

Taxation (Relief, Refunds and Miscellaneous Provisions) Bill

Commentary on the Bill

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Taxpayer financial relief

NEW RULES ON TAXPAYER FINANCIAL RELIEF

(Clauses 61(2), (3), (6), (7), (8), (10), 73, 74, 76, 78 and 79)

Summary of proposed amendments

Amendments to the Tax Administration Act 1994 will give effect to the tax debt and taxpayer hardship proposals outlined in the Government discussion document *Taxpayer compliance, standards and penalties: a review*, released in August 2001. They aim to correct deficiencies in the current legislation and to provide guidance to both Inland Revenue and taxpayers as to the appropriate treatment of a person in debt.

The effectiveness of these proposals relies on, and encourages, taxpayers to contact Inland Revenue with their debt problems as early as possible. The rules provide Inland Revenue with considerable flexibility. The outcome of early discussion is more likely to be positive, with reduced stress and cost for taxpayers.

Application date

The proposed amendments will apply to tax that is outstanding as at 1 July 2002 unless that tax is subject to an instalment arrangement entered into before 1 July 2002, or the Commissioner of Inland Revenue has advised the taxpayer that the outstanding tax has been written off. The proposals will apply to all taxes, and will not apply to child support and student loans.

Key features

The current debt and hardship provisions in sections 176 and 177 will be rewritten:

- to provide that Inland Revenue's role is to maximise the recovery of outstanding tax but not if:
 - recovery represents an inefficient use of Inland Revenue's resources; or
 - a taxpayer is placed in serious hardship;
- to provide that if Inland Revenue can collect more of the debt over time through an instalment arrangement than from bankruptcy or liquidation, Inland Revenue would be required to enter the instalment arrangement and any amount not recovered will be written off as unrecoverable;
- to provide that amounts not recovered will be written off permanently, and generally cannot be reinstated;
- to include fairer instalment arrangements, including provision that late payment penalties will stop when taxpayers contact Inland Revenue stating they want to negotiate payment of the debt;
- to clarify the application of the rules, the definition of "serious hardship" lists both circumstances which meet that test and circumstances which do not.

Background

The current debt and hardship rules in the Tax Administration Act date back to the 1930s. They were designed for asset-rich but cashflow-poor taxpayers of the Depression era, and were not reviewed as part of the introduction of the current compliance and penalty legislation. As a consequence, no significant consideration of their purpose or consequences was undertaken until the Finance and Expenditure Committee's 1999 Inquiry into the Powers and Operations of the Inland Revenue Department.

The current rules are significantly deficient. They provide little guidance to either taxpayers or Inland Revenue on the appropriate treatment of a person in debt.

Details of the proposed reforms

The rules outlined in the bill provide a framework for Inland Revenue to consider how best to provide relief for taxpayers in financial difficulties. More prescriptive administrative guidelines will be prepared, providing the necessary balance needed to ensure that taxpayers have their specific circumstances taken into account.

Maximising the amount recovered

Under the proposed section 176(1) Inland Revenue's role will be to maximise the recovery of outstanding tax as this maintains both the equity and efficiency of the tax system.

Under this provision Inland Revenue will be required to adopt the approach which maximises the amount collected. If Inland Revenue can collect more of the debt over time through, for example, an instalment arrangement, than from bankruptcy or liquidation, Inland Revenue will be required to enter an instalment arrangement. Any amount not covered by this instalment arrangement will be written off as unrecoverable.

The specific requirement for Inland Revenue to undertake net present value calculations is being removed. However, in line with Inland Revenue's role to maximise the amount of outstanding tax recovered when the repayment options are very similar, the net present value calculation is still likely to be used in determining which repayment option is preferable.

Recognition of the administrative costs of collection of tax

Recovering overdue taxes uses administrative resources. The new section 176(2)(a) will provide Inland Revenue with a clear discretion allowing for effective use of administrative resources. Debt will be written off if the administrative costs of recovering the debt outweigh the amount collected.

Inland Revenue will determine when this provision will apply. In other words, taxpayers cannot write to Inland Revenue asking that a debt be written off merely because they consider that the administrative costs of collecting the debt are more than the amount that will be collected.

In collecting outstanding tax, Inland Revenue will also consider the effect that requiring payment will have on taxpayers who comply with all of their tax obligations. In some cases requiring payment of an amount that is equivalent to the cost of collection may encourage the taxpayer to pay promptly in future, resulting in Inland Revenue not incurring administrative costs in the future.

Financial relief

Under the new rules a taxpayer can contact Inland Revenue requesting financial relief. There will be two forms of financial relief:

- some or all of the taxpayer's outstanding tax may be written off; and/or
- the taxpayer and Inland Revenue enter an instalment arrangement.

Late payment penalties

Under the new rules, late payment penalties will stop being imposed when a taxpayer contacts Inland Revenue seeking financial relief. If the taxpayer is granted financial relief, late payment penalties will not be imposed. For example, if all the taxpayer's outstanding tax is written off, late payment penalties will not be imposed from the date the taxpayer contacted Inland Revenue to the date the tax is written off.

If the taxpayer and Inland Revenue enter an instalment arrangement, late payment penalties will not be imposed if the taxpayer complies with the arrangement. If the taxpayer defaults on the arrangement, late payment penalties will start applying from the date of default. The late payment penalties previously not imposed either while the instalment arrangement was being negotiated or while the taxpayer was complying with the arrangement will not be reinstated.

