has been made for income tax purposes. Officials do not consider that additional detail is required in the legislation.

The requirement to take into account previous output tax adjustments is a transitional rule to ensure that over-taxation does not arise if a taxpayer who currently makes periodic output tax adjustments changes to either the annual or one-off basis. Such a rule is not required if the periodic basis continues. The *Tax Information Bulletin* will provide further explanation on the operation of the rule.

Recommendation

That the submission be declined but that a *Tax Information Bulletin* provide a detailed explanation of the changes.

Submission
(12 – ICANZ)

The bill as drafted is not clear that a taxpayer has a choice and does not provide protection for a taxpayer who has not made an adjustment in periods subject to Inland Revenue audit because they intended to make an adjustment later.

Comment

Officials consider that it is clear from the legislation that taxpayers have a choice regarding the time at which an output tax adjustment is made. This is supported by the commentary on the bill and the discussion document and will be further supported by the *Tax Information Bulletin* on the legislation, which will also state that taxpayers will not incur penalties if they make a legitimate choice and therefore have a reduced output tax liability in a period or periods before the change takes effect.

Recommendation

That the submission be declined.

Submission
(12 – ICANZ)

The proposed section 21C(2) should be replaced with a test that focuses on a material change in use.

Comment

Proposed section 21C(2) requires a further output tax adjustment if a person has made a one-off adjustment and the non-taxable use of the asset increases by 20 percent or more. This rule seeks to balance compliance cost concerns with the need to maintain the GST base.

It is not clear what changes the submission would consider are material, and a specific threshold is likely to promote more certainty.

This submission noted that a change of 20 percent in private use could occur in one period but not in another, while still triggering an output tax adjustment. Officials note that this difficulty would also arise in relation to material changes in use and is one of the factors for taxpayers to weigh up when considering whether to elect the one-off basis.

Allowing one-off adjustments is designed to reduce compliance costs for assets with relatively constant use so as to eliminate the need to make ongoing adjustments in each taxable period. The submission highlights difficulties in relation to assets with significant fluctuations in use. It is, however, expected that taxpayers will not choose to prepay their adjustments in relation to these assets but will instead continue to make period-by-period adjustments or make adjustments annually.

Recommendation

That the submission be declined.

Submission
(12 – ICANZ)

There should be a rule which allows for input tax adjustments if circumstances giving rise to an initial or subsequent output tax adjustment made on a one-off basis are reversed.

Comment

As explained above, the one-off adjustment option will provide compliance benefits in relation to assets with relatively constant use. It is anticipated that in relation to assets with fluctuating use, taxpayers will choose to make period-by-period or annual adjustments. In that case any change in use that occurs during that period will be taken into account.

Recommendation

That the submission be declined.

Issue: The threshold below which taxpayers are not required to make adjustments

Submission
(12 – ICANZ)

The threshold for exempt supplies under which an output tax adjustment may not be required should be raised to $120,000.

Comment

The submission notes that for the last 14 years taxpayers have, in effect, overpaid GST because the growth in the value of goods and services owing to inflation over the period has had the effect of lowering the worth of the thresholds.

The proposed increase (from $48,000 to $90,000) will, however, ensure that inflation will not affect the value of the threshold for the next five to ten years.

In setting the threshold there are competing considerations between reducing compliance costs and protecting GST revenue. Increasing the threshold on the basis of inflationary expectations only ensures that the balance achieved when the threshold was originally set is preserved.

Recommendation

That the submission be declined.

Submission
(12 – ICANZ)

The thresholds in the GST Act should be set by Order in Council, as this is a more flexible and timely manner in which to alter thresholds.

Comment

The legislation already provides that some thresholds, such as the registration threshold, may be changed by Order in Council. Given the current frequency of tax legislation, we do not believe that use of this Order in Council process would provide greater flexibility or timeliness. However, officials do consider that reviews of the statutory thresholds should occur more frequently than in the past.

In relation to the registration threshold, for instance, officials plan to recommend the inclusion of regular reviews of the threshold in the Government's tax policy work programme. Other thresholds should also be subject to regular reviews on this basis.

Recommendation

That the submission be declined but that thresholds be subject to regular reviews.

Issue: Calculating the extent of taxable and non-taxable use

Submission
(12 – ICANZ)

"Interest netting" should be allowed in the turnover calculation. That is, interest expenses should be allowed to be deducted from interest income in calculating the value of exempt supplies.

Comment

The turnover calculation in relation to exempt supplies uses the formula:

$$\frac{\text{total value of exempt supplies}}{\text{total value of all supplies}}$$

The calculation of the value of exempt supplies is a matter of administrative detail. If Inland Revenue publications authorise a particular method for calculating exempt supplies, the legislation will not preclude it. Officials consider that there should be some flexibility in the legislation to allow for different calculations where appropriate.

Recommendation

That the submission be declined.

Issue: Application date

Submission
(12 – ICANZ)

The amendment to prevent an unintended output tax liability for services provided by employees should apply from 1 October 1986 to remove any risk that an output tax adjustment is required from 1 October 1986.

Comment

The bill clarifies that an output tax adjustment is not required in relation to a supply of services by employees. Officials agree that the amendment should apply from 1 October 1986 to remove any risk of a requirement to make an output tax adjustment in relation to earlier taxable periods.

Recommendation

That the submission be accepted.

INPUT TAX ADJUSTMENTS

Issue: Scope of adjustments

Submission
(12 – ICANZ)

The word "are" in the proposed section 21E(3) should be replaced with the phrase "are or were" to recognise that a change in use adjustment can be made where a person has owned goods for some time.

Comment

Officials do not consider that the draft legislation precludes an input tax adjustment in relation to taxable use of an asset acquired in an earlier taxable period. Section 21E applies to assets acquired for the principal purpose other than that of making taxable supplies that are applied in a taxable period (being the taxable period in which the asset was purchased as well as future taxable periods) for a purpose of making taxable supplies. Section 21E(3) provides that a single deduction may be made in relation to capital assets that cost less than $18,000.

Recommendation

That the submission be declined.

Issue: Timing of adjustments

Submission
(9W – Ernst and Young for Community Housing)

Section 21F should be amended to allow one-off input tax credits to be claimed at the time of a change in use from exempt to taxable supplies. If the use changes again, from taxable use to exempt use, a person should be required to make an offsetting output tax adjustment.

The removal of the ability to claim one-off input tax adjustments where there are genuine changes of use of assets will result in significant compliance costs. The compliance costs arise in relation to both GST and income tax.

For GST purposes, input tax credits would be required to be spread (potentially over a long period of time). For tax depreciation purposes, the cost of an asset is reduced by any input tax adjustment arising on a change in use. The cost is reduced in each income year by the amount of input tax credits. Accordingly for each of the remaining years of the property's economic life, an adjustment to its depreciable cost base needs to be made before tax depreciation can be calculated.

The submission also considers that the proposed amendment would create an unjustified distinction in the GST treatment of an input tax credit claim in relation to a change in use of property and the sale of property.

Comment

Officials consider that the current legislation is unclear on whether or not a taxpayer may make a one-off input tax adjustment if the use of goods or services (that cost more than $10,000) changes entirely. It was not intended that the proposed amendment impose significant compliance costs by changing any existing practice of claiming one-off input tax adjustments.

If the legislation were amended to allow taxpayers to claim input tax credits on a one-off basis significant revenue risks would arise. For example, if a registered person purchases property for the purposes of both commercial and residential rental but the property is used mainly for residential purposes the registered person would not be entitled to an input tax credit as the property is not acquired for the principal purpose of making taxable supplies. However, if the use subsequently changes so that some apartments are converted to offices the registered person would be entitled to an input tax credit for the increased taxable use. If an input tax credit for the increased taxable use were allowed in one taxable period rather than being spread over the time the property was owned by that person, that person could receive a significant tax advantage if the property was then sold as residential property. This opportunity arises because if an asset is acquired for the principal purpose of making non-taxable supplies, any sale of the asset will also be non-taxable.

A similar risk would also arise in relation to private assets (such as cars) used for taxable purposes.

To reduce the scope for avoidance officials consider that one-off input tax credits should not generally be allowed in relation to any change in use of goods and services from non-taxable use to taxable use. However, to address the particular compliance cost concerns raised in the submission, officials consider that the bill should be amended to allow taxpayers to apply to the Commissioner for a one-off input tax adjustment in relation to 100 percent changes in use of goods and services that cost $18,000 or more. Officials agree with the recommendation in the submission that to the extent that the taxable use changes to non-taxable use taxpayers be required to make a one-off output tax adjustment.

This change is an interim measure to ensure that the proposals in the bill (which are intended to reduce compliance costs) do not inadvertently increase compliance costs to taxpayers with assets that have entire changes in use. This approach will be subject to review as part of the general review of the GST treatment of changes in use included in the Government's tax policy work programme.

The criteria to be applied by the Commissioner in approving a taxpayer's application for a one-off input tax adjustment would include:

- Whether the taxpayer has made one-off input tax adjustments before the introduction of the bill;

- Whether the taxpayer has elected to make one-off output tax adjustments for any previous changes from taxable use to non-taxable use;
- Whether making period-by-period or annual adjustments is practical in the circumstances;
- The nature of the goods or services (for example, the length of ownership of real property is likely to be longer than that of other goods or services);
- The extent of fluctuations in taxable use. (One-off adjustments should not be made if the extent of taxable use changes often. Few compliance benefits would arise if offsetting output tax adjustments were relatively frequent.)

The supply of goods and services in relation to which a one-off input tax adjustment has been made will be treated as a taxable supply.

Recommendation

That the submission be accepted in part by allowing taxpayers to apply to the Commissioner for a one-off input tax adjustment in relation to entire changes in use of goods and services that cost $18,000 or more.

That if a one-off input tax adjustment is allowed and the taxable use reverts back to non-taxable use the taxpayer be required to make a one-off output tax adjustment.

Note that this approach will be subject to review as part of the general review of the GST treatment of changes in use included in the Government's tax policy work programme.

Issue: Tax advantages arising from the valuation of changes in use

Submission
(Matter raised by officials)

The bill should be amended to include a specific anti-avoidance provision allowing the Commissioner to disregard a deemed supply for a change from taxable to non-taxable use of goods if the Commissioner considers that the registered person is making the change in contemplation of the sale of the goods.

Comment

The bill proposes that taxpayers may choose to make one output tax adjustment in relation to changes from taxable to non-taxable use of good and services. The adjustment would be valued under the existing legislation at the lesser of the cost of the goods and services or the open market value of the deemed supply (for example, the market value of the rental of an asset).

Officials understand that taxpayers contemplating the sale of high-value assets (such as real property) after the bill is enacted are being advised to change the use of their property from business to private, make a one-off output tax adjustment for the

change in use and then sell the property. Under this scenario the GST liability would be one-ninth of the original cost of the asset compared with one-ninth of its market value if the taxpayer deregistered prior to sale.

An existing opportunity to avoid paying GST on the basis of the market value is available if taxpayers deregister prior to selling their assets. A proposal in the bill seeks to correct the anomaly in the GST treatment between assets retained and sold after deregistration and assets sold before deregistration, thus removing the tax advantages.

However, taxpayers may seek to avoid paying GST at market value by changing the use of their assets from business to private immediately prior to sale.

Officials consider that a specific anti-avoidance provision should be introduced to provide that a deemed supply would not arise if a registered person were contemplating the sale of the asset for which a change in use was claimed. Therefore output tax based on the asset's market value would be payable on any sale of the asset.

The GST Act already contains a similar provision in relation to deregistration. If the Commissioner believes that the registered person is planning to sell the asset in the near future and that they applying for deregistration to avoid charging GST, the Commissioner may require the person to remain registered.

Recommendation

That the submission be accepted.

Issue: Exception from requirement to make output tax adjustments for changes in legislation

Submission
(Matter raised by officials)

The bill should be amended so that a person is not required to make an output tax adjustment for changes in use arising from a change in the law only in relation to assets acquired before the introduction of GST.

Comment

Proposed section 21(2)(b) provides that an output tax adjustment is not required if the change in use occurs because of a change in legislation. This exception should be limited to changes in use of goods and services acquired before the introduction of GST, as input tax credits were not allowed on their acquisition. Therefore there is no GST effect from the legislative change to make a supply exempt – no input tax credits were allowed and no output tax is payable. This achieves the same effect as an initial exemption.

However, an output tax adjustment should arise in relation to assets acquired after GST. The output tax liability offsets the input tax credit allowed. Again, this has the same effect as if the assets had always been exempt.

Recommendation

That the submission be accepted.

TAX INVOICES

Clause 86

Issue: Threshold for when an abbreviated tax invoice may be issued

Submissions
(11 – Corporate Taxpayer Group, 12 – ICANZ)

Increasing the threshold when an abbreviated tax invoice may be issued is adequate – but more should be done to reform the statutory tax invoice requirements. Suggested reforms include:

- removing the need to have the words "tax invoice" and a description of the goods and services supplied appear on the document; and
- raising the threshold when a tax invoice does not have to be issued from $50 to $1,000.

Comment

The bill increases the threshold when an abbreviated tax invoice may be issued, from $200 to $1,000.

A tax invoice is a document that meets the following statutory criteria by displaying:

- the words "tax invoice" in a prominent place;
- the name and registration number of the supplier;
- the name and address of the recipient;
- the date the tax invoice is issued;
- a description of the goods and services supplied;
- the quantity or volume of the goods and services supplied;
- either -
    - The total amount of tax charged, the consideration, excluding tax, and the consideration, inclusive of tax for the supply; or
    - Where the amount of tax charged is the tax fraction of the consideration, the consideration for the supply and a statement that it includes tax.

An abbreviated tax invoice does not require the name or address of the purchaser nor the quantity of the goods and services to be disclosed.

Tax invoices are the key means by which Inland Revenue can maintain an audit trail and verify the claiming of input tax credits by registered persons. The statutory details build on the information that is ordinarily displayed for commercial purposes

(including a description, and the quantity, of what is supplied) by requiring the following additional disclosures:

- the words "tax invoice" displayed in a prominent place;
- the supplier's GST number; and
- whether the supply includes GST.

A "tax invoice" is required for the deduction of input tax. Removing the requirement to have the words "tax invoice" could lead to there being more than one such document for a single supply. This could result in multiple input tax credits for a supply. Using the term "tax invoice" to a large extent removes this possibility.

In relation to the suggestion that the threshold under which a tax invoice is not required should be raised from $50 to $1,000, officials are concerned at the potential risk to the revenue that could be created by such a move.

Although the revenue involved in a single transaction of less than $1,000 is small, the huge volume of these transactions means that there is a very significant revenue risk. Further, materiality considerations could mean that any tax discrepancies arising from amounts of less than $1,000 are unlikely to be noticed during routine audit and audit selection. It should also be noted that the revenue risks associated with not issuing a tax invoice are such that some jurisdictions do not have a similar threshold.

Recommendation

That the submissions be declined.