For example, a taxpayer contacts Inland Revenue stating that she cannot pay her outstanding tax. Inland Revenue determines that part of the amount outstanding should be written off and the other part of the amount outstanding is payable immediately. The amount payable immediately will be treated like an instalment arrangement, and late payment penalties will not be imposed from the date the taxpayer contacted Inland Revenue. If she then defaults on the amount payable immediately, late payment penalties will apply from the date of the default. The amount written off and the late payment penalties not previously imposed will not be reinstated.

If a taxpayer contacts Inland Revenue saying he wishes to enter an instalment arrangement and an arrangement is not then entered into, the late payment penalties that were not imposed while the taxpayer and Inland Revenue negotiated will then be imposed as if the request to enter the arrangement had not been received.

Recent amendments to the late payment penalty legislation in section 139B mean that from 1 April 2002 if a taxpayer enters an instalment arrangement before the due date for payment of the tax, the second phase of the initial late payment penalty is not imposed. These principles will also apply under the new rules that provide taxpayer financial relief. This provision provides an incentive for taxpayers to contact Inland Revenue before administrative costs are incurred.

Serious hardship

Inland Revenue will be prevented from recovering tax if the recovery places the taxpayer in serious hardship. Recovery of a debt will continue until the point where further recovery would place a taxpayer in serious hardship. This ensures that taxpayers are not seen as being rewarded, or unduly punished, for failure to make payment. Any debt that cannot be recovered will be written off.

Section 177A will define “serious hardship” to include significant financial difficulties that arise because of:

- the taxpayer’s inability to meet minimum living expenses according to normal community standards; or
- the cost of medical treatment for an illness or injury of the taxpayer or the taxpayer’s dependant; or
- a serious illness suffered by the taxpayer or the taxpayer’s dependant; or
- the cost of education for the taxpayer’s dependant.

Serious hardship will not include significant financial difficulties that arise because:

- the taxpayer is obligated to pay tax; or
- the taxpayer may become bankrupt; or
- the taxpayer’s social activities and entertainment may be limited; or
- the taxpayer is unable to afford goods or services that are expensive or of a high quality or standard according to normal community standards.

“Dependant” will be defined to mean within one degree of relationship (for example, husband and wife).

For example, under the provision that provides that serious hardship does not include financial difficulties that arise because the taxpayer is unable to afford goods or services that are expensive or of a high quality or standard according to normal community standards, a taxpayer who sends her children to a private school would instead be required to send them to a public school. Normal community standards in this case do not extend to private schooling of dependants. Similarly, a taxpayer may be required to trade down to a car of a lesser value or rent accommodation rather than owning a house.

Consideration of serious hardship will be generally limited to people. Legal entities, such as companies, cannot suffer hardship. However, the recovery of the full amount of tax from a company may cause serious hardship for a shareholder who owns, or two shareholders who jointly own, 50 percent or more of that company. The legislation will provide Inland Revenue with the discretion to “look through” the company and examine the effect of its actions on such shareholders.

“Write off”

For clarity, the legislation will set out a number of circumstances in which tax may be genuinely written off. Inland Revenue will be able to write off tax that cannot be recovered. This provision will cover cases where:

- the taxpayer is facing serious hardship; and
- the administrative costs of collecting the tax are greater than the amount to be collected.

In addition to those cases in which Inland Revenue considers that the outstanding tax cannot be recovered, it must write off tax that cannot be recovered in the following situations:

- bankruptcy;
- liquidation; or
- confirmation of the distribution of a deceased taxpayer’s estate.

Evasion or abusive tax position

The proposed section 177C(3) will not permit the write-off of tax when the taxpayer is liable for a abusive tax position or evasion shortfall penalty in relation to that tax. This provision is aimed at ensuring that those taxpayers who take such tax positions face the entire consequences of their actions.

Tax losses

As part of the determination of a taxpayer’s assets, Inland Revenue will take into account the tax losses of a taxpayer. If any tax revenue is written off, Inland Revenue will have the authority to extinguish part or all of the taxpayer’s tax losses at the rate of 33% in proportion to the amount written off. For example, if a taxpayer had losses of \$2000 and was facing serious hardship and had \$600 of tax written off, the losses would be reduced by \$1818. Inland Revenue will send the taxpayer a new notice of determination of loss.

Reversal of write-off

Unlike the present practice, when tax is written off under the new legislation it will be permanently written off. However, the legislation will provide for two situations where the amount written off can be reversed. The first, as set out in the discussion document, is when the amount that is written off is based on false or misleading information provided by the taxpayer.

The second situation is when the taxpayer applies to have tax written off on grounds of serious hardship, and within one year of the amount being written off the taxpayer declares bankruptcy. This second situation was raised in submissions on the discussion document *Taxpayer compliance, standards and penalties: a review*. The submissioner was concerned that the taxpayer’s other creditors could encourage the taxpayer to have an amount owing to Inland Revenue written off so that when the

taxpayer subsequently declares bankruptcy the dividend paid to those other creditors was greater. The Government agreed with the concerns expressed in the submission.

Instalment arrangements

The recovery of most debts involves the consideration of serious hardship, the writing off of tax, or the use of Inland Revenue's administrative resources. It also involves taxpayers trying to comply with their tax obligations but facing cashflow problems. One option, an alternative to applying whatever recovery action is considered appropriate, is for the taxpayer and Inland Revenue to enter an instalment arrangement.

The amendments are aimed at providing financial relief for taxpayers facing financial difficulties, including writing off amounts outstanding when they cannot be collected and providing a clearer and more flexible instalment arrangement process which will ensure that taxpayers who are attempting to comply voluntarily can quickly resolve their problems.

Taxpayers who contact Inland Revenue, either in writing or by telephone, will be able to initiate an instalment arrangement by telephone or in writing. On receipt of a request for an instalment arrangement, Inland Revenue will suspend any late payment penalties and recovery action currently under way. Any amount not recovered through an instalment arrangement will be written off as unrecoverable, either because collection would place the taxpayer in serious hardship or because recovery represents an inefficient use of Inland Revenue's resources.

Inland Revenue may overturn an instalment arrangement if the arrangement is based on information provided by the taxpayer which is later found to be misleading or fraudulent. If an arrangement is overturned, late payment penalties will apply as if the instalment arrangement had not been entered.

Reasons for declining an arrangement

Under the proposed section 177B(2) Inland Revenue will have the discretion to decline to enter an instalment arrangement if:

- to do so does not maximise the recovery of outstanding tax from the taxpayer;
- Inland Revenue considers that the taxpayer is in a position to pay all of the outstanding tax immediately;
- the taxpayer is being frivolous or vexatious;
- the purpose of the request for an instalment arrangement is simply to stop recovery action;
- the taxpayer has not complied with a previous instalment arrangement; or
- the taxpayer has previously made a request to enter into an arrangement and the request has been declined.

Inland Revenue must not knowingly place a taxpayer in serious hardship and must use administrative resources efficiently. These requirements will override any instalment arrangement. For example, taxpayers may consider that they can pay back the tax owed, and they may be willing to incur serious hardship to do so. Nevertheless, they should not be required to do so. Another example is where the taxpayer is initially in a position to pay but the taxpayer's financial affairs worsen during an instalment arrangement, to the extent that serious hardship applies. At this point, part of the taxpayer's debt would be written off and the rest would be subject to a new instalment arrangement.

Response periods

The amendments do not specify a time period in which Inland Revenue must respond to a request for an arrangement. If a taxpayer enters an instalment arrangement, late payment penalties will cease applying when the taxpayer contacts Inland Revenue. Ensuring a timely response can best be addressed by establishing appropriate standards as part of Inland Revenue's annual reporting process.

In circumstances where Inland Revenue requests more information or makes a counter-offer, the legislation will provide that the taxpayer should be given ten working days from the date of Inland Revenue's response to provide any financial or other information required by Inland Revenue or consider the counter-offer. If the circumstances warrant, however, Inland Revenue will have the authority to set a longer period.

If the information or response is not provided within the standard ten-day period (or the longer period set by Inland Revenue), late payment penalties will recommence as if no application had been made.

If Inland Revenue and the taxpayer cannot agree as to the terms of an instalment arrangement, late payment penalties and recovery action will recommence as if no application had been made.

If an agreed instalment arrangement involves Inland Revenue writing off part of a taxpayer's outstanding tax and the taxpayer making payment of the remainder, default by the taxpayer in payment will not result in reinstatement of the amount already written off.

Renegotiation of arrangements

The legislation will clearly provide taxpayers with the option to renegotiate an instalment arrangement if their financial situation changes. Under the proposed section 177B(5) a renegotiation will be treated in the same manner as a request for financial relief. If taxpayers' circumstances improve in the intervening period, resulting in them being able to repay the debt more quickly they can contact Inland Revenue and arrange to do so. Use-of-money interest, which compensates the Crown for not having the use of its money, also provides taxpayers with an incentive to repay the debt as quickly as possible. Any amount previously written off will not be reinstated merely because a taxpayer's circumstances change.

If taxpayers' circumstances change, resulting in their not being able to meet the repayment obligations under the instalment arrangement, they should contact Inland Revenue as soon as possible stating that they wish to renegotiate the arrangement. One of the clear criteria, provided by the amendments, for Inland Revenue declining an instalment arrangement is when a previous arrangement has not be adhered to, so any delay in contacting Inland Revenue may result in unfavourable consideration of future instalment arrangement applications.

Inland Revenue will have an option to renegotiate an arrangement only after two years from the date the arrangement is entered.

Transfers of overpaid tax

NEW RULES ON TRANSFERS OF OVERPAID TAX

(Clauses 48(4), 61(4), (5), (7)(a) and 77)

Summary of proposed amendment

Comprehensive new rules governing the transfer of overpaid tax are to be inserted into the Tax Administration Act 1994. Taxpayers may request a transfer to another period or tax type of the taxpayer, or to another taxpayer. The legislation sets out the effective date of transfer, which differs depending on the relationship between the transferor and the transferee.

Currently, there is uncertainty about the rules relating to such transfers, and the proposed new rules should address this.