Issue: Offence not to issue a tax invoice

Submission
(11 – Corporate Taxpayer Group)

The legislation should be amended so as to:

- reinstate the failure to issue a tax invoice as a specific offence in the Tax Administration Act; and
- allow a registered person that has requested a tax invoice the right to claim an input tax credit without the invoice.

Comment

The submission notes that before the reforms made as part of the Taxpayer Compliance, Penalties and Disputes Resolution Bill in 1996, it was a specific offence if a registered person did not supply a tax invoice within 28 days of being requested to do so.

The Tax Administration Act 1994 now makes it an offence "not to provide information (including tax returns and tax forms) to the Commissioner or any other person when required to do so by a tax law". The legislation is not specific on whether the failure to issue a tax invoice is an offence under the Tax Administration Act 1994.

Although the failure to issue a tax invoice is arguably covered by the present wording of the Tax Administration Act, officials consider that it would be desirable to clarify the application of the law.

In respect of the submission's second proposal, the main concern seems to be the situation where a document is issued that purports to be a tax invoice, but does not meet the statutory criteria as set out in section 24 of the GST Act. In some instances it can be difficult to get the supplier to issue another document that complies with the Act.

Officials consider that the proposed solution is too broad and may include situations where the supplier is not legally required to issue an invoice and/or no GST is payable, such as where the supplier is not registered. Rather than giving an automatic right to registered persons to claim an input tax credit after 28 days of a request being made, officials consider that a better solution is the discretion that the Commissioner has under the Act to allow the original document to be treated as if it were a tax invoice.

Recommendation

That the submission be accepted in part. Officials recommend that an amendment be made to the Tax Administration Act 1994 to make the failure to issue a tax invoice under the GST Act an absolute penalty offence.

DEBT FACTORING

Clauses 87 and 88

Issue: The amendment should not proceed

Submission
(12 – ICANZ)

Proposed section 26A should not proceed. When a debt is factored the vendor is prepared to accept an amount that is less than the full value of the debt. The difference between the amount the customer is charged and the value realised by the vendor should not be subject to GST as it is intrinsically a financial service. Consideration should be given to allowing a bad debt deduction for debts factored by a person on an invoice basis.

Comment

The broad policy intent of GST is that the final consumer pays the tax on a supply of goods and services made by a registered person (the supplier). The supplier is then responsible for returning that GST to Inland Revenue. If the debt is not collected the GST liability is not adjusted for a registered person on the invoice basis other than where it can be demonstrated objectively that the debt has become bad. In the case of a registered person who accounts on a payments basis, no adjustment is required since the payments basis requires GST to be recognised only to the extent that payment is received.

Debt factoring raises a completely different set of circumstances. Debt factoring involves the assignment of a debt to a third party. The consumer is still obliged to pay the GST charged by the supplier. Therefore, unless the supplier adjusts the amount that is to be paid by the consumer, such as by providing a prompt payment discount, no adjustment of the GST liability of the supplier should be allowed.

The amendments contained in the bill seek to resolve two problems involving the treatment of factored debts:

- The potential scope for avoidance by registered persons on the payments basis, who might factor debts in order to convert taxable supplies into exempt supplies. The tax advantage that is created is equal to one-ninth of the discount (the GST component of the discount allowed on assignment).
- The disparity in the way that GST liabilities are recognised by registered persons on the different accounting bases, with persons accounting on a payments basis being unduly advantaged.

Officials acknowledge that the bill does not deal with situations where a registered person accounting for GST on an invoice basis may pay GST on amounts not received. Officials considered the possibility of a deduction being allowed for the discount given when a debt is factored. However, there are a number of concerns with this approach, including:

- The adjustment that is allowed in respect of bad debts is intended to address situations where it is certain that a debt will not be recovered. Allowing deductions for what are, in effect, doubtful, but not bad, debts undermines this certainty.
- The GST timing advantage that would be gained if the assignor factored the debt rather than left it on their books and used normal debt collection mechanisms would provide an incentive to factor debt.
- There would be difficulties in determining what portion of the payment for the debt related to the value of the debt as opposed to the time value of money loss borne by the factor in carrying the debt.
- If an input tax credit were allowed for the discount component of a debt which was not bad at the point of assignment there would be no mechanism for the deduction to be clawed back in the event that the factor recovered an amount in excess of the debt's transfer value. This is because amounts recovered in the course of a debt factoring activity are either exempt or are not connected with any supply. So, for example:

  > Company A sells two items for $100 each on a GST inclusive basis. Each debt is factored to Company B for $80. Company B recovers $100 on the first debt and $70 on the second debt. There is thus a total loss of $30. However, if Company A were allowed a deduction on assignment to Company B, a deduction of $40 would be allowed.

The bill (clause 87) does, however, provide relief for suppliers accounting for GST on an invoice basis where debts have been assigned on a recourse basis. A debt that has been assigned with recourse allows the purchaser of the debt, in the event that the debt proves to be uncollectable, to exercise a right to recover the purchase price of the debt from the assignor (the supplier). The debt is then returned to the assignor. In these circumstances, under clause 87, the assignor would, where the debt becomes bad, be entitled to adjust the GST liability on the supply of goods and services underlying that debt.

Recommendation

That the submission be declined.

Issue: Clarification of amending legislation

Submission
(Matter raised by officials)

A bad debt adjustment should be allowed in circumstances where a factored debt is found to be uncollectable and there is recourse to the assignor of the debt.

Comment

Proposed section 26A requires a registered person accounting for GST on a payments basis to return GST on the book value of the debt if the debt is assigned to a third party. In some instances the third party will have recourse to the registered person if the debt is subsequently found to be uncollectable.

In these circumstances, where the registered person recognises that the recourse debt is bad, it is appropriate that the registered person should be able to adjust the GST liability that was due on the goods and services underlying that debt.

The present wording of the amending legislation is intended to provide relief in these circumstances. However, as the amendment is currently drafted, this relief is only available where the registered person accounts for GST on an invoice basis; if the registered person accounts for GST on a payments basis the legislation provides no relief. This is contrary to the intention of the amending legislation. Officials recommend that section 26 (which allows a registered person relief from a GST liability when a debt is bad) be amended accordingly.

Recommendation

That the submission be accepted.

SPECIFIED AGENTS

Clause 91

Issue: Commissioner's right to withhold payments

Submission
(14 – PricewaterhouseCoopers)

The proposed amendment should not proceed, as:

- It is unprincipled for the Crown to prefer itself over other creditors.
- The Crown should have to prove its debt in the same manner as any other creditor.

Also, default assessments, which are usually not objected to within objection deadlines, are commonly issued in receiverships.

Comment

The bill proposes to allow a "specified agent" (receiver, liquidator etc) to deduct any input tax relating to supplies made before the agency period (period of receivership, liquidation etc) if the incapacitated company or other incapacitated person has not previously deducted the input tax.

The bill also proposes to allow the Commissioner to set off the pre-agency input tax credits claimed by a specified agent against the pre-agency period tax debt of the incapacitated person.

The submission notes that in the event that the Commissioner offsets any refund due against any tax due, whether preferential or non-preferential, the Commissioner would gain a preference over all other creditors which would be in breach of the Companies Act 1993, section 30 of the Receiverships Act 1993 and general common law principles.

Officials consider that the Commissioner should be able to set-off input tax credits relating to supplies before the agency period because this will ensure that the credits are properly recognised in the period to which they belong and the Government is not disadvantaged merely because the credits are claimed late.

With regard to the submission that the proposed amendment creates an "unprincipled" new preference, officials note that GST already has a degree of preferential status over other debts because of the fact that it is collected and paid by registered suppliers on behalf of the consumers who bear the cost of the tax. The proposed amendment is consistent with this preferential status. In any event, officials' view is that the proposed amendment is a clarification of the existing law, rather than the creation of a new preference.

With regard to the argument in relation to default assessments issued by the Commissioner, taxpayers are able to challenge such assessments by filing the necessary returns. The whole process is at the control of the specified agent in these circumstances. Thus the focus in the submission on default assessments does not present any reason why the set-off should not as a matter of policy be allowed.

Recommendation

That the submission be declined.

Submission
(14 – PricewaterhouseCoopers)

If the previous submission is rejected, the proposal should be expanded to provide that, in circumstances where a specified agent is appointed, an exception will be made with regard to the deadline for challenging a notice of assessment.

Comment

The submission suggests that the appointment of a liquidator or receiver be classed as an "exceptional circumstance" so as to provide taxpayers with a legal opportunity to challenge an assessment in which the Commissioner has set off refunds against any tax payable.

Officials understand that the issue arises because the standard time for challenging a notice of assessment may be insufficient where a change-over is occurring and a receiver or liquidator needs to become familiar with the tax affairs of the incapacitated person.

Officials do not consider that this should be regarded as an exceptional circumstance.

Recommendation

That the submission be declined.

REGISTRATION THRESHOLD

Clause 93(1)

Issue: Registration threshold should be increased to $50,000

Submission
(12 – ICANZ)

The registration threshold should be further increased to $50,000 in order to further reduce compliance costs to small businesses.

Comment

The registration threshold for GST determines when a person should be required to register for GST. If the total value of a person's supplies in a 12-month period exceeds $30,000, the person is required to be registered. The threshold was last reviewed in 1990 and was raised from $24,000 to $30,000 as a consequence.

In setting the registration threshold for GST there are two competing considerations:

- A high registration threshold reduces compliance costs because it allows many small businesses to fall outside the GST system.
- A low threshold reduces the potential for smaller businesses to place significant competitive pressures on businesses operating above the threshold.

The increase in the registration threshold from $30,000 to $40,000 was calculated with regard to inflation and ensures that the balance achieved when the threshold was originally set is preserved.

The $50,000 threshold proposed by ICANZ changes this balance and could create a new level of market distortion. Registered suppliers competing with a significantly increased number of unregistered suppliers would incur more of the economic incidence of GST. This could create a decline in the profitability of registered suppliers in affected industries. It would also create more incentive to manipulate turnover to remain under the threshold.

For example, independent operators in the taxi industry would be able to charge GST-exclusive prices for fares because they would not have to register for GST. This could lower the market price for taxi fares and force larger taxi operators who are registered for GST, either to absorb the GST that they would have previously passed on to their customers or to alter their dealings in order to achieve a turnover below the threshold.

Furthermore, a significant number of businesses have a turnover around $50,000, including many personal services operators such as hairdressers and personal tradespersons. These professions tend to have a higher proportion of final consumers as customers and lower amounts of inputs that are charged with GST. Consequently, they would be likely to opt out of the GST system if the threshold was raised to

$50,000. This would reduce the tax base and lead to a significant loss in GST revenue.

Approximately 23,800 small businesses have a turnover between $40,000 and $50,000 (exclusive of GST). These businesses returned approximately $47 million in GST in the year ending June 1999.

Recommendation

That the submission be declined.

Issue: The registration threshold should be indexed to inflation

Submission
(12 – ICANZ)

The registration threshold should be indexed to inflation and reviewed approximately every two years, increasing by multiples of $5,000.

Comment

As mentioned above, the threshold was last increased in 1990. The submission suggested that reviews of the threshold should be conducted more regularly and should be pegged to inflation. ICANZ has suggested biennial reviews rising in multiples of $5,000 (where necessary) as an appropriate standard.

Officials agree that the threshold should be reviewed on a more regular basis and plan to recommend the inclusion of regular reviews of the threshold in the Government's tax policy work programme. However, officials consider that reviews every two years, given New Zealand's low inflationary environment, would be unnecessary and costly. The frequency suggested by ICANZ could increase compliance costs by creating uncertainty as to movements in the threshold.

The objective of reviewing the threshold is to ensure that it is set at an appropriate level so that persons over the threshold are able to sustain the costs incurred in complying with the GST system. Officials consider that inflation, although an important consideration in such a review, is not the only matter that should be taken into account. Future reviews of the threshold should not be restricted in what they can consider.

Recommendation

The submission be declined.

UNINCORPORATED BODIES

Clause 95

Issue: Liability of trustees

Submission
(12 – ICANZ)

GST debts should be recoverable from individual members of an unincorporated body, but trustees should only be liable to the extent of the assets which were held as part of the trust and not to the extent of the personal assets of the trustees.

Comment

Because unincorporated bodies are not separate legal entities, generally their members are personally liable for all debts of the body. This treatment arises under common law in relation to other debts and is reflected in the GST Act. As a practical matter, this liability can be reduced to some extent by the trust deed giving the trustees a right to be indemnified out of the trust property.

Recommendation

That the submission be declined.

Issue: Liability of members' estates

Submission
(12 – ICANZ)

A previous member's estate should not be liable for tax payable by the unincorporated body.

Comment

ICANZ considers that tax should only be recoverable from an estate if the person is a member of the unincorporated body at the time of death.

The current legislation provides that after a member's death the member's estate is liable for any tax still unpaid. This liability should include amounts payable by a retired member for GST debt relating to supplies made when he/she was a member. This liability should not be removed if a debt due to the Crown remains unpaid. A person's estate should be liable for the GST debt relating to the period when the person was a member of the unincorporated body, whether or not the person was a member at the time of their death.

Recommendation

That the submission be declined.

Issue: Definitions in section 57

Submission
(19W – NZLS)

Remove as many as possible of the definitions from section 57 and make them applicable to the whole Act. It is only necessary to retain the definition of "body" in section 57 itself. As a consequence, proposed sections 21D(4), 21E(4) and 42(2A) could be removed.

Further consequential amendments should be made to section 2, section 42(2)(a) and section 42(2)(c).

Comment

Officials consider that the submitted changes are desirable as they would reduce the number of cross-references in the Act and simplify the legislation.

Recommendation

That the submission be accepted.

GENERAL ANTI-AVOIDANCE PROVISION

Clause 100

Issue: Publication of a standard practice statement

Submission
(12 – ICANZ)

Following the amendment to section 76 (the general anti-avoidance provision in the GST Act), the Inland Revenue Department should publish a standard practice statement which considers examples of tax avoidance in a GST context to provide guidance to registered persons.

Comment

The general anti-avoidance provision in the GST Act is intended to be a "backstop" provision used to fill gaps that the various specific anti-avoidance provisions do not cover. There is a policy preference to rely primarily on specific anti-avoidance rules because they are generally easier to interpret and apply in specific situations, and therefore their application is more certain. The general anti-avoidance provision is relied on where the more precise specific anti-avoidance rules do not apply to counteract certain arrangements entered into to gain a tax advantage.

An example of where the general anti-avoidance provision may apply is an arrangement entered into to avoid the restrictions on input tax credits for sales of second-hand goods between associated persons. This could involve an unrelated party being interposed in a back-to-back arrangement involving the sale of second-hand goods between two associated persons.