Application date

Subclause (2) sets out the various application dates for different types of tax. The new provisions apply to:

- excess tax paid in the 2002-2003 and future years;
- excess tax paid in an earlier year if the excess arises on an assessment made after enactment of the legislation;
- refunds in relation to childcare and charitable donations rebates claimed after enactment of the legislation;
- GST on supplies made on or after 1 April 2002;
- tax deducted on behalf of another taxpayer that is paid on or after 1 April 2002; and
- dividend withholding payments and duties paid on or after 1 April 2002.

Key features

New Part XB is being inserted into the Tax Administration Act 1994 to allow Inland Revenue, at the request of a taxpayer, to transfer tax that is overpaid by the taxpayer to another period or type of tax or to another taxpayer.

Sections 173L and 173M set out the effective date of transfer, which differs depending on the relationship between the transferor and transferee.

Section 173L applies to transfers to another period or type of tax of the same taxpayer. When there is a transfer of excess tax that was paid directly to Inland Revenue by the taxpayer (such as provisional tax or tax deducted on behalf of another taxpayer), the date of transfer is any date chosen by the taxpayer that comes after the date of overpayment of the tax. In the case of a transfer of a GST refund or tax deducted at source on behalf of the taxpayer, it is any date after the first day after the end of the taxable period, or income year respectively.

Section 173M applies to transfers to other taxpayers. In the case of a transfer to associated taxpayers listed in subsections (2)(a) – (e) and (3), the same date of transfer as described in the previous paragraph will apply. In the case of all other transfers, the date of transfer is a date chosen by the taxpayer but no earlier than the later of the date of the transfer request and the date of filing of the relevant return.

Background

There is uncertainty about the rules relating to transfers of excess tax because there are no comprehensive rules relating to such transfers in the revenue Acts.

Proposals for new rules to legislate for transfers were set out in the discussion document *Taxpayer compliance, standards and penalties: a review*, issued in August 2001. The legislation is essentially in the same terms as the proposals.

Detailed analysis

Application

New section 173K sets out the circumstances in which the new transfer rules will apply, and the effect of the rules.

The Commissioner of Inland Revenue is authorised to transfer excess tax at the request of the taxpayer. “Tax” includes all taxes, levies and duties included in the definition of “tax” in section 3. In addition, it specifically includes rebates for childcare and charitable donations (new paragraph (ca) of the definition).

The section applies only to tax that is refundable. This means, in the case of income tax, that it will not apply when the company’s imputation credit account has insufficient credits and the amount is retained by the Commissioner under sections MD 2 or MD 3 of the Income Tax Act.

The new rules also do not apply if the Commissioner offsets the excess against an outstanding tax liability under section MD 1(3) of the Income Tax Act. That provision overrides the new rules. Tax should not be available for transfer to another taxpayer if the taxpayer has an outstanding tax liability.

The amount transferred is treated as a refund to the transferor. So, for example, a corporate transferor should record the amount transferred as a refund in its imputation credit account. The amount transferred is tax paid by the transferee on the date of transfer for all purposes except the imposition of shortfall penalties. Therefore when tax is transferred by taxpayer A to satisfy an unpaid tax liability of taxpayer B as at the due date of the tax, any accrued use-of-money interest and late payment penalties in relation to the underpayment will be cancelled.

Transfers within a taxpayer's own accounts

Section 173L applies to requests by a taxpayer for a transfer to another period or to another type of tax of the same taxpayer.

Taxpayers may choose the date on which the excess is to be transferred, provided it is after the dates set out in the section. In relation to GST refunds and tax deducted at source on behalf of a taxpayer, the transfer can be made only after the end of the taxable period or income year respectively. In relation to taxes that are paid directly to Inland Revenue (for example, provisional and terminal tax, taxes deducted on behalf of another taxpayer, and duties), the transfer can be made at any time after the date the tax is paid.

Allowing taxpayers to choose the date of transfer, subject to these limitations, enables them to choose a date that is most advantageous for them.

The effect of a transfer at this date is that taxpayers can transfer overpaid tax to another period or type of tax at the earliest opportunity to reduce use-of-money interest on underpaid tax. This should mean that taxpayers are not charged use-of-money interest (currently at 11.93%) in relation to an underpayment over the same period that they are also receiving use-of-money interest at a lower rate (currently 4.83%) in relation to an overpayment.

Example 1

In September 2002, A is assessed in relation to her 2001-2002 income year and discovers she has overpaid tax. She has in the meantime paid her first provisional tax instalment for the 2002-2003 year on 7 July 2002, using the standard uplift method. However, she is now concerned that that amount will not be sufficient and a use-of-money interest liability will arise. She requests Inland Revenue to transfer the excess as at 7 July, which it does.

Transfer to certain listed associated taxpayers

Section 173M applies to transfers to other taxpayers. If the transfer is between certain listed associated taxpayers, the date of transfer is the same as that applying to transfers within a taxpayer's own accounts (see the previous commentary on section 173L). This applies to transfers between:

- companies in the same group (that is, companies that are at least 66 percent commonly owned);
- a shareholder employee and company;
- partners in the same partnership;
- family members within one degree of relationship (husband/wife, parent/child); and
- a family trust and a beneficiary.

Because tax can be transferred between these taxpayers generally at the date of overpayment, a transfer may offset unpaid tax liabilities and cancel use-of-money interest and late payment penalties of the transferee. The taxpayers eligible for this treatment fall into one of two categories. They either are, or consider themselves to be, one economic entity, or they share in an income stream and allocate income amongst themselves after the end of the year.