The Inland Revenue Department is currently preparing a policy statement on the Income Tax Act 1994 general anti-avoidance provision to replace the existing statement that was published in 1990. The new GST general anti-avoidance provision in the bill has been modelled on the general anti-avoidance provisions in the Income Tax Act 1994 1994. The new policy statement being prepared by Inland Revenue on the Income Tax Act 1994 general anti-avoidance provision will, therefore, be directly relevant to the GST provision. This alignment of the general anti-avoidance provisions in the GST and Income Tax Acts will allow a similar analysis to be used when considering each provision. Aligning these provisions also means that the case law dealing with the income tax provision can be used to interpret the GST provision.

The structure of the general anti-avoidance provision in the Income Tax Act 1994 was endorsed by the Committee of Experts on Tax Compliance in 1998.

The *Tax Information Bulletin* item on the bill will contain some examples of arrangements to which Inland Revenue considers the amended GST general anti-avoidance provision will apply.

Recommendation

That the submission be noted.

Issue: The need for section 76(5) – (7)

Submission
(12 – ICANZ)

Proposed section 76(5), (6) and (7) should be deleted. These provisions are not required because of the change to the deregistration provisions. Anyone who brings themselves under the compulsory registration threshold and deregisters must account for GST at open market value.

Comment

Proposed section 76(5), (6) and (7) re-enacts the existing section 76(3). There has been no change in the scope of the provisions. The provisions are designed to prevent persons artificially splitting their business activities between associated persons and themselves to take advantage of the longer return period options, the payments basis of accounting for GST and the registration threshold. For the purpose of these threshold levels the value of all taxable supplies made by the persons involved in an arrangement are aggregated and attributed to each of those persons.

Officials do not consider that these provisions will become unnecessary because of the new rules that will require people deregistering to account for output tax on assets acquired after the introduction of GST at their open market value. The provisions are unrelated. Section 76(5), (6) and (7) is not concerned with securing a one-off amount of output tax on the open market value of the assets employed in a taxable activity, but instead is directed at preventing output tax being avoided or postponed on the on-going supplies made by groups of associated persons.

Recommendation

That the submission be declined.

Issue: The form of section 76(6)

Submission
(12 – ICANZ)

Proposed section 76(6) should not be an anti-avoidance rule, but should be a charging section.

Comment

Proposed section 76(6) is one of three provisions (the others being section 76(5) and (7)) which prevent persons artificially splitting their business activities to take advantage of the registration threshold, the payments basis of accounting, or the longer return period options. Officials do not consider these provisions have a charging effect, which would involve them deeming a supply to exist or increasing the consideration for a supply. Rather, the provisions apply only for the purposes of the threshold levels described above. Section 76(5), (6) and (7), read together, is properly regarded as an anti-avoidance provision. These provisions also constitute a simple re-enactment of the existing law contained in section 76(3), which has been in place since the enactment of the GST Act in 1985.

Recommendation

That the submission be declined.

Issue: The scope of section 76(5) – (7)

Submission
(21W – Denham Martin & Associates)

The anti-avoidance rule in section 76(5), (6) and (7) should be redrafted so as to limit its scope and reduce compliance costs by:

- Having the rule operate only in relation to dispositions of taxable activities that occur after the date of Royal assent of the bill (or the date the bill was introduced).
- Where the vendor ceases to have any taxable activity following the sale to the associated person, having the rule only operate in the 12 month period surrounding the disposition of the taxable activity and only apply to assess the turnover of the recipient of the taxable activity.
- Having the rule operate, rather than it being "disapplied", where the Commissioner thinks fit.

Comment

In the submission it seems to be assumed that proposed section 76(5), (6) and (7) is being enacted for the first time in this bill. For example, the submission refers to the legislation having "potential application to all taxpayers retrospectively to the introduction of GST, being 22 August 1985". Proposed section 76(5), (6) and (7), however, simply re-enacts existing section 76(3), which has been in place since the enactment of the GST Act in 1985.

During the approximately 15 years that existing section 76(3) has been in place, it has not been identified as imposing high compliance costs on taxpayers, and its operation has not been problematic.

Ensuring that a vendor who has ceased to have any taxable activity (and therefore will not have any output tax liability in any event) is not affected by this rule is achieved by the Commissioner having the discretion under section 76(7) not to apply the provision to such a person when it is considered that this would be equitable. The discretion would be so exercised if there was no prospect of any output tax liability because the vendor has ceased to have any taxable activity.

Recommendation

That the submission be declined.

Issue: The breadth of the definition of "tax avoidance"

Submission
(13W – Rudd Watts & Stone)

Paragraph (e) of the definition of "tax avoidance" in proposed section 76(8), referring to a reduction in the total consideration payable by a person for a supply of goods and services, should be removed from the bill because it is too wide.

Comment

The submissioner states that paragraph (e) in the definition of "tax avoidance" in proposed section 76(8) is too wide because it will treat as tax avoidance normal commercial arrangements such as where a purchaser receives a discount for prompt payment from an unrelated supplier. Officials note that the general anti-avoidance provision applies to counter arrangements that are contrary to legislative intent. It should, therefore, not apply to an arrangement such as that mentioned in the submission. The proposed section 76 is based on the general anti-avoidance provision in the Income Tax Act 1994. As was noted by the Committee of Experts on Tax Compliance in its 1998 report, giving meaning to the terms of a widely drafted general anti-avoidance provision such as that in the Income Tax Act 1994, is ultimately a matter of judgement for the courts. Therefore, simply because the general anti-avoidance provision is widely drafted does not mean that arrangements which are not contrary to legislative intent will be nullified.

The submissioner also considers that it is not appropriate for the Commissioner to increase the amount of consideration paid between non-associated parties. (The submission also noted that this principle may not be applicable in the case of associated parties, where "due to their association the value of the consideration may not actually be parted with in a broader economic sense".)

There is a policy concern with vendors making supplies to associated persons for inadequate consideration, and a specific anti-avoidance rule (section 10(3)) treats the vendor as having received consideration equal to the market value of the supply. However, paragraph (e) of the definition of "tax avoidance" in the GST general anti-avoidance provision would be relevant if an arrangement was entered into which

involved interposing an unassociated party between two associated parties and arranging for a back-to-back supply arrangement for inadequate consideration. This is consistent with the backstop role of a general anti-avoidance rule, which is necessary to fill the gaps that specific anti-avoidance rules do not cover.

It is, therefore, necessary that paragraph (e) of the definition of "tax avoidance" in proposed section 76(8) be retained to ensure the efficacy of the GST general anti-avoidance provision.

Recommendation

That the submission be declined.

MINOR DRAFTING CHANGES

Clauses 66, 68, 70, 74, 84 and 95(3)

Submissions
(Matters raised by officials)

The following minor drafting changes should be made to the bill:

- Remove the reference to section 13 in section 2(1) (clause 66) with effect from 1 October 1996 (the date section 13 was repealed).
- Clarify in proposed section 3(1)(k) (clause 68) that a deliverable futures contract for financial commodities need only be supplied on arm's length terms, as opposed to being traded on arm's length terms.
- Omit the reference to "indemnity" in the proviso to proposed section 5(13) in clause 70.
- Amend clause 74 in relation to proposed section 11A(1)(l) to clarify that it is subject to section 11A(2).
- Amend proposed section 21D(3)(c) (clause 84) to ensure that it achieves its purpose of preventing a double input tax deduction in respect of the same goods.
- Amend the term "output tax payable" in proposed section 21C (clause 84) so that it is consistent with the terminology used elsewhere in the GST Act.
- Amend proposed section 21D (clause 84) to ensure that section 21E allows an input tax adjustment for the taxable use of goods and services for which output tax adjustments have previously been made for any non-taxable use.
- Amend proposed section 57(3) (clause 95(3)) so that it refers to tax relating to the taxable periods during which the person is a member.

Recommendation

That the submissions be accepted.

Alienation of income - the attribution rule

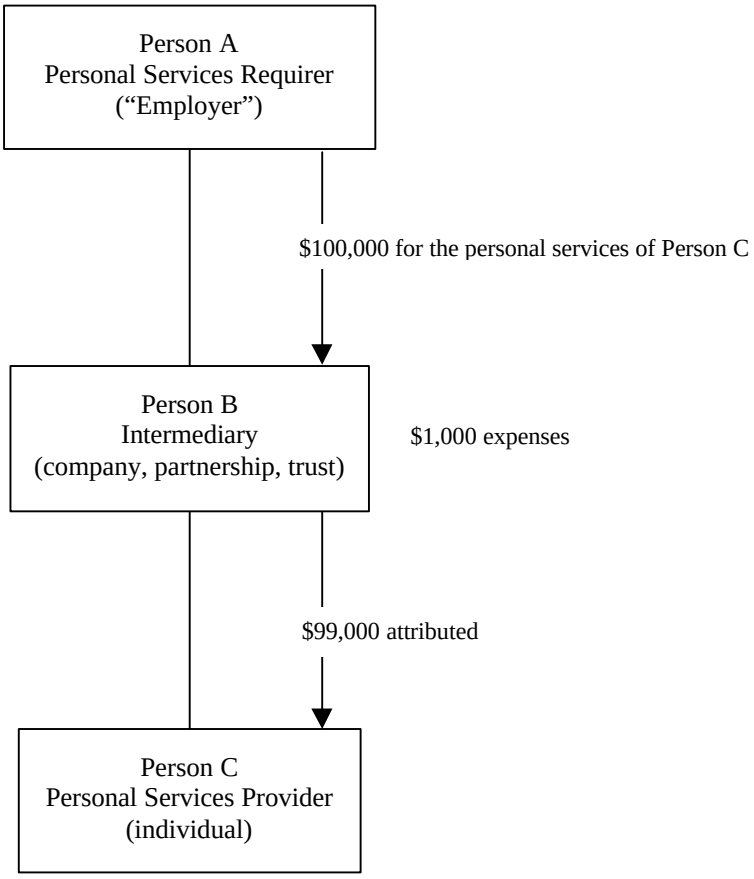
General comments

The attribution rule is an anti-avoidance rule aimed at ensuring that in defined circumstances a person's income from personal exertion is attributed to that person for tax purposes. When designing the rule officials kept two particular points in mind: that the deduction of expenditure would not be affected, and that the "employer" relationship should not be recategorised.

The rule only applies when *all* of the following criteria are met:

- The personal service provider (person C) and the interposed entity (person B) must be associated; and
- 80 percent of the gross income from the services of person B must be derived from one source (person A or an associate of person A); and
- 80 percent of the gross income from the services of person B must relate to the services personally provided by person C and related persons; and
- Substantial business assets are not a necessary part of the business structure used to derive the income from services.

Example:



If all four criteria are met, the $99,000 net income of the intermediary will be attributed for tax purposes to Person C, the personal services provider.

This attribution is required for tax purposes only. Officials expect that the accounting treatment will frequently follow the tax treatment. In most cases where it could apply, the intermediary's personal service income will be paid out to the personal services provider as salary, so the rule will not actually apply. This outcome is in accordance with the policy.

Submissions received on the proposed attribution rule raised a number of issues. A key issue raised is that of double tax. There are some instances where this could happen. Officials have suggestions as to how this could be addressed. We have also recommended that a number of other submissions be accepted.

A number of submissions commented that the current anti-avoidance rules are sufficient to combat the establishment of interposed entities simply to avoid tax. Officials disagree with these submissions in that the current anti-avoidance rule is subjective and can be difficult and time-consuming to apply. The attribution rule offers the certainty that in carefully defined circumstances the income from personal exertion is attributed to the person who provided it. It will also apply to structures to which the anti-avoidance rule will not apply, because it is objective. However, it does no more than allocate income to those whose personal exertions cause it to be derived.

Officials have undertaken further consultation with ICANZ, PricewaterhouseCoopers, the New Zealand Employers' Federation, the Federation of Commercial Fishermen and the Seafood Industry Council to discuss their submissions. As well, we spoke less formally with a number of other groups that made submissions. These discussions and consultations have been very useful in that some of the concerns expressed in submissions have been eased and other concerns will be the subject of specific recommendations.

The Committee's advisor, Therese Turner, has also provided very useful comment and criticism.

PURPOSE OF THE ATTRIBUTION RULE

Issue: Attribution rule's impact on structures

Submission
(1 – C. Smith)

The attribution rule should not be adopted because it unnecessarily impinges upon structures set in place for non-tax reasons such as creditor protection.

Comment

In officials' view, the rule does not impinge on usual creditor protection arrangements.

In any case, the circumstances outlined in the submission make it clear the rule will not apply.

Recommendation

That the submission be declined.

Issue: The need for an attribution rule

Submission
(17 – New Zealand Employers' Federation)

The attribution rule is not necessary as the current general anti-avoidance rules are sufficient to circumvent the use of interposed entities between an employee and employer to allow the employee to avoid the top personal tax rate.

Comment

There are many reasons why a taxpayer might enter into the sort of structure targeted by the attribution rule. The general anti-avoidance rule will often not apply to "undo" these. Further, the general anti-avoidance can be difficult and time-consuming to apply. However, the result of these structures is that the 39% tax rate might not apply to the personal services income unless the attribution rule applies.

Recommendation

That the submission be declined.

Issue: Attribution rule wider than just "anti-avoidance"

Submission
(19W – New Zealand Law Society)

The commentary on the bill states that the attribution rule is "a specific anti-avoidance rule to address cases where an employee has structured his or her employment relationship to interpose an entity between themselves and their employer".

The submission suggests that the rule exceeds this purpose and consequently should be limited to a "dominant purpose" test. This test would focus on whether the arrangement has been established with the purpose or effect of defeating the intent and application of the new top personal tax rate. Adoption of such a test would also avoid any difficulties with the GST implications of the attribution rules.

Comment

Although the rule is anti-avoidance in nature, it is correct that it will apply to businesses that are genuine. This is necessary to ensure that it is properly targeted. When the attribution rule was being developed there was decisions on whether the rule should be objective or subjective. In the end, officials recommended that the test be objective. This remains our view. The attribution rule is designed to apply in narrow circumstances where there is essentially one stream of personal services income, regardless of the taxpayer's reasons for setting the structure up.

Officials have considered the GST issue and do not consider that a problem will arise in practice. This is because the market value and associated persons provisions in the GST law will not cause the personal service provider to be deemed to be GST registered.

Recommendation

That the submission be declined.

APPLICATION DATE

Issue: Retrospective application of the proposal

Submission
(12 – ICANZ, 14 – PricewaterhouseCoopers, 17 – Employers' Federation)

The rule is retrospective in that it applies generally from 1 April 2000 (2000-2001 income year). It is submitted that the rule should apply generally from 1 April 2001 (2001-2002 income year).

The retrospective application of the rule places taxpayers in the difficult position of having to take into account the proposed rules in the year beginning 1 April 2000, even though they have no certainty as to whether, and to what extent, the rule will apply to them. Furthermore, arrangements that have been in place for a long period of time may well be affected.

Particular reference is made to the payment of provisional tax, the first instalment of which was generally due on 7 July 2000, and that in a situation where the interposed entity pays sufficient tax related to the income attributed to the individual, no penalties or use-of-money interest should apply.

Comment

Under the compliance and penalties legislation it seems clear that, so long as the provisional tax is paid appropriately by either the intermediary or the personal services provider, penalties should not apply.

The rule was announced at the end of March 2000 as applying from 1 April 2000. It is officials' view that some, probably a majority, of taxpayers and their agents will generally have relied upon the rule applying for the 2000 year and paid provisional tax accordingly. Changing the application date to 1 April 2001 would cause confusion. Furthermore, it would provide a window of opportunity for affected taxpayers to avoid the 39% tax rate imposed on 1 April 2000.

Use-of-money interest relief is appropriate, however, if the intermediary pays the tax instead of the personal services provider. This is dealt with separately later in this report.

Recommendation

That the submission be declined.

Issue: Application to entities established before 1 April 2000

Submission
(12 – ICANZ, 20 – KPMG)

The attribution rule should only apply when the structure was put in place at the time of the 1 April 2000 introduction date of the 39% marginal tax rate. This is on the basis that the rule should target those arrangements that were put in place as a consequence of the 39% tax rate (with motivation being important).

Comment

A number of taxpayers have had arrangements which they could use to avoid the 39% (or even the 33%) tax rate in place for a long time. A number of other taxpayers are reported to have entered into arrangements more recently in express contemplation of the 39% tax rate.

Given the objective nature of the rule, there is no reason that it needs to be targeted solely at arrangements put in place around 1 April 2000. Rather, it should apply to all arrangements where the effect (regardless of motivation) is to divert or alienate income that is derived by the personal services provider.

Recommendation

That the submission be declined.

SCOPE OF THE ATTRIBUTION RULE

Issue: Proposed threshold

Submission
(12 – ICANZ)

The attribution rule should only apply where the income of the personal services provider exceeds $60,000 (as either monetary remuneration or fringe benefits).

In the alternative, where the intermediary is a company, the attribution rule need not apply if the company income before any attribution is less than $60,000.

It is suggested that the rule produces compliance problems and that such a limitation will reduce these problems.

Comment

The attribution rule, as drafted, will apply regardless of whether the personal service provider has income of greater or less than $60,000. Given that the stated intention of the rule is to buttress the 39% tax rate, officials can understand why it is suggested that it might apply only where the provider's income exceeds $60,000.

Several issues, however, need to be considered. First, it seems that significant work may be involved in confirming that the personal services provider would not otherwise earn more than $60,000. To do this the attribution rule's calculation would have to be applied to the intermediary(ies) associated with the personal services provider. Further complexity would be caused by the need to take into account fringe benefits received by the personal services provider.

Second, is it appropriate to assume the intermediary(ies) accountant(s) has (have) sufficient knowledge of the personal service provider's tax affairs? In most cases this should not be an issue, however.

Third, although incidental, the attribution rule targets income splitting – for example, between spouses. There is no reason in principal for personal services providers deriving less than $60,000 from services to have opportunities to split income that are denied to those earning more than $60,000.

The question is whether the complexities and compliance costs outweigh the gain. On balance, officials recommend the submission be accepted.

Recommendation

That the submission be accepted.

Issue: Exemption for legitimate business

Submission

(14 – PricewaterhouseCoopers, 6 – New Zealand Confederation of Commercial Fishermen, 7 – New Zealand Seafood Industry Council)

The rule will apply to legitimate business entities that are not established to avoid tax, and therefore will add cost and complexity to their businesses and affect how they distribute their service income.

PricewaterhouseCoopers submits that such entities should have the ability to apply to Inland Revenue for an exemption from the rules. The onus would be on the entity to prove that it was carrying on a legitimate business, which could include the following:

- *New businesses building up capital for future investment* – Such businesses could be forced to distribute income to the personal services provider, who would then reinvest this income back into the business. The amount of income available for reinvestment could be reduced if the individual was subject to the 39% marginal tax rate rather than the 33% company rate.
- *Businesses unable to pay out income to avoid the rules* – The proposal may be severe on businesses which, owing to insufficient cashflow, cannot pay out income to avoid application of the rules. This could occur where a business incurs expenditure that is not immediately deductible, forcing such a business to be subject to the attribution rules when it is not engaged in tax avoidance.
- *Businesses with a history of providing services to unrelated clients.*
- *Businesses that contract independently with a number of associated companies.*

The New Zealand Federation of Commercial Fishermen and the New Zealand Seafood Industry Council also submit that the attribution rule should be substituted with a test of whether the entity in question is carrying on a "legitimate business" or simply acting as a vehicle for an individual to avoid tax.

Comment

Although the rule is anti-avoidance in nature, it is true that it will apply to businesses that are genuine. This is necessary to ensure that it is properly targeted. The attribution rule is designed to apply in narrow circumstances where there is generally one stream of personal services income (perhaps as well as another, different, business), regardless of the taxpayer's reasons for setting the structure up.

The rule is a "hard" rule which has limited targeted application and no discretion. This "no discretion" is an important feature. New Zealand tax practice is moving away from Inland Revenue discretions, which are expensive to administer and often cause anomalies. Further, they can leave the taxpayer uncertain. An advantage of the rule, as proposed, is its certainty.

It is also important to remember that, aside from imposing the 39% tax rate, the attribution rule does not inhibit the build-up of capital for future investment (aside from insisting that tax at 39% is paid where appropriate), nor does it require businesses to pay out cash in order to ensure the rule does not apply. This is because, while the amount attributed will usually be recorded as an expense for accounting purposes, it does not need to be paid out in cash.

As was pointed out by PricewaterhouseCoopers in its verbal submission, however, where the personal services are an ancillary, but integral part of the provision of a product of the intermediary, it is inappropriate to apply the rule.

Recommendation

That the submission be declined, but that where the personal services are an ancillary, but integral, part of the provision of a product, the attribution rule should not apply.

Issue: Application only when a certain percentage of income is not appropriately distributed

Submission
(12 – ICANZ)

The attribution rule should only apply to the extent the interposed entity does not distribute a certain percentage (say, 70 percent) of its annual earnings to the principal service provider.

Comment

The bill proposes a minimum threshold of $5,000 for amounts to be attributed. This is for compliance cost reasons. From a policy perspective, where the attribution rule applies, there is no reason the entire amount to be attributed should not be so attributed.

Leaving 30 percent of the income in the intermediary could undo the intended effect of the attribution rule. For example:

The intermediary's net income from personal services is $90,000 and this is caused by one personal services provider. If 70 percent ($63,000) is paid to the provider by way of salary, the balance ($27,000) is subject to tax at 33% (or less).

This negates the intent of the rule.

Recommendation

That the submission be declined.

Issue: Application to partnerships

Submission
(12 – ICANZ)

Partnerships should be excluded from the attribution rule as all income is distributed to partners. This is on the basis that the present attribution rule overrides the present fair and reasonable partnership allocation rule.

An example is provided as follows:

> "Assume a family partnership where the work in relation to the service business is structured so that one member actually provides the services while another provides all the administrative support to ensure that the business can operate. Further assume that to recognise the value of the inputs to the partnership, the partnership income is allocated 75/25% to the service provider and to the administrator.
>
> As the amount allocated to the administrator is not deductible to the partnership, the total partnership income will be attributed to the service provider even though the administrator is properly entitled to a 25% share."

Comment

The application of the attribution rule to partnerships is intended to do little more than buttress the present partnership allocation rule. Specifically, the present partnership profit allocation rule requires profits to be allocated based, among other things, on inputs provided.

The example provided by the submission raises a good point. Where the personal service provider and another person provide services to a partnership intermediary, the partnership income to be attributed should be apportioned between the provider and the other persons.

This issue should not arise for intermediaries that are companies or trusts, because they can, and almost always will, pay the administrator a salary (so can a partnership, but it is more difficult).

Recommendation

That the submission be declined, but that a rule allowing for the contribution to a partnership by any person be provided.

Issue: Implications for non-residents

Submission
(12 – ICANZ, 14 – PricewaterhouseCoopers)

The implications of the attribution rule for non-resident entities contracting in New Zealand should be closely examined with the view to alleviating the double taxation of non-residents.

Non-residents can generally claim a tax credit in their resident country for tax paid in New Zealand. However, as the attribution rules apply for the purposes of New Zealand taxation only, a non-resident intermediary may not be able to substantiate in its home country that tax has already been paid on the amount of income attributed under the attribution rule to the personal service provider. Therefore the non-resident may not be able to claim their full tax credits. Further, there appear to be issues with double tax treaties and the application of non-resident contractors withholding tax (NRCWT) and the attribution rule.

Comment

The issue with NRCWT is particularly valid. NRCWT applies only to non-residents. Accordingly, where both the intermediary and the personal services provider are non-resident, the rule should not apply.

Recommendation

That the submission be accepted.

DERIVING 80 PERCENT OF INCOME FROM ONE SOURCE

Issue: Amendment to the income measurement period

Submission
(12 – ICANZ)

The attribution rule can only apply where 80 percent of the services income of the intermediary is from one source. This 80 percent is proposed to be measured on an income year basis. This submission proposes that the income year basis be modified "to allow compliance with any prior continuous 12 month period that includes at least six months of the current income year."

> "For instance, that person may be contracting and intend to work on one contract for nine months during an income year. However, that person is not able to be contacted at the end of that time or the contract is extended, then the person would be subject to the attribution rule."

The submission is that if the person can show that they would not have been subject to the 80 percent rule for a continuous 12-month period, including six months of the earlier year, the attribution rule should not apply.

Comment

This submission also draws attention to the fact that the attribution rule may not apply merely where there was one change of service requirer. For example, suppose a personal service provider had, through her intermediary, contracted with computer company A for five years, and then, at the expiry of the five years, she decided, again through her intermediary, to contract with the completely independent computer company B.

If the change takes place in the middle of a tax year the attribution rule will not apply for the year, whereas if it takes place at the beginning or end of a tax year it may easily apply.

The point being made is that the timing of the application of the 80 percent of the services income of the intermediary condition is arbitrary. Although this is correct, it also has the merit of being simple to understand and apply. While more complicated variations could be used, it is our judgement that this complication will not yield a sufficient gain to make it worthwhile. The balance of the attribution rule ensures that it applies only to income generated by personal services, and there seems no reason why the personal services provider should not personally pay tax on that.

Recommendation

That the submission be declined.

Issue: Exemption where income is derived independently from associated companies

Submission
(14 – PricewaterhouseCoopers)

Entities may in some cases independently contract with two or more companies that are associated with each other.

PricewaterhouseCoopers submits that the entity should be able to apply to the Commissioner for exemption from the attribution rules where it can show that the contracts are unrelated. In such cases where this can be proved, these contracts should be treated the same as if they were with unrelated companies (irrespective of the fact they are associated companies).

Comment

A similar case could also be made for independent contracts with one "employer".

New Zealand tax practice is moving away from Inland Revenue discretions, which are expensive to administer and often cause anomalies. This lack of discretion is a design feature which is part of the targeted application of the rule.

Again, officials consider that, from a policy perspective the personal services provider should pay the tax.

Recommendation

That the submission be declined.

Issue: Scope of the 80 percent rule

Submission
(17 – New Zealand Employers' Federation)

The proposed 80 percent income source rule only focuses on the proportion of income from various sources rather than the effort concerned. While an entity may derive more than 80 percent of its income from one source, it may only spend 40 percent of its time on this contract. The measurement base should be inputs, not outputs.

Comment

Inputs, (effort put in to the intermediary) are subjective, and in a number of cases they would not be measured. In contrast, outputs (monies earned by the intermediary) are considerably more objective and can be determined directly from the intermediary's financial records.

Recommendation

That the submission be declined.

DOUBLE TAXATION ISSUES

Issue: Implications for companies

Submission
(12 – ICANZ, 13W – Rudd, Watts and Stone, 14 – PricewaterhouseCoopers, 20 – KPMG)

Care should be taken that to ensure that double taxation does not arise. The submissions comment that the bill does not provide any relief from double taxation for amounts subject to the attribution rule.

ICANZ and PricewaterhouseCoopers suggest that relief could be granted via the Commissioner being given the power to exempt distributions from tax which had already been taxed under the attribution rules.

KPMG suggests that the double tax issues that occur when the intermediary is a company be dealt with by providing two tax credits.

Comment

The amount attributed is expressly provided to be a deductible expense of the intermediary. Where this attribution is included as an expense in the financial statements it is exceedingly unlikely that there will be any double tax. Furthermore, where the intermediary is a partnership or (with one exception) a trust, there is no prospect of double taxation. This trust situation is addressed in the next submission.

Double taxation can arise where the intermediary is a company and income is distributed as a dividend. There are two separate circumstances where this could happen:

- first, where the income is distributed by way of dividend prior to it being realised that the attribution rule applies; or
- second, where, for whatever reason, the accounting treatment of the amount attributed does not follow the taxation treatment (that is, the amount is not shown as an expense in the intermediary company).

When double tax could arise, chances are that the company concerned will be a qualifying company and, therefore, it is less likely there will be double taxation. Also, officials note that offering relief may be complex.

However, we are persuaded that relief from double tax is desirable. We recommend that, where the attribution rule applies, a credit be added to the imputation credit account, calculated at 33% of the amount attributed. This would allow for both:

- any dividend from the income that was attributed to be imputed; and
- a transfer to the personal service provider of any tax paid by the intermediary in respect of the amount attributed, at the effective dates it was paid.

The extra credit should be dated on 31 March of the income year in which the attribution was made.

Several technical issues arise:

- If the intermediary is a qualifying company, the credit could be used to shelter its income. However, this is of little concern because dividends from qualifying companies are either fully imputed or exempt.
- If the financial statements are then "adjusted" to reflect an amount attributed (say, for the same or another year) there will need to be a reduction in the imputation credit account – again at the rate of 33% of the amount adjusted. This is because there is no need for the extra credit if the financial statements do not reflect the amount attributed as an increase in retained earnings available for dividend. This debit should be on 31 March of the income year for which the financial statements are adjusted.

Recommendation

That the submission be accepted and that relief be offered by way of:

- An extra imputation credit account credit dated 31 March of the year in which an amount is attributed, calculated at 33% of the amount attributed.
- This credit to reverse if the financial statements are then adjusted to reflect an amount attributed, at the rate of 33% of the amount adjusted. This debit to be dated 31 March of the income year for which the financial statements are adjusted.

Issue: Double tax of trusts

Submission
(12 – ICANZ, 14 – PricewaterhouseCoopers, 20 – KPMG)

These submissions were concerned about the potential double tax where trusts are intermediaries. ICANZ and KPMG suggested that sections DJ 19 and HH 3(1) should be amended to address this.

Comment

The submission identifies an important issue.

The proposed solution may not be the appropriate one, however, because the problem seems generic to the Income Tax Act 1994. The attribution rule merely highlights existence of the problem.

The problem is that the Income Tax Act, because of the way it operates gross and net amounts, does not limit the aggregate amount of income on which the beneficiaries and trustees pay tax to the net income of the trust before distribution to the beneficiaries. Rather, the aggregate amount is limited to the gross income of the trust.