It is not appropriate for all transfers to other taxpayers to be made at this date. This would result in high administrative costs on Inland Revenue, as it would need to field and action transfer requests and reissue statements of account to reflect the transfers and resulting cancelled interest and late payment penalties. This increases the complexity of the tax system. To allow all transfers to cancel accrued use-of-money interest and late payment penalties of the transferee also undermines the incentive for individuals to pay the right amount of tax on time.

Example 2

A Co estimates its provisional tax and paid provisional tax of \$120,000 at each instalment date for the 2002-2003 year (7 July and 7 November 2002 and 7 March 2003). In May 2003 A Co files its return, which shows that its residual income tax is \$300,000 for the year. It has therefore overpaid tax of \$20,000 at each instalment date.

B Co is in the same group as A Co, being 66 percent commonly owned. B Co underestimated its first provisional tax instalment at 7 July 2002 by \$20,000 and has incurred use-of-money interest on the underpayment. A Co therefore requests Inland Revenue to transfer the \$20,000 excess tax paid on 7 July to B Co as at that date. A Co has no outstanding tax liability, and its imputation credit account has sufficient credits, so Inland Revenue actions the transfer at the date requested.

The amount transferred is treated as a refund to A Co. It therefore records a debit of \$20,000 in its imputation credit account. The amount transferred is tax paid by B Co, which records a credit in its imputation credit account. Use-of-money interest that has accrued in relation to B Co's underpayment is cancelled.

All other transfers

Section 173M(4)(b) sets out the effective date for all other transfers. Again, taxpayers can choose the effective date but it must be no earlier than the later of the date of the request and the day after the relevant return is filed. This is broadly a proxy for the date of processing the transfer request.

Example 3

In July 2005, A Co's 2002-2003 return is reassessed. The reassessment results in excess tax which A Co requests Inland Revenue to transfer to unrelated company B Co. B Co underpaid its provisional tax in the 2002-2003 year, incurring a use-of-money interest liability. A Co cannot transfer its excess to B Co retrospectively. The date of transfer must be no earlier than the later of the date of the request (July 2005) and the date the relevant return was filed (May 2003). A Co therefore decides not to transfer the excess and Inland Revenue refunds it.

The date of request is the date on which the taxpayer requests the transfer of that particular excess. So, if in example 3, A Co had calculated in its 2002-2003 return that it had overpaid tax and requested in May 2003 that the excess be transferred, this is not the relevant date of request in relation to the excess arising on reassessment.

Transfer of a rebate for childcare or charitable donations

Section 173N provides that a rebate for childcare or charitable donations can be transferred only at the later of the date of the request and the date on which the taxpayer applies for the refund. It cannot be transferred at an earlier date because no use-of-money interest is payable in relation to these rebates. Therefore the rebate should not be transferable to another type of tax or another taxpayer so that use-of-money interest, in effect, becomes payable on it.

Example 4

A makes a charitable donation in the 2002-2003 year and claims a refund in December 2003. A's husband underpaid his provisional tax on 7 July 2003. A therefore requests in a letter attached to the claim form that the refund be transferred to her husband as at 7 July 2003 in order to minimise use-of-money interest on the underpayment.

Inland Revenue will transfer the excess only as at December 2003.

Excess tax retained by Commissioner because ICA has insufficient credits

A new section MD 2(5A) is being inserted into the Income Tax Act as an adjunct to the amendments relating to transfers of excess tax at the request of a taxpayer. Section MD 2(5) applies when income tax paid in excess is not refunded to a corporate taxpayer because its imputation credit account has insufficient credits. Instead, it is retained and applied in payment of tax that is payable by the company. It is not clear that the excess can be credited as at a date on which there is no liability to pay provisional tax but from which use-of-money interest applies in relation to underpaid residual income tax. The amendment clarifies that the excess can be credited as at that date.

Further tax
simplification measures

OVERVIEW

The bill introduces a number of amendments aimed at further simplifying the tax system and reducing compliance costs for taxpayers. Compliance costs range from the money and time value of complying with tax obligations (such as completing income tax returns) to the stress that comes from not being certain whether all the tax rules have been met correctly, or even what they are. It is expected that the amendments will reduce compliance costs for taxpayers by:

- removing the need to file income tax returns on behalf of deceased taxpayers and for small amounts of income from which tax has not been withheld;
- simplifying family assistance by better targeting the payment of the family tax credit and aligning the process for determining family assistance entitlements with the general income tax rules;
- removing the need for companies to file multiple imputation returns in order to receive refunds of income tax;
- reducing the risk of use-of-money interest applying for more provisional taxpayers;
- making it easier for banks and other interest payers to communicate resident withholding tax information to their customers; and
- not requiring small businesses to value and make adjustments for small amounts of trading stock at the end of the year.

These initiatives were presented in a Government discussion document on tax simplification, *More time for business*, released in May 2001. The document, while primarily aimed at reducing tax-related compliance costs and risks for small businesses, put forward a wide-ranging set of tax simplification proposals.

Some of the ideas contained in *More time for business* that were supported by submissions are being implemented as part of the Government's continuing tax simplification programme.