The specific attribution problem should be addressed by a rule that applies where the attribution rule causes the trust to be in a net loss position. To the extent of that net loss, any amounts distributed as beneficiary income should be reduced, in proportions specified by the trustees. Failing specification, the reduction should be pro rata over all beneficiary income.

This will ensure that there can be no double tax when trusts are intermediaries.

Recommendation

That the point of the submission be accepted, and future consideration be given to a generic change to the Income Tax Act 1994 to address the wider problem.

ASSETS

Issue: Substantial assets

Submission
(12 – ICANZ, 20 – KPMG)

The substantial assets test should be broader than just depreciable assets. It should be expanded to include other property that is not depreciable property. Often an intermediary will have substantial capital tied up in the development of intangible property, such as plans, formulas, models and methodologies, that are not depreciable.

Comment

The provision (by sale or licence) of a product does not lead to income from personal services. We recommend, as a result of another submission, excluding from the scope of the attribution rule services that are ancillary to the provision of a product. This would seem to address the concern that arises in this submission.

Recommendation

That the submission be declined.

Issue: Necessary part of the business structure

Submission
(12 – ICANZ)

It should be clarified as to what is meant by "a necessary part of the business structure". The submission then goes on to discuss assets subject to leases, including premises.

Comment

Where the tax law regards leases and hire purchases as transferring the ownership obligation to the lessee, officials agree that those assets qualify. This is also the subject of a separate specific submission.

However, where the assets (including premises) are subject to an operating lease it is inappropriate to regard them as being assets required to operate the business – the lessee has no ownership interest in these assets and does not carry the ownership obligations. The intermediary is not using any capital to derive the income.

Recommendation

That the specific submission be declined, but that the finance lease and hire purchase aspects of submission be dealt with separately.

Issue: Premises

Submission
(12 – ICANZ)

Where an intermediary leases premises independent from the service requirer the attribution rule should not apply.

Comment

The fact that the intermediary might operate from independent (presumably leased) premises does not, by itself, suggest that the attribution rule should not apply. The significant assets rule is designed to let out those businesses that use capital and can expect a return on it. No capital is involved in renting premises, in the same way as no capital is involved in being the lessee under an operating lease. Therefore officials consider there is no need to bring leased premises into the "substantial assets" test.

Recommendation

That the submission be declined.

Issue: Finance leases and hire purchase

Submission
(12 – ICANZ – 20 – KPMG)

The "cost" of the asset should be extended to "cost, acquisition cost and lessees' acquisition cost". This is on the technical grounds that the use of "cost" implies that assets subject to financial lease or hire purchase agreement are not to be regarded as "substantial business assets".

Comment

On economic terms, because the intermediary suffers the "ownership" risks, these assets should be included within the substantial assets test. The owners of the intermediary can rightly expect to derive a return on these assets. Thus, in our view, they should be included in the "substantial assets" test.

Recommendation

That the submission be accepted.

Issue: Proportion of private use

Submission
(12 – ICANZ, 20 – KPMG)

There should be one threshold for both vehicles and other assets. This threshold should be "not acquired predominantly for private purposes" (or "acquired principally for business purposes").

The point is made that test is going to be performed at the end of the taxpayer's income year and that more certainty is required. Also, ICANZ suggested that upon IRD audit there might be discussion as to "the practicalities of the situation, the scheme and purpose of the Act and whether care and management provisions should be applied to allow the Commissioner to overlook the transgression".

The suggestion is that rather than an arbitrary fixed threshold, it should be worded in such a way to encourage the rule to achieve its purpose without giving rise to unnecessary compliance costs.

In the alternative, ICANZ suggests the proposed 20 percent motor vehicle test should be adopted for all assets. The bill requires that these other assets not be used at all for private use or enjoyment. The point is made there is frequently some private use of things like computers and cell phones and tradesmen's tools.

Comment

The care and management provisions would have no relevance to an audit discussion of the application of the attribution rule's substantial assets test.

Any threshold is arbitrary. The 80 percent threshold for motor vehicles recognises that the vehicles may have some aspect of private running, but ensures that their predominant use is substantially business.

Officials consider it appropriate to reduce the threshold for assets other than vehicles to the same threshold as vehicles. There is no compelling reason to treat vehicles differently from other business assets. This allows for incidental private use. If this use was measured using the Income Tax Act's present fringe benefit tax and private use apportionment requirements there would be no additional compliance costs as these calculations have to be done anyway.

In our view, it is not appropriate to apply an "at acquisition" test as actual use could, and frequently will change over time. In any case, adopting the FBT or private use approach does not add any extra compliance costs.

Recommendation

That the first submission regarding "principal use" be declined, but that the alternative submission concerning one 20 percent or less private use test for all assets be accepted, to be based on present taxation apportionment.

Issue: Quantum of depreciable assets

Submission
(12 – ICANZ, 20 – KPMG)

The gross figure of $75,000 of depreciable assets should be reduced to $50,000. The figure is arbitrary and there will always be boundary issues: ICANZ notes that "it is very difficult to set an exact figure as to the value of equipment that separates a self-employed person from an employee. However, on the context of this provision and considering the types of people the rule is seeking to exclude a figure of $50,000 is more appropriate."

Comment

The amount used must be large enough to justify an economic return on the assets. In this context, it can be agreed that both $75,000 and $50,000 are arbitrary. However, the arguments raised do not, by themselves, justify reducing it to $50,000.

Recommendation

That the submission be declined.

Issue: The 25 percent rule

Submission
(20 – KPMG)

The exclusion when assets cost at least 25 percent of gross services income should not be retained because its application is uncertain. This is because the income is not known until year end.

Comment

Officials agree that there will be some uncertainty generated by this rule. It is designed to exclude from the attribution rule businesses that require in comparison to their income, significant assets.

Our judgement is that the advantages of this exclusion outweigh the uncertainty it will create.

Recommendation

That the submission be declined.

Issue: Choice of methods of calculating private proportion of vehicle usage

Submission
(12 – ICANZ)

The bill proposes that the private proportion of motor vehicle usage for the significant asset test be either:

- based on the days of private use for fringe benefit purpose compared with total potential availability; or
- based on the amount of expenditure on the vehicle that is non deductible compared with total expenditure.

It should be clarified as to which method is used when.

Comment

Officials agree the legislation should make it clear that, where the asset is subject to the fringe benefit tax rules, apportionment is to be done using those rules.

Recommendation

That the submission be accepted.

ASSOCIATED PERSONS, RELATION TESTS

Issue: Associated persons

Submission
(12 – ICANZ)

The personal services provider is unlikely to have sufficient information to apply the detailed associated persons rule to consider whether the personal service requirers are associated.

Comment

The associated persons test that determines the relationship between personal services requirers should be removed, or at least, made simpler. The bill proposes the one associated persons rule for all purposes.

This submission is valid in circumstances where the personal services provider cannot be expected to be aware of the association of personal service requirers.

Recommendation

That the associated persons rule, which associates personal services requirers, not apply where it would not be reasonable for the personal services provider to know about the association, other than by having made specific enquiry.

Issue: Related persons test

Submission
(12 – ICANZ)

The phrase "a relative of person" should be removed from the test which considers whether the service of income of the intermediary is derived through the effort of one person and his/her relatives. The result is that if a person operates a services business though an interposed entity together with an unrelated person the attribution rule may not apply. However, if that person operates the same services business with the relative, the attribution rule could apply. This would result in taxing family service businesses differently from other businesses. This is contrary to the separate treatment of spouses under the New Zealand tax law.

Comment

New Zealand tax law explicitly considers the position of spouses in income splitting arrangements – there are specific rules concerning wages paid to spouses. Also, there are detailed tax rules concerning matrimonial property splits.

When the attribution rule was being developed it was suggested during consultation that care should be taken to ensure that the rule's application could not be defeated merely by the insertion of a relative into the intermediary. This is necessary from an anti-avoidance perspective.

However, following discussions with Therese Turner, officials agree that the relative test proposed is too wide. The standard relative test brings in relation to the fourth degree. This test will work appropriately with relations to the second degree.

Recommendation

That the submission be declined, but that the relationship test be limited to that of second degree.

Issue: Clarification that government departments are not deemed to be associated sources of income

Submission
(14 – PricewaterhouseCoopers)

There is uncertainty about whether government departments are deemed to be associated by their relationship with the Crown for the purpose of the 80 percent of income from one source rule. If government departments were deemed to be associated, entities with multi-departmental contracts would be caught. Therefore express clarification is needed that government departments are not associated for the purpose of the attribution rules.

Comment

Officials agree that government agencies should not treated as being associated for the purposes of the attribution rule merely because of their connection with the Crown.

Recommendation

That the submission be accepted.

MECHANICAL CALCULATIONS

Issue: Calculation of interposed income

Submission
(12 – ICANZ)

If an intermediary has income other than income from services, the net amount of income from services should be clearly identified. The bill can be read to suggest that all of the intermediary's income is treated by the rule as if were income derived from services only.

Comment

Officials agree that clarification would be helpful.

Recommendation

That the submission be accepted.

Issue: Apportionment of expenses

Submission
(12 – ICANZ)

Rules should be included to apportion the expenses of the intermediary in circumstances where the intermediary has other income, so that the net income from services can be correctly calculated.

Comment

During the policy development process it was envisaged that, aside from the express apportionment rule provided in sub-section GC 14C(3), and the allocation of "head office" expenses to the income from services, the usual apportionment rules apply.

In this respect, the direct expenses associated with deriving the services income and the other income of the intermediary would be so allocated and indirect expenses would be apportioned. While it is not the place of the Income Tax Act to provide these detailed rules, this apportionment should be expressly discussed in the *Tax Information Bulletin* item on the attribution rule.

Recommendation

That the submission be declined, but the matter be expressly addressed in the *Tax Information Bulletin* item on the attribution rule.

Issue: Concessionary expense allocation rules

Submission
(12 – ICANZ)

The rule that apportions remuneration provided by the intermediary to the personal service provider should be deleted.

Comment

It appears that this submission is underpinned by the lack of clarity referred to in the submission on the calculation of interposed income, above. Officials believe this rule will be to the benefit of taxpayers. It means that all remuneration paid by the intermediary to the personal services provider will be regarded as being paid in respect of the intermediary's personal services income. Where not all of the intermediary's income is in respect of services performed by the personal services provider, apportionment of the remuneration paid as salary is, therefore, not necessary.

The uncertainty arises because of the lack of clarity of the intermediary's "net income from services". As noted above, we agree this needs further elaboration.

Recommendation

That the submission be declined, but, as recommended above, the underlying lack of clarity be addressed.

Issue: Quantifying the value of services

Submission
(21W – Denham Martin)

Clarification is needed in relation to the 80 percent threshold tests in sections GC 14B(2) and GC 14C(6) regarding how to quantify services where these are performed by more than one person.

This allocation could be made based on either the amount of time each person takes in performing the services multiplied by what that person makes, or by the amount of time multiplied by their charge-out rate.

The threshold tests can be argued to be "but for" tests. That is, a single person could be responsible for securing all the contracts, but not for performing the work, which would be undertaken by others. The single person would thus be responsible for the income being derived.

Comment

The use of the words "gross income from services" indicates clearly that it is income that is relevant, not costs or inputs.

We doubt the words proposed "services personally performed" can actually be construed as a "but for" test. This is because of the explicit reference to "services personally performed" in the second 80 percent test.

Recommendation

That the submission be declined.

Issue: More than one related personal service provider

Submission
(21W – Denham Martin)

Provision should be made where two (or more) related personal services providers are affected by the attribution rule.

Comment

This is expressly addressed in the proposed legislation where any amount to be attributed is divided between the service providers depending on their contribution.

Recommendation

That the submission be declined.

OTHER ISSUES

Issue: Transfer and utilisation of losses

Submission
(12 – ICANZ, 14 – PricewaterhouseCoopers)

Losses transferred from other entities and losses brought forward from earlier years should be able to be utilised against the intermediary's personal services income, before the attribution rule applies to the reduced net amount. If the other activities of the intermediary cause it to have a loss in any one year, that loss will not be offset against the services income of that intermediary in a future year. The submissions request that all losses (both brought forward and offset from other corporate taxpayers) should be able to be offset against intermediary's income that would otherwise be attributed.

C**omment**

The overall intent of the rule is to attribute that net services income to the service provider. Given this policy intent, it could reasonably be argued that even if the intermediary has other current year losses that do not exceed the amount of the intermediary's services income, those losses should not be offset against that income before attribution.

As a practical measure (and to recognise that in a significant number of cases the losses can be utilised anyway by way of the loss attributing qualifying company rules), the Government agreed that the current year losses of other activities of the intermediary should be allowed as an offset to the intermediary's services income, to the extent of that income. The submission asks that this be extended to losses transferred from other entities and to losses brought forward.

PricewaterhouseCoopers has, during discussions, suggested that where the loss arises from a business of which the personal services income is a part, it should be available for offset. For example, a computer person causes his or her intermediary to derive income from personal services and the intermediary is also developing, say, a website application.

The PricewaterhouseCoopers "one business" suggestion assumes that the personal services income relates to a wider business activity of the intermediary, that of developing the web application. Another analogy is that of a farmer who also provides farm advisory services.

Except where the personal services are an ancillary, but integral, part of providing product, the "one business" agreement does not hold. This is because there is clearly more than one activity taking place: on one hand, that of providing personal services (mainly to one service requirer) and, on the other hand, the sale or licencing (using the PricewaterhouseCoopers' example) of a computer-based product.

In this case, the provision of the personal services of the sort to which the attribution rule applies is unlikely to cause a problem with losses to carry forward as it is generally unlikely that a loss can be generated from the provision of personal services.

We do not believe that the rules need to be generally relaxed further in this respect. Taxpayers have ordered their affairs to allow, amongst a host of other things, their income from personal services to offset current year losses of their intermediary. Wage earners who are subject to the 39% tax rate do not readily have this choice.

However, where an intermediary which supplies personal services is going through a start up process it could generate losses. If all of the future income of the intermediary is subject to the attribution rule, these losses may not be utilisable.

Therefore we suggest that where:

- the intermediary is a company or a trust; and
- the only business or trading income of the intermediary is from the provision of personal services;

it should be able to carry any loss forward to the next year and use it to reduce any amount to be attributed.

Recommendation

That the submission be declined, except that where the intermediary is a company or a trust that has had no other business or trading activity, it be allowed to utilise losses brought forward.

Issue: Attribution of provisional tax

Submission
(12 – ICANZ, 20 – KPMG)

If income is attributed to a personal service provider, any provisional tax paid by the intermediary in respect of the attributed income should also be attributed to the personal service provider.

This is because it might be very difficult at the beginning of a year to confirm whether the attribution rule applies or not.

If taxpayers do not correctly judge whether the rule will or will not apply to them they could be exposed to use-of-money interest.

In the alternative, relief should be provided from penalties/use-of-money interest to the extent that either the intermediary or the personal service provider had paid tax.

Comment

As previously suggested, officials believe the attribution rule will only apply infrequently because the amount otherwise to be attributed will be paid out to the personal service provider by way of salary. Furthermore, in most cases where it could apply, its application will be clear-cut.

However, the rule does have hard boundaries that could cause taxpayers to unexpectedly be subject to the rule.

So long as appropriate care is taken administratively to ensure there is no problem with overdrawn imputation credit accounts where the intermediary is a company, the submission should be accepted. The principle of such transfers is already embodied in section MB 9, which deals with transfers of tax between wholly-owned group companies. It also seems appropriate that the transfer should be allowed where the attribution rules would have applied had a salary, from which tax deductions were not required to be made, not been paid.

Recommendation

That this submission be accepted and extended as suggested.

Issue: Source deduction

Submission
(Matter raised by officials)

It needs to be made clear that amounts attributed are not subject to source deduction (such as PAYE) by the intermediary.

Comment

Amounts attributed cannot be determined until after year end. Therefore, it cannot be expected that intermediaries that are companies or trusts should have to deduct PAYE or other withholding taxes.

Recommendation

That the submission be accepted.

Issue: Alignment with new fringe benefit tax rules

Submission
(12 – ICANZ)

The definition of "cash remuneration" that drives the fringe benefit tax rule in the Taxation (FBT, SSCWT and Remedial Matters) Bill should be amended to include "amounts distributed in accordance with section GC 14C". This is on the basis that the attribution rule could be used to avoid the 64% (or presumably even the 49%) rate of FBT being applied in the circumstances where it clearly should.

Comment

The point this submission makes is good.

Recommendation

That the submission be accepted.

Issue: Clarification of the relevant income year

Submission
(12 – ICANZ)

The relevant income year should be clarified. The submission discussed issues concerning the income flowing from the personal service requirer to the intermediary and the income flowing from the intermediary to the personal service provider.

Comment

The issue concerning income years as between the service requirer and the intermediary is irrelevant. What is relevant is how much income in personal services is derived by the intermediary in an income year and the attribution of that income to the service provider in the same income year. The proposed legislation can be enhanced to make this clearer.

Recommendation

That the submission be accepted.

Issue: Clarification of dates for association, etc.

Submission
(12 – ICANZ, 13W – Rudd, Watts and Stone)

At the moment the date of application of the two associated person tests, the relative test and the substantial business assets test are not specified. They should be.

Comment

Officials agree that some specification is advisable.

Recommendation

That:

- the associated persons tests apply at the time the services are provided;
- the relatives test apply at the beginning of the year;
- the dollar tests in the substantial assets test apply at balance date for simplicity of compliance.

Issue: Alignment of return filing dates

Submission
(12 – ICANZ, 20 – KPMG)

The return filing dates of the intermediary and the personal services provider should be aligned if one of the parties had an earlier filing date than the other.

Comment

In the majority of circumstances both the intermediary and the personal services provider will be on tax agents' client lists and will, therefore, automatically be entitled to extension of time of arrangements. However, this submission can and should be accepted by Inland Revenue's administration to ensure tax return filing alignment.

Recommendation

That the submission be accepted by Inland Revenue.

Issue: Multiple intermediaries

Submission
(21W – Denham Martin)

The opportunity to avoid the attribution rule by using multiple intermediaries should be closed.

Comment

Officials believe that no such opportunity exists because provision is made to deal with multiple intermediaries where there is one service provider.

Recommendation

That the submission be declined.

MISCELLANEOUS ISSUES

Issue: Numbering of sections

Submission
(12 – ICANZ)

The proposed new section CD 8 should be section CD 7, as there is no current CD 7.

Comment

This is obviously an oversight.

Recommendation

That the submission be accepted.

Issue: Use of the term "personal services"

Submission
(21W – Denham Martin)

The bill uses the term "services" when the provisions are intended to apply only to income from "personal services". Therefore the term "personal services" should be used throughout the bill to ensure it applies as intended. Furthermore, the term "personal services" should be defined in the bill.

Comment

The term "personal services" should be used as appropriate. Because any definition will introduce doubt about that definition's boundary, officials believe the term is better left undefined.

Recommendation

That the submission regarding the use of the term "personal services" be accepted, but that it not be defined.

Issue: Nil amounts to be attributed

Submission
(12 – ICANZ)

The attribution rule currently does not apply if the calculation of the amount to be attributed results in a negative number. This is circular. In these circumstances the amount to be attributed should be nil, rather than stating that this section does not apply.

Comment

Officials consider that adopting this suggestion will add to the clarity of the rule.

Recommendation

That the submission be accepted.

Issue: Terminology

Submission
(12 – ICANZ)

The phrase "deductible expense" used in the proposed sub section GC 14C(3) should be replaced with the term "allowable deduction".

Comment

The use of "allowable deductions" is consistent within the core provisions of the Income Tax Act 1994. However, the objective is not to cause the salary to be deductible, but to apportion the deductible amount. The usual deductibility tests still have to be met.

Recommendation

That the submission be declined, but the sub section be re-examined to see if it can be clarified.

Issue: Location of definitions

Submission
(12 – ICANZ)

The definitions for the attribution rule should be in section OB 1.

Comment

Because the definition is specific to the attribution rule it is not appropriate to relocate it as submitted. However, a cross reference from section OB 1 is appropriate.

Recommendation

That the submission be declined, but that section OB 1 cross reference the definition.

Other policy changes

GROUP INVESTMENT FUND MANAGEMENT FEES

Submissions
(15W – Trustee Corporations Association of New Zealand)

A number of minor amendments, already discussed with officials, should be made to ensure that technical issues affecting group investment funds (GIFs) are adequately dealt with.

Individual issues are:

Issue 1 The deduction provision should be elective.

Issue 2 The amendment should ensure that management fees paid by GIFs on behalf of investors are not treated as income in investors' hands.

Issue 3 The kinds of fees to which the amendment applies should be expanded.

Comment

Section 32 of the Trustee Companies Act 1967 prohibits the charging of management fees by GIFs. To get around this, GIFs pay management fees on behalf of the investors. The policy intention of the amendment is that, despite the prohibition, a deduction should be allowed for tax purposes to GIFs for management fees paid on behalf of investors.

Issue 1

One (and possibly, for a period, two) trustee companies have not been deducting management fees at the GIF level. The suggested change will ensure that those companies are not required to depart from their existing practice.

Issue 2

The policy intention of the amendment is that GIFs are treated as if the management fees are paid on their own behalf. It would not be consistent with that policy for any portion of the management fee to be treated as income in the investors' hands. The suggested change will ensure that this does not occur.

Issue 3

Section 32 of the Trustees Act refers to " a charge for management … commission or other recompense or remuneration". The suggested change will ensure that a deduction is allowed in all circumstances contemplated by section 32.

Recommendation

That the submission be accepted.

Issue: Year in which ACC base premiums are payable

Submission
(12 – ICANZ)

The Income Tax Act 1994 should specifically allow a deduction in the year in which the due date (as specified in an invoice supplied by ACC) falls.

Comment

The policy intention of the legislative amendment is to allow a deduction on a "discount date" where a base premium is paid by that date. ICANZ's concern is that some employers negotiated a new due date for payment which may fall before the discount date. Those employers could be disadvantaged if the deduction was to be allowed on the discount date. Officials agree that this issue needs to be addressed.

However, samples of invoices provided to Inland Revenue by ACC include both a discount date and a date by when payment is due. Accordingly, ICANZ's submission would not solve the difficulty in all cases.

Recommendation

That the substance of the submission be accepted, but that the deduction be allowed on the discount date if:

- payment is made on or before the discount date; and
- the discount date is before the date on which the amount is shown as due *on the invoice*.

The definition of "due date" would be omitted.

GIFTS OF FINANCIAL ARRANGEMENTS

Submission
(12 – ICANZ)

The proposed rules which deem financial arrangements which have been transferred for nil or inadequate consideration to have been transferred at market value should clearly provide that the transferee acquires the financial arrangement at market value.

Comment

The policy intent of the amendment is that when a financial arrangement is transferred for nil or inadequate consideration, the financial arrangement should be deemed to be sold by the transferor, and acquired by the transferee, for market value. Acquisition by the transferee at market value ensures that when the base price adjustment is performed for the transferee at the time the transferee ultimately comes to dispose of the financial arrangement, it will not result in double taxation of the difference between the market price and the actual consideration paid.

Officials consider that this policy intent is achieved by the proposed new sections EH 16(5) and EH 49(2A), which provide that where the market price of a financial arrangement is treated as being the consideration on sale, this applies for both seller and purchaser or transferor and transferee.

The submission acknowledges these provisions but is concerned that the operative sections EH 16(3) and EH 49(1) refer only to a financial arrangement that is sold or transferred and realised. The sections do not make it clear that they also apply to the party acquiring the financial arrangement.

Officials consider that the policy intent can be made clearer by adding a reference in the proposed sections EH 16(3) and EH 49(1) to the purchase of the financial arrangement by the transferee.

Recommendation

That the submission be accepted.

FOREIGN TAX CREDITS

Issue: Prevention of abuse of foreign tax credit rules

Submission
(3 – Michael Scott)

The proposed amendments to deny a credit for foreign tax when, in substance, the tax has not been paid are unnecessary and should not proceed. If, however, they do proceed, their application date should be retrospective.

Comment

The anti-avoidance measures to prevent the abuse of foreign tax credits were first included in the Taxation Reform (Companies and Other Matters) Bill, introduced on 2 June 1994. The tax credit measures were divided from the bill to form the separate Income Tax Amendment Bill 1994. Consideration of the provisions was deferred by the Finance and Expenditure Committee until the Commission of Inquiry into Certain Matters Relating to Taxation (commonly referred to as the "wine-box inquiry") had reported. The bill remains under consideration.

The original provisions have been redrafted and included in the current bill. In the 1994 bill, the amendments were to apply from 2 June 1994. Under the current bill, they will apply only from 5 April 2000, the date they were announced by the Minister of Revenue. This later application date avoids the need to make complicated retrospective amendments to the now repealed Income Tax Act 1976.

The bill proposes that a foreign tax credit be denied when a corresponding benefit is provided to a taxpayer or associate and requires disclosure of this. It also proposes for countries for which no tax credits are allowed to be determined by Order in Council rather than amending legislation.

The bill also puts beyond doubt that a tax avoidance arrangement involving foreign tax credits is void under the general anti-avoidance provisions and can be reconstructed under the Income Tax Act.

The submission suggests that amendments to deny a credit for foreign tax are unnecessary.

Although, as noted in the Commentary to the bill, it was always the Government's view that current anti-avoidance provisions would apply to tax avoidance schemes, the bill goes beyond this. The amendments are modelled on provisions in the United States Tax Code that the United States considered necessary to reverse the result of a number of United States court decisions. Such legislation also seems desirable for New Zealand.

This issue of whether a tax avoidance arrangement involving foreign tax credits is void and can be reconstructed under the Income Tax Act has not been determined by our courts. Given this, it seems useful that the amendments proceed to ensure there is no ambiguity in the application of the Act. Progressing the amendments is also consistent with the recommendations of the Commission of Inquiry that it remains desirable for the foreign tax credit anti-avoidance measures to be enacted.

The submission suggests that if the amendments to deny a foreign tax credit do proceed, they should still apply retrospectively, rather than from 5 April 2000 as currently provided in the bill. The submitter's concern is that non-retrospectivity may prejudice the Commissioner's ability to apply the existing anti-avoidance provisions to any tax credit abuse pre-dating the application date of the amendment.

Officials do not consider this would be the case. The Privy Council in *CIR v Databank Systems Limited* (1990) 12 NZTC 7,227 has held that a subsequent amendment to a provision being interpreted by the court cannot be used as an argument in interpreting the provision before its amendment.

Officials are not aware of any transaction that would be covered by retrospective legislation, but cannot guarantee that this is the case.

Recommendation

That the submission be declined.

Issue: Drafting issues in rules to prevent abuse of foreign tax credit

Submission
(12 – ICANZ)

A number of minor drafting amendments are proposed to the rules to prevent the abuse of foreign tax credits:

Comment

The submission contains seven pages of suggested minor drafting changes.

The submission suggests that section LC 3(1)(a)(i) should state the sections under which a foreign tax credit arises, consistent with the reference to the section under which the amount of dividend withholding payment on a foreign dividend is calculated. Officials agree with this submission.

The submission also suggests that, in a couple of places in section LC 1, commas be replaced with parentheses to aid readability. Officials note that the use of parentheses is determined by drafting style – they are used to enclose explanations and digressions, not to enhance readability. On review, however, officials agree that parentheses could be used in section LC 1(3A), as suggested in the submission, but not in section LC 1(3B).

A number of suggestions were made that are inconsistent with the current drafting style for tax bills:

- Clarification is needed that "this section" in section GB 1(2A) refers to section GB 1, and not to another section referred to in the subsection.
- The words "credit of tax" should be included in quote marks in section GB 1(2B), as it is a defined term.
- In section LC 13(2), "their" should be changed to "the taxpayer's".
- In section LC 3(1), references to "that subsection" should be changed to "section LC 1(3A)" for clarity.
- In section LC 3, it should be made explicit that:
  - Subsection (2) is subject to subsection (3) and applies to amounts calculated under subsection (1); and
  - Subsection (3) does not apply to itself.
- In section LC 1A(2), "31 December in the year following" should be changed to "31 December of the subsequent year". Similarly "following year" should be changed to "that subsequent year".
- In section LC 1A(3), a cross-reference should be added to state that the Order in Council referred to is "made under subsection (1)(a).

The submission also suggested that there were a number of places where technical amendment is required to make the legislation operate correctly. Officials consider, however, that the legislation does operate correctly, and that changes are not necessary. A brief summary of the submission's points, and officials' views, are set out below.

1. References in the amendments to section LC 4 should also refer to section LC 5, as the rules for group companies complement the ordinary rules for controlled foreign company tax credits.

   Section LC 5 can only apply to the extent that a credit arises under section LC 4. If a credit is denied under section LC 4, as the amendment effects, section LC 5 will have no relevance, hence an additional cross-reference would be unnecessary.

2. Section LC 1(3A) requires clarification that a credit for foreign tax will be denied only to the extent it is effectively refunded.

   The subsection already has this effect. It reads, "if ***and to the extent that*** a taxpayer … pays foreign tax, and the taxpayer … receives a refund, … the taxpayer is not allowed a credit for income tax paid in a country or territory outside New Zealand against income tax payable in New Zealand" (emphasis added).

3. References in the amendments to section LC 1(3A) should also refer to section LC 1(3B), as they operate in tandem.

Section LC 1(3A) deals with the substantive question of whether a credit for foreign tax should be denied. Section LC 1(3B) deals only with the consequences if section LC 1(3A) applies. Consequently, it is unnecessary to also cross-reference section LC 1(3B) when references to section LC 1(3A) are made.

4. The heading in the new section LC 1A(1) should be in bold face.

There is no heading in a subsection to be bold faced.