NON-FILING FOR DECEASED TAXPAYERS

(Clauses 63(3), 63(6) and 64)

Summary of proposed amendment

The bill removes the requirement for a return to be filed or an income statement requested on behalf of a deceased taxpayer in respect of income earned in the income year in which the death occurred. The amendment will apply if the deceased taxpayer would have been able to use the non-filing provisions (that is, would not have been required to file a return or request an income statement) were he or she alive. The amendment will also apply to executors and administrators of deceased taxpayers' estates.

This is a tax simplification measure designed to reduce stress for the families of deceased taxpayers and compliance costs for executors and administrators.

Application date

The amendment will apply from the start of the 2002-03 income year.

Key features

Section 33A(2)(1) of the Tax Administration Act 1994 is being repealed as it excludes deceased taxpayers from the non-filing provisions in section 33A(1).

Section 43(4) is being replaced to ensure that the executors and administrators of a deceased taxpayer's estate are also able to apply the non-filing provisions. However, had the deceased taxpayer been a person to whom the Commissioner of Inland Revenue would have issued an income statement or who would have otherwise been required to request one, the same responsibility will vest with the executor or administrator.

A new section 43(5) is being added to allow executors and administrators of the estates of deceased taxpayers who are to be covered by the non-filing provisions to request income statements on their behalf if so desired.

Background

Taxpayers who are eligible not to file income tax returns or receive income statements are required to have returns furnished or income statements requested on their behalf in respect of income earned in an income year if they die in that year. Equally, the executors and administrators of a deceased taxpayer's estate are not eligible to apply the non-filing provisions.

The amendment will reduce compliance costs for executors and trustees of deceased persons' estates which often involves only very small amounts of income, if any, and income that generally has already had tax deducted at source (for example, interest and dividend income). The compliance costs incurred in determining whether a deceased taxpayer had a tax file number, obtaining the relevant source documents, filing a return or requesting an income statement and going through the time-consuming process of waiting for the part-year assessment to be confirmed often outweigh the tax consequences of filing.

The amendment will also reduce the stress placed on families of deceased taxpayers from having to comply with tax obligations at a difficult time.

\$200 THRESHOLD FOR RETURNING INCOME FROM WHICH TAX HAS NOT BEEN WITHHELD

(Clauses 63(2) and 63(5))

Summary of proposed amendment

Taxpayers with small amounts of income from which tax has not been withheld will no longer be required to return it. The amendment will apply if the value of this income is \$200 or less, before any allowable deductions.

This tax simplification measure will reduce compliance costs associated with returning small amounts of non-withheld income as well as the risk of penalties applying for not returning the income.

Application date

The amendment will apply from the start of the 2002-03 income year.

Key features

Section 33A(1) of the Tax Administration Act 1994 is being amended to include a \$200 gross income threshold for income from which tax has not been withheld, under which a taxpayer does not need to return this income.

Background

There is currently a \$200 gross income threshold for withholding income from which tax has not been correctly withheld during the year, under which taxpayers are not required to request an income statement or file a return to reconcile the errors. A similar threshold is required for income from which tax has not been withheld as taxpayers with small amounts of such income often incur compliance costs disproportionate to the amount of the income in order to return it. And if they do not return this income, taxpayers may be subject to penalties and interest. The amendment will remove the risk of penalties and interest applying if a taxpayer earns \$200 or less of income during the year, from which tax has not been withheld, and does not return that income.

FAMILY TAX CREDIT TO BE PAID TO THE PRINCIPAL CAREGIVER

(Clause 42)

Summary of proposed amendment

The family tax credit is to be paid to the principal caregiver instead of both spouses in a two-parent family. This will allow payment of the family tax credit to be better targeted and will reduce compliance costs associated with applying for and reconciling family assistance.

Application date

This amendment will apply from the start of the 2003-04 income year to allow time for communicating the changes to recipients.

Key features

Section KD 3(4) of the Income Tax Act 1994 is being amended to allow the family tax credit to be paid to the principal caregiver, as defined in section OB 1.

Background

The family tax credit guarantees a minimum family income of \$15,080, after tax, for families in which at least one spouse is in paid employment – that is, working for salary and wages.

The amendment will allow better targeting of family assistance to the person with the primary responsibility for the day-to-day care of a child or children. It will also reduce compliance costs associated with the family assistance application process, as only one spouse will need to complete an application form and have a bank account to receive family assistance payments.

The amendment will also simplify the end-of-year square-up, where family assistance recipients must complete a declaration and reconcile family assistance payments made during the year with income earned. The end-of-year reconciliation will be limited to only one spouse, which will allow the administration of family assistance to be further simplified.

ADJUSTMENTS REQUIRED FOR FAMILY ASSISTANCE PURPOSES TO BE REMOVED

(Clause 41)

Summary of proposed amendment

The determination of family assistance entitlements is to be simplified by removing the need to make a number of complex adjustments when calculating them. The adjustments move the assessment of family assistance from a taxable income basis more towards a welfare definition of “income”.

The amendment is designed to align the family assistance rules with the general income tax rules, thereby reducing compliance costs associated with making the necessary adjustments for family assistance. It will also reduce the risk of family assistance debt resulting from incorrect application of adjustments.

Application date

This amendment will apply from the start of the 2003-04 income year to allow time for communicating the changes to recipients.