Recommendation

That section LC 3(1)(a)(i) be amended to state the sections under which a foreign tax credit arises, and that section LC 1(3A) be amended to replace commas with parentheses as suggested in the submission, but that the remainder of the submission be declined.

Issue: Amendments to the income statement process

Submission 1
(12 – ICANZ)

The amendment should be described as making the return filing period for income statements consistent with other returns by agents.

Comment

The amendment extends the time that tax agents have to return income statements. Such extensions exist for income tax returns prepared by agents.

Once the amendment is enacted, Inland Revenue will explain the measure in its *Tax Information Bulletin*. The proposal can be described in the manner suggested in that publication. The description to which the submission objects does not appear in the bill, but in the commentary on the bill.

Recommendation

That the submission be declined.

Submission 2
(12 – ICANZ)

The term "income statement" should be defined in section OB 1 of the Income Tax Act 1994 and the term "personal tax summary" should be defined in the same section as having the same meaning as "income statement".

Comment

Income statements are provided to taxpayers to confirm the amount of income earned and the amount of tax paid in respect of that income. "Income statement" is defined in the Tax Administration Act 1994 for the purposes of that act.

Although in practice the income statement is referred to as a personal tax summary, it retains its original title in the legislation, and the term "personal tax summary" is not used. ICANZ points out that having two names for this document causes confusion.

Officials consider that it would be inappropriate to define a term that is not used in the legislation. The issue identified in the submission would be better addressed by replacing every incidence of the term "income statement" with the term "personal tax summary". However, given that "income statement" is used frequently in the legislation, this would necessitate a large number of legislative amendments and would, therefore, be more appropriately undertaken as part of a post-implementation review once the reforms have been fully implemented.

The term "income statement" is used in the Income Tax Act, and officials agree that "income statement" should be defined in that act.

Recommendation

That:

- an amendment be made to define "income statement" in section OB 1 of the Income Tax Act 1994;
- the submission that the definition of "income statement" include a reference to the term "personal tax summary" be declined; and
- officials be asked to consider this matter as part of the post-implementation review of the tax simplification reforms for wage and salary earners.

Submission 3
(12 – ICANZ)

ICANZ agrees with the proposal and suggests that the legislation could be drafted in a simpler manner.

Comment

The submission supports the proposal and suggests that the concept of terminal tax date be used in the new subsections of section 80H to draft them more simply.

It would not be a simplification to use the phrase "terminal tax date" because that date does not apply to wage and salary earners, who instead have a due date for the payment of tax. However, it is possible to make a number of minor drafting changes that would render the provision easier to read.

Recommendation

That the submission be accepted and that minor drafting amendments be made to clauses 50, 51, 53 and 54 to simplify their construction.

Issue: Increasing the flexibility of the rebate claim process

Submission
(Matter raised by officials)

An amendment should be made to allow rebates for childcare and housekeeper expenses or donations to be claimed late in specified circumstances.

Comment

A new process to claim rebates for donations and payments for housekeeping or childcare expenditure was introduced as part of the reforms that removed the need to for wage and salary taxpayers to file income tax returns. Under the new process, taxpayers with standard or early balance dates must claim their rebates between 1 April and 30 September after the end of the income year in which the donation or payment was made.

The bill contains an amendment to section 41A of the Tax Administration Act 1994 that allows rebates to be claimed early in circumstances where it would cause difficulties to delay making a claim until the claim period begins.

Some taxpayers will face similar difficulties in meeting the deadline for claiming their rebate. Such circumstances include being out of the country during the period in which rebates should be claimed. The suggested amendment ensures that these taxpayers will not be disadvantaged and increases the flexibility of the new rebate claim process. To ensure consistency with other provisions that support that process, this change should apply from the implementation of that new procedure, 1 April 2000.

Recommendation

That the submission be accepted.

Submission
(Matter raised by officials)

An amendment should be made so that the provisions that require taxpayers to provide Inland Revenue with receipts evidencing that donations do not apply to rebate claims made by tax agents on behalf of their clients.

Comment

The law requires anyone claiming a rebate for a donation to provide receipt evidence of the payment to Inland Revenue. This also applies to tax agents who claim rebates on behalf of their clients.

Officials consider that exempting tax agents from this requirement would reduce the compliance costs. In order to prevent false claims, agents would, however, be required to sight the receipts before a claim is made, and the receipts would need to be retained by taxpayers for audit purposes.

To ensure consistency with the new rebate claim process, this change should apply from 1 April 2000, when the process was implemented.

Recommendation

That the submission be accepted.

Submission
(12 – ICANZ)

The deadline for claiming rebates should be extended to 31 March following the end of the income year to which the rebate relates.

Comment

ICANZ made the same submission last year to the Finance and Expenditure Committee as part of the committee's deliberations over the Taxation (Simplification and Other Remedial Matters) Bill.

Officials consider that, except in special cases, six months should be adequate to claim a rebate, given the simplicity of the new process. Difficulties caused by special circumstances are best addressed by allowing exceptions to the deadline, rather than extending the deadline in all cases. Officials also consider that extending the deadline to claim rebates to 31 March following the end of the year to which the rebate relates has the potential to reduce some of the benefits of the new process by separating it from the process of preparing income tax returns.

ICANZ has also expressed concern that Inland Revenue staff have stated that taxpayers will be able to claim rebates immediately after they incur the expenditure or make the donation. Such a statement would be completely contradictory to all statements of government policy and publicity material from Inland Revenue about the new rebate claim process. Officials also consider that any confusion the statements may have caused about the earliest time in which rebates can be claimed would not be addressed by extending the deadline for claiming them.

Recommendation

That the submission be declined.

Issue: Income statements and student loan borrowers

Submission
(Matter raised by officials)

The criteria for issuing income statements should be amended to reflect that student loan borrowers who are eligible to receive base interest write-offs should be issued with an income statement.

Comment

Section 33A of the Tax Administration Act 1994 states that all student loan borrowers who earn less than the student loan repayment threshold are to receive an income statement. This is an attempt to ensure that all those who are eligible for a base interest write-off have their tax affairs squared-up so that they can receive their write-off. However, officials recognise that some borrowers who earn less than the

threshold are not eligible for a base interest write-off and, therefore, do not require a square-up of their tax affairs. Officials also note that a small number of taxpayers who earn over the threshold may be eligible for a partial base interest write-off but are not currently required to receive an income statement. Likewise, borrowers who pay off their loan during an income year and have a nil balance at the year end may also be eligible for a base interest write-off.

Therefore officials consider that section 33A(1) should be amended to specify those borrowers who require a square-up in order to receive a full or partial base interest write-off. To ensure consistency in the legislation, this amendment should apply from the date of application of the tax simplification initiatives, the 1999-2000 income year.

Recommendation

That an amendment be made to section 33A of the Tax Administration Act 1994 so that student loan borrowers who meet all other non-filing criteria are not required to receive an income statement unless they are eligible for a base interest write-off.

Issue: Income statements for casual agricultural employees

Submission
(Matter raised by officials)

A reference to the casual agricultural employee, CAE, tax code should be added to the provisions that determine which taxpayers are to be issued with an income statement.

Comment

As part of the simplification initiatives, a new tax code for casual agricultural employees was created. This tax code replaced the shearing shed hand (SSH), casual agricultural worker (CAW) and shearer (SHR) tax codes and has a rate of 21%.

It was intended that taxpayers who use this code in certain circumstances should receive an income statement. For example, if a taxpayer earns over $38,000 in an income year and uses the CAE code the taxpayer should receive an income statement to ensure that the correct amount of tax has been deducted.

Because of a drafting omission this code was not referred to in section 33A(1) of the Tax Administration Act 1994. To correct this omission officials consider that a reference to the CAE tax code should be added to the Tax Administration Act 1994 so that taxpayers who earn over $200 of income using the CAE code are issued with an income statement.

Recommendation

That an amendment to section 33A of the Tax Administration Act 1994 be made to include a reference to the CAE tax code, and that the amendment apply from 1 April 1999, to be consistent with the introduction of the simplification legislation.

RWT ON INTEREST PAID BY INLAND REVENUE

Submission
(12 – ICANZ)

The legislation should be amended so that Inland Revenue is not required to deduct resident withholding (RWT) tax on interest paid by it.

Should the first suggestion not be accepted, ICANZ supports the proposal.

Comment

Officials do not consider that exempting Inland Revenue in this way from deducting RWT would solve the underlying concern in the submission about the inherent complexity of administering use-of-money interest. As the submission points out, Inland Revenue makes a large number of interest payments and consequential adjustments on those payments, and frequently these are retrospective adjustments. The complexities arise from the need to determine accurately the amount of interest income earned. Therefore that complexity would not diminish unless Inland Revenue were also exempt from providing taxpayers with information about the interest they have earned. The effort required to deduct RWT is relatively minor once interest income has been quantified.

The simplification reforms that removed the need for wage and salary earners to file income tax returns rely on the application of the RWT rules by those who pay interest. Exempting Inland Revenue from the rules would create a group of taxpayers who do not pay the correct amount of tax on their interest as they earn it. As well as creating an inequity between different sources of interest, this would also create an obligation for some taxpayers to complete and return income tax returns where they would otherwise not have been required to do so.

Inland Revenue has allocated significant resources to modify its systems so that the RWT rules are applied correctly.

Recommendation

That the recommendation be declined.

Issue: Application of the RWT rules

Submission
(Matter raised by officials)

The proposed amendment to the RWT rules can be improved by changing the wording.

Comment

In general, when a taxpayer overpays an amount of tax, that taxpayer is eligible to receive use-of-money interest. According to the RWT rules, payments of use-of-money interest must have RWT deducted. If the amount of overpaid tax is recalculated, the amount of interest the taxpayer is to receive and the amount of RWT to be deducted must be recalculated.

The proposed amendment attempts to clarify the process that Inland Revenue should follow when recalculating RWT to be deducted from updated payments of interest. Officials consider that this amendment can be improved by making a minor change to the wording and inserting an explicit reference to RWT that is to be deducted.

Recommendation

That a change be made to the proposed amendment to clarify how the RWT rules apply if interest paid to a taxpayer relates to an amount of overpaid tax that has been recalculated.

INCOME TAX RATES

Submission
(12 – ICANZ)

The submission raises concerns about the compliance costs and administrative costs of the implementation of policy proposals to support or buttress the increase in the top personal tax rate to 39%.

Comment

The Government's revenue strategy, as announced in this year's Budget, is "to generate the Government's revenue requirements at least possible economic cost, whilst supporting the Government's equity objectives."

The increase in the top personal tax rate was to generate additional revenue to meet the Government's social policy commitments. The Government is aware that the policy proposals to support the tax rate increase have compliance and administrative costs and has been mindful that these costs should be kept to a minimum.

INCREMENTAL PENALTY FOR LATE PAYMENT OF TAX

Issue: Application date

Submission
(12 – ICANZ)

The application date should be brought forward to apply to tax payments due on or after 1 April 2001.

Comment

The proposal, as currently drafted, will apply from 1 April 2001. This means that payments that are due after this date but have not been made within a month of the due date will incur the reduced penalty. For example, if terminal tax that is due on 7 April 2001 has not been paid by 7 May 2001, the incremental penalty will be applied at 1% rather than 2% of the outstanding amount.

Officials have discussed the submission with ICANZ, which agrees that no change is required to the proposed provision.

Recommendation

That the submission be declined.

Submission
(Matter raised by officials)

If the incremental late payment penalty is applied after 1 April 2001, it should apply at the rate of 1% per month of the outstanding tax.

Comment

The proposal, as currently drafted, precludes reducing the penalty in relation to tax that is due before 1 April 2001. Failure to pay that tax liability would continue to incur a 2% penalty each month of the outstanding amount, whereas the failure to pay a tax liability that arises after 1 April 2001 would be penalised at 1% each month of the outstanding amount.

This outcome is contrary to the policy intent of the proposal, which is to reduce the level of the incremental late payment penalty for debt outstanding after 1 April 2001.

Recommendation

That the recommendation be accepted.

Issue: Cancellation of incremental penalties where instalment arrangements are being met

Submission
(12 – ICANZ)

Section 183B of the Tax Administration Act 1994 should be replaced to provide remission of incremental penalties each month as taxpayers comply with their instalment arrangements.

Comment

The *Less Taxing Tax* discussion document proposed to cancel incremental late payment penalties each month that taxpayers complied with the terms of their instalment arrangements. This proposal had not been developed sufficiently to be included in the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill. Its implementation raises a number of significant administrative issues. Until those issues have been resolved the proposal cannot be introduced into legislation.

Recommendation

That the submission be declined.

GRACE PERIOD FROM USE-OF-MONEY INTEREST

Submission
(12 – ICANZ)

The application date should be brought forward to apply to statements issued on or after 1 April 2001.

Comment

The proposal, as currently drafted, will apply from 1 April 2001. This means that debts specified in statements of account issued after 1 April 2001 will not attract any further interest if they are paid within thirty days of the statement being issued.

Officials have discussed the submission with ICANZ, which agrees that no change is required to the proposed provision.

Recommendation

That the submission be declined.

SERIOUS HARDSHIP AND FINANCIAL DIFFICULTY

Issue: Date of effect

Submission
(12 – ICANZ)

The proposal is strongly supported, but it should be immediately effective.

Comment

The proposal to extend the relief provisions to all tax types applies to tax liabilities that arise on or after 1 April 2001. In order to bring the implementation date forward for this proposal, it would be necessary to reprioritise Inland Revenue's existing commitments to implement other proposals considered more urgent, such as the changes for student loan borrowers and the Government's operational priorities for the department. It is, however, feasible to increase the scope of tax payments eligible for relief by applying the amendment to applications for relief made after 1 April 2001. This would mean that applications for relief could be made in relation to tax payments that are due before 1 April 2001.

Recommendation

That the submission be declined and instead an amendment be made so that the proposal applies to applications for relief that are made on or after 1 April 2001.

Issue: Applications in writing

Submission
(Matter raised by officials)

Applications for relief by way of remission in cases of financial difficulty should continue to be in writing.

Comment

The bill proposes a new section 177 of the Tax Administration Act 1994. The current formulation of section 177 requires applications for relief in the form of remission to be in writing. That requirement was inadvertently omitted when the new section 177 was drafted, and a new provision is required to reinstate the requirement that applications for relief in the form of remission be in writing.

Recommendation

That the submission be accepted.

Issue: Applications in writing – date of effect

Submission
(Matter raised by officials)

The proposed provision removing the requirement for applications to pay overdue tax by instalments to be in writing should apply from the date of enactment.

Comment

If enacted in its current form, this provision will apply for the 2000-2001 income year. The provision is intended to apply from the date of enactment. As currently drafted, the proposed provision will create an unintended retrospective application.

Recommendation

That the submission be accepted.

ALIGNMENT OF PAYMENT DATES

Submission
(4 – Retail Merchants Association of New Zealand Inc)

Tax payment dates should be aligned with normal commercial payment practices to the 20th of each month.