Key features

Section KD 1(1) of the Income Tax Act 1994 is being amended as follows:

- Certain exempt income for taxable income purposes, such as interest from Post Office Development Bonds, scholarships and bursaries is to remain exempt for family assistance purposes as well.
- Deposits to income equalisation and adverse event income equalisation accounts are to be treated as allowable deductions and refunds from these accounts as income for family assistance purposes.
- If a taxpayer spreads income to future or preceding income years, this income is to be realised in those years for family assistance purposes (not solely in the year in which payment is received).
- Depreciation claimed on buildings is to be treated as an allowable deduction and amounts derived from the sale of buildings as income for family assistance purposes.
- Development expenditure relating to agriculture, farming, forestry and aquaculture that is deductible on a taxable income basis is to be treated as an allowable deduction for family assistance purposes as well.

Background

The tax system uses taxable income for assessing tax, and the benefit system uses a welfare definition of income for assessing benefits. The definition of income for family assistance purposes is a compromise between the tax and welfare definitions. For example, a current-year business loss can be offset against a family's other income for tax purposes but the offset is disallowed for family assistance purposes.

In the calculation of family assistance entitlements, certain types of income that may be exempt for income tax purposes are not for family assistance purposes and vice versa. Similarly, certain allowable deductions under the general income tax rules are not allowed for family assistance. The adjustment process is undertaken when the family applies for or renews family assistance and is also part of the end-of-year square-up process

The amendment will bring family assistance more into line with the general income tax rules, thereby reducing compliance costs associated with providing the necessary information to Inland Revenue, making the requisite adjustments and, most importantly, getting the adjustments right. The amendment will also reduce the risk of overpayments (and therefore end-of-year tax debt) resulting from the incorrect application of adjustments.

It is expected that a significant number of taxpayers will benefit from reducing the number of instances in which family assistance applicants have to turn their mind to whether they received income or incurred expenditure that forms part of the adjustments for family assistance purposes. This will also reduce the complexity of family assistance applications. For example, the family assistance application form, which currently has to cover all of the adjustments, can be simplified.

Detailed analysis

The amendment relates to the following adjustments:

Exempt income (Clauses 41(1) and 41(8))

Section KD 1(1)(a) of the Income Tax Act 1994 is being amended to remove the requirement to add back to income for family assistance purposes:

- interest from Post Office National Development Bonds or New Zealand Savings Certificates;
- interest on any farm vendor finance bond or in respect of any farm vendor mortgage; and
- any amount of a scholarship or bursary paid in respect of attendance at an educational institution.

This income is exempt under sections CB 1(1)(a) and (c) and CB 9(d) respectively.

The requirement to add back to income for family assistance purposes any alimony, spousal maintenance and child support payments received (within the meaning of section CB 9(a)) and the amount of any overseas pension (within the meaning of section CB 5(1)(f)) is to remain.

Income equalisation accounts (Clauses 41(2), 41(3) and 41(7) to 41(9))

Section KD 1(1)(b) of the Income Tax Act 1994 is being amended to include deposits to an income equalisation account and adverse event income equalisation account, under sections EI 3 and EI 13 respectively, as allowable deductions for family assistance purposes. The amendment will apply to deposits made in the 2003-04 and subsequent income years. Consequently, section KD 1(1)(c)(iii) is being repealed on the first day of the 2003-04 income year.

Refunds from income equalisation and adverse event income equalisation accounts, under sections EI 4, EI 5, EI 7, EI 9 and EI 14 and EI 15, respectively are to be gross income for family assistance purposes from the 2003-04 income year. However, if the refunds relate to deposits that have not been allowed as a deduction for family assistance purposes they will not be gross income.

To that effect, sections KD 1(1)(e)(i) and (vi) are being amended so that refunds from income equalisation and adverse event income equalisation accounts in the 2003-04 and subsequent income years are not gross income if the deposits to which those refunds relate have not been allowed as a deduction for family assistance purposes. This will apply to deposits to income equalisation and adverse event income equalisation accounts before the 2003-04 income year.

Spreading income (Clauses 41(3), 41(5), 41(8) to 41(9))

Section KD 1(1)(d) of the Income Tax Act 1994 is being repealed. The provision requires certain income that is allowed to be spread to future or preceding income years, for taxable income purposes, to be wholly realised in the income year in which payment is received for family assistance purposes. With repeal, the following types of income will be allowed to be realised, for family assistance purposes, in each of the spread income years:

- remission of specified suspensory loans deemed to be gross income and allowed to be spread over the income year of remission and two succeeding years under section DC 2;
- income derived from the sale or other disposition of timber that is allowed to be spread over the income year in which payment is received and a maximum of three preceding years under section EJ 1;
- compensation for scrapie deemed to be gross income and allowed to be spread over the years in which stock was exterminated under section EJ 2;
- income derived from assignment of or grant of interest in copyright that is allowed to be spread over the income year in which payment is received and a maximum of two preceding years under section EN 3; and

- income derived from the acquisition of land by the Crown that is allowed to be spread over the income year in which payment is received and three subsequent years under section EN 4.

A consequential amendment is being made to section KD 1(1)(e)(ii) so that income that is allowed to be spread to future income years for taxable income purposes, but is realised wholly in an income year before 2003-04 for family assistance purposes, is not realised in those future years.

For example, income from the sale of land to the Crown, if received in the 2001-02 income year would, under the current family assistance rules, be gross income in that year but not in any of the three subsequent years to which that income is allowed to be spread. Once the relevant amendment is enacted however, from the 2003-04 income year the opposite can occur. Given that the potential spread will fall into the 2003-04 and 2004-05 income years, unless otherwise exempted, the income received and fully accounted for in 2001-02 will also need to be incrementally accounted for in the 2003-04 and 2004-05 income years. The consequential amendment deals with this potential double accounting of income for family assistance purposes by exempting spreading income accounted for in an income year before 2003-04.

Sections KD 1(1)(e)(iii), (iv) and (viii) are being repealed, as they are redundant.

Depreciation on buildings (Clauses 41(2), 41(3), 41(6), 41(8) and 41(9))

Depreciation claimed on a building is being allowed as a deduction for family assistance purposes in the 2003-04 and subsequent income years. Section KD 1(1)(b) of the Income Tax Act 1994 is being amended to reflect this and, consequently, section KD 1(1)(c)(i) is being repealed from the start of the 2003-04 income year.

Conversely, any amount derived from the sale of a building (under section EG 19) is being treated as gross income for family assistance purposes in the 2003-04 and subsequent income years. Section EG 19 requires any depreciation allowed as a deduction to be added back to income upon the disposition of depreciable property.

However, when depreciation claimed on a building has not been allowed as a deduction for family assistance purposes these amounts will not have to be added back to income upon the sale of that building. A consequential amendment is therefore being made to section KD 1(1)(e)(v) to ensure that when depreciation on a building has been claimed before the 2003-04 income year (but not allowed as a deduction in those years), the amount of any depreciation before 2003-04 is not added back to income for family assistance purposes if that building is sold in the 2003-04 or a subsequent income year.

Development expenditure (Clauses 41(3) and 41(9))

Section KD 1(1)(c)(ii) of the Income Tax Act 1994 is being repealed as it denies a deduction for any development expenditure relating to agriculture, farming, forestry and aquaculture. A deduction for taxable income purposes is allowed for these expenditures under sections DL 2, DO 3 to DO 5 and DZ 2 to DZ 4 respectively.

REMOVAL OF INTERIM IMPUTATION RETURN REQUIREMENTS

(Clauses 48(1), 48(2), 48(3) and 48(5))

Summary of proposed amendment

Companies with credit balances in their imputation credit accounts will be allowed to have these amounts refunded once they have filed an imputation return for that imputation year. This tax simplification measure will remove the requirement for multiple imputation returns to be filed in certain circumstances before income tax refunds can be released.

Application date

The amendment will apply from 1 April 2002 to refunds of income tax paid on or after this date.

Key features

A new section MD 2(1A) is being added to the Income Tax Act 1994 so that a company is eligible to be refunded income tax to the value of the credit balance of its imputation credit account on the last day of the imputation year for which an imputation return has been furnished.

Background

The dividend imputation system allows companies to pass on to their shareholders credits for income tax they have paid in New Zealand. This allows shareholders to get the benefit of the income tax the company has paid. Tax credits available for transfer may alternatively be refunded on receipt of a return for the relevant imputation year.

If a company has passed on imputation credits to its shareholders in one year and in the following year is entitled to a refund of income tax paid in the earlier year, the Commissioner of Inland Revenue would, if the company has a nil or debit balance in its imputation credit account, effectively be refunding an amount which has already been passed on by way of credits to shareholders. There is, therefore, a limit on the amount of income tax that may be refunded: the amount must not exceed the credit balance in the imputation credit account as at the end of the previous imputation year. Every company must complete an annual imputation return at the end of every imputation year and furnish it either as part of its income tax return or as a separate return.

A company that is allowed an extension of time, up to the end of the following imputation year, to file an imputation return may also have to file an “interim” imputation return before any income tax can be refunded. The “interim” return relates to the company's imputation credit account balance in the extension of time period. These returns are technically redundant and removing this requirement should reduce compliance costs for businesses.

Detailed analysis

Under section MD 2(1) of the Income Tax Act 1994, an imputation credit account company entitled to a refund of income tax must provide an imputation return for the most recently ending imputation year (year ending 31 March for all taxpayers) before this refund can be released. This creates problems for companies that have extension of time arrangements for filing their returns.

For example, a company with a 31 March balance date can file its returns including its annual imputation return up to one year after the income year to which the returns relate. So if the income tax and imputation returns relate to the 2001-02 income / imputation year, the company will have until 31 March 2003 to file its returns for that year. In turn, these returns will not be processed until the beginning of the 2003-04 income year, by which time, under section MD 2(1) of the Income Tax Act 1994 an “interim” imputation return must also be filed for the 2002-03 imputation year before any refund of income tax (relating to the 2001-02 imputation year) can be released.

The amendment will be a proviso to section MD 2(1) of the Income Tax Act 1994, allowing income tax to be refunded if there is a credit balance in a company's imputation credit account at the end of a relevant imputation year, without the need for another imputation return to be provided for the following imputation year, if the original return is filed before the end of that following year.

Companies would still have incentives to ensure that their imputation credit accounts do not shift from a credit balance to a debit balance in the interim. A debit balance at the end of an imputation year would arise if income tax refunded exceeds the credit balance in the imputation credit account. This amount is treated as further income tax to pay