Comment

Less Taxing Tax discussed aligning payment dates. The 20th of the month was one of the suggestions for alignment. The response to the proposal was mixed. The proposal was not included in the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill because it requires further development if it is to serve as a simplification measure.

Recommendation

That the submission be declined.

Remedial amendments

FINANCIAL ARRANGEMENT TERMINOLOGY

Submission
(12 – ICANZ)

Clause 14 should be struck out and the underlying section EH 18 should be repealed. The provisions of the Income Tax Act 1994 which were amended to reflect the change in terminology in the accrual rules brought about by the Taxation (Accrual Rules and Other Remedial Matters) Act 1999 should be made readily accessible to the taxpayer, rather than requiring the taxpayer to refer to repealed legislation.

Comment

With the enactment of the Taxation (Accrual Rules and Other Remedial Matters) Act 1999, it was intended that the other provisions of the Act which were amended to reflect the change in terminology in the accrual rules would continue to apply to Division 1 financial arrangements as they were immediately before the enactment of the 1999 Act.

There are two ways in which this can be achieved. One is to include a provision like section EH 18, to provide that the provisions continue to apply to Division 1 financial arrangements as if the 1999 Act had not been enacted. The other is to include in the legislation the provision as it applied to Division 1 and as it applied to Division 2. For example, section CE 1(1)(c) would provide:

> "(c) For the purposes of Division 1 financial arrangements, income derived under the *qualified accruals rules.*
>
> For the purposes of Division 2 financial arrangements, income derived under the *accrual rules*."

The Act adopts the first approach. Whilst the first option does require a taxpayer with a Division 1 financial arrangement to refer to the legislation as it was immediately before the 1999 Act, officials consider this is to be preferred to the second option, which makes the legislation significantly longer and more cumbersome. A further disadvantage of the second option is the difficulty of knowing when the provisions in relation to Division 1 can be repealed.

The issue will be considered as part of the rewrite bill (due for introduction in 2001), which will include the accrual rules.

Officials acknowledge, however, that there is a problem where the previous provision refers to a section which no longer exists. For example, the former section FF 2 refers to a provision which is no longer contained in section EH 9(c) but, rather, is now in section EH 11(c).

Consequently, officials consider that the proposed new section EH 18 should be amended to ensure that both the provisions and the sections referred to in those provisions are applied as they were before the enactment of the Taxation (Accrual Rules and Other Remedial Matters) Act 1999.

Recommendation

That the submission be declined. However, the proposed new section EH 18 should be amended to provide that in relation to financial arrangements subject to Division 1, provisions in other parts of the Act, and sections referred to in those provisions, must be applied as they were before the enactment of the Taxation (Accrual Rules and Other Remedial Matters) Act 1999.

FOREIGN INVESTOR TAX CREDIT RULES

Submission
(19W – New Zealand Law Society)

Although the Law Society does not normally support retrospective legislation, it does support this amendment, which is to the benefit of those affected and corrects an unintended consequence of an earlier amendment.

Comment

The amendment rectifies an inadvertent outcome of a 1998 amendment. It clarifies that section LE 3 can apply to a holding company that is a member of a consolidated group, but not in the case of dividends received by an LE 3 holding company from a member of the same consolidated group. The amendment is to be retrospective to the date of the 1998 amendment.

Recommendation

That the submission be accepted.

DEFINITION OF "TAX"

Submission
(12 – ICANZ)

1. The proposed change is strongly supported.

2. The Committee should review the Commissioner's approach to the application of section 6A to determine the appropriateness of that approach.

3. IRD should be encouraged to apply an appropriate "care and management" approach to interpreting tax law (with specific reference to section 6A), particularly where the underlying legislation is impractical or unworkable and it takes too long to achieve necessary changes.

Comment

ICANZ made a similar submission to the Finance and Expenditure Committee's *Inquiry into the Powers and Operations of the Inland Revenue Department.*

The Government agreed in response to the Committee's recommendations that the Commissioner should exercise discretion on a case by case basis within the care and management provisions. The Committee did note in its report that it did not consider it necessary to amend the Tax Administration Act 1994 to deal with the issue.

Work is continuing on the development of a standard practice statement for the interpretation of section 6A of the Tax Administration Act 1994 as a result of feedback received on the draft policy statements issued in October last year. ICANZ has been involved in the development and currently has the latest draft for consideration.

The proposed amendment is to ensure that the definition of tax for the purposes of section 6A reflects the original policy intent. Its purpose is not to clarify the intention or application of section 6A.

Recommendation

That parts two and three of the submission be declined.

PROVISIONAL TAX FOR THOSE CHANGING BALANCE DATES

Issue: Provisional tax due dates and taxpayers commencing business

Submission
(14 – PriceWaterhouseCoopers)

The proposed amendment to Schedule 13 of the Income Tax Act 1994 should be changed so that taxpayers with a preceding income year are not liable for provisional tax before they commence business.

Comment

The proposed amendment to Schedule 13 is designed to ensure that taxpayers who commence business in a transitional year (that is, a year in which they change their balance date) are not liable for instalments of provisional tax before they commence business. However, the proposed amendment would not provide for taxpayers who commence business during a transitional year and have a preceding income year, such as wage and salary earners.

Officials agree with this submission and consider that the proposed amendment should be changed so that taxpayers who have a preceding income year but are not provisional taxpayers are not liable to pay provisional tax before they commence business.

Recommendation

That the submission be accepted.

Issue: Provisional tax due dates and new provisional taxpayers

Submission
(14 – PriceWaterhouseCoopers)

The proposed amendments to section 120K(3) of the Tax Administration Act (TAA) 1994 should be changed to take into account that:

- Both natural and non-natural provisional taxpayers should not be liable for provisional tax payments, and therefore should not be charged use-of-money interest, for any provision tax due dates that were before the taxpayer began business.
- In redrafting this section care is taken not to exclude non-natural taxpayers whose residual income tax is less than $30,000.
- This section should not apply in a transitional year.

Comment

Section 120K(3) sets out certain taxpayers' income tax liability for use-of-money interest purposes. The proposed amendment to this section is intended to ensure that this section applies to both natural and non-natural persons. However, as currently drafted, the amendment would not ensure that this section applies to natural persons. Officials agree that this section should apply to both natural and non-natural persons, including non-natural persons whose residual income tax does not exceed $30,000. Therefore officials agree that this proposed amendment should be redrafted to apply to these taxpayers.

As indicated in the submission, section 120K(4A) is designed to apply to taxpayers who are in a transitional year, whereas section 120K(3) is intended to relate to taxpayers who are not in a transitional year. Officials agree, therefore, with this submission and recommend that the words "other than in a transitional year" be added to this proposed amendment.

Recommendation

That the submission be accepted.

Issue: Provisional tax instalment dates and transitional income years

Submission
(14 – PriceWaterhouseCoopers)

The following changes should be made to the proposed amendment to section 120K(4A), which relates to the application of use-of-money interest to taxpayers in a transitional year:

- The singular reference to instalment date should be changed to reflect the fact that taxpayers in a transitional year may have a number of instalment dates; and
- The transitional year provision, section 120K(4A), should apply to both new provisional taxpayers and existing provisional taxpayers; and
- An explicit reference is made to the fact that use-of-money interest will not be applied to an instalment date that occurs within 30 days of that taxpayer's first day of business.

Comment

This submission suggests that the reference to a single instalment date in the proposed amendment to section 120K(4A)(a) could be interpreted as implying that all income tax is due on one date for use-of-money interest purposes. This is not the case. Officials agree that including a reference to "instalment date or dates" will avoid any potential uncertainty.

The existing section 120K(4A) applies to all provisional taxpayers in a transitional year and does not expressly allow for new provisional taxpayers who commence business part way through that year. To resolve this issue, a reference to new provisional taxpayers was included. However, a reference to existing taxpayers was omitted. Officials agree with the submission that this section should apply to both new provisional taxpayers and existing provisional taxpayers.

The proposed new section 120K(4A) sets out the due dates for provisional tax instalments for use-of-money interest purposes. The submission raises an issue of whether sections MB 5A and MB 4 would apply to this provision. The submission argues that if these sections did not apply, use-of-money interest could potentially be applied to an instalment date even though no provisional tax was due on that date. Officials consider that to remove all possible doubt as to the application of use-of-money interest the suggested amendment to section 120K(4A) be redrafted to make it explicit that no interest is be applied to instalment dates for which no provisional is payable.

Recommendation

That the submission be accepted.

Issue: Instalments of provisional tax for use-of-money interest purposes

Submission
(14 – PriceWaterhouseCoopers)

The term "income tax liability" used in section 120K of the TAA to calculate a taxpayer's provisional tax instalment for use-of-money interest purposes should be defined to allow for credits of tax.

Comment

To calculate the amount of provisional tax due on each instalment date, a taxpayer's income tax liability for the year is spread over the provisional tax instalment dates. Use-of-money interest is then applied to any unpaid or overpaid tax. Before the enactment of the Taxation (Core Provisions) Act 1996 the use-of-money interest rules applied to "income tax payable". This was defined as a person's residual income tax liability, that is, their income tax liability less credits for tax already paid.

The Taxation (Core Provisions) Act 1996 repealed the term "income tax payable" and replaced it with "income tax liability". However, income tax liability is not defined in the TAA, but is defined in the Income Tax Act 1994 as the product of the applicable tax rate and a taxpayer's taxable income, before the application of tax credits. That this definition apply to section 120K of the TAA was not intended. Therefore officials consider that an amendment should be made to ensure that "income tax liability" is correctly defined for the purposes of section 120K of the TAA to include credits for tax already paid.

Recommendation

That the submission be accepted.

Issue: Late payment penalties for provisional tax

Submission
(12 – ICANZ, 14 – PriceWaterhouseCoopers)

The proposed amendment to section 139C(2) be changed to take into account:

- Provisional tax payable should be the lesser of the provisional tax the taxpayer was obliged to pay under section MB 5 or section MB 5A and the taxpayer's actual residual income tax apportioned to each instalment date on and appropriate basis.
- The appropriate basis of apportionment of each instalment should be consistent with the rules in sections MB 5 and MB 5A.
- New provisional taxpayers have no provisional tax payable on some instalments.

Comment

Officials agree with these submissions that for the purposes of the late payment penalty the provisional tax payable should be the lesser of the amount calculated under section MB 5 or MB 5A and the taxpayers actual residual income tax apportioned on an appropriate basis. The proposed amendment does not allow for this, and therefore officials consider that changes of the nature suggested in submissions should be made. These changes would ensure that taxpayers could not be potentially liable for a late payment penalty in the event they adhered to the provisional tax rules in section MB 5 or MB 5A and their actual tax liability is larger than the amounts estimated under these sections.

Officials also agree that the proposed amendment is not consistent with the basis of apportionment used in sections MB 5 and MB 5A. Officials consider that a change to the proposed amendment is necessary to rectify this.

A further issue raised by submissions is that, as currently worded, it is not clear that for the purposes of the late payment penalty no provisional tax is due on an instalment date if that instalment date if within 30 days of the taxpayer's first day of business. Officials agree that a change is required to clarify that no penalty should be applied in this situation.

Recommendation

That the submissions be accepted.

Issue: Provisional tax instalments using the uplift method

Submission
(14 – PriceWaterhouseCoopers)

The proposed amendment to the definition of "p" for the formulae used in section MB 5A needs to be changed to account for the enactment of sections MB 2AA and MB 2AB.

Comment

The definition of "p" for the formulae for calculating provisional tax instalments in transitional years has been redefined in order to clarify that "p" does not necessarily represent the amount of provisional tax payable in a transitional year. However, the proposed new definition of "p" does not take into account the fact that because of the new top marginal tax rate, transitional year rules are required for the 1999-2000 and 2000-2001 income years.

Officials agree with the submission that the definition of "p" should relate to section MB 1A. This section indicates the appropriate provisions in the provisional tax rules that apply for each income year.

Recommendation

That the submission be accepted.

Issue: Definition of "provisional taxpayer"

Submission
(12 – ICANZ)

The change to the definition of "provisional taxpayer" should be made retrospective.

Comment

The definition of "provisional taxpayer" in section OB 1 of the Income Tax Act 1994 is being amended to exclude taxpayers from the application of the provisional tax rules. The submission supports this change but questions why this amendment is not effective from the last date at which the provisional tax rules were changed.

Officials consider that there is no benefit to making this amendment retrospective and that doing so would create unnecessary uncertainty for taxpayers as to the meaning of this term in the retrospective period.

Recommendation

That the submission be declined.

Issue: Use of the term "provisional tax payable"

Submission
(Matter raised by officials)

A consequential amendment relating to the use of a definition for "p" in section MB 5A is required.

Comment

Officials have identified that the reference to "provisional tax payable" in section MB 5A(8) relies on the existing definition of "p" in the formulae used in sections MB 5A(5), (6), and (7). To ensure consistency in the legislation, officials consider that section MB 5A(8) should instead refer to the amount of tax payable according to the appropriate provision.

Recommendation

That an amendment be made to section MB 5A(8) so that it refers to the appropriate provisional tax calculation and not provisional tax payable.

MINOR REMEDIAL AMENDMENTS

Issue: Amendment to section 90 of the Tax Administration Act 1994

Submission
(Matter raised by officials)

Section 90 should be amended to correct cross-references to section EH 1.

Comment

Section 90 of the Tax Administration Act 1994 contains incorrect cross-references to section EH 1. Section 90(1)(c), 90(1)(d) and the proviso to subsection (1) refer to section EH 1(5). The reference should be to section EH 1(6). Paragraphs (e) and (f) refer to section EH 1(6) and EH 1(7) respectively. These references should be to section EH 1(7) and EH 1(8).

Officials consider that the cross-references should be corrected with effect from 20 May 1999, the date from which they became incorrect.

Recommendation

That the submission be accepted.

Issue: Amendment to section 124A(3) of the Tax Administration Act 1994

Submission
(Matter raised by officials)

Section 124A(3) should be amended to correctly refer to Part III of the Income Tax Act 1976.

Comment

Section 124A(3) of the Tax Administration Act 1994 incorrectly refers to Part IIIA of the Income Tax Act 1994. The reference should be to Part III.

Officials consider that the correction should apply from 20 May 1999, the date from which section 124A(3) was effective.

Recommendation

That section 124A(3) be corrected to refer to Part III of the Income Tax Act 1976 from 20 May 1999.

Issue: Amendment to Income Tax Act 1994

Submission
(Matter raised by officials)

The definition of "expenditure on account of an employee" should be amended to correctly refer to a close company.

Comment

In section OB 1, paragraph (b) of the definition of "expenditure on account of an employee" incorrectly refers to a "proprietary company". This definition was repealed in 1994 and replaced by the definition of "close company". Officials consider that the reference should be corrected with effect from the 1995-96 income year, the time from when the reference became incorrect.

Recommendation

That the definition of "expenditure on account of any employee" be amended to correctly refer to a close company from the 1995-96 income year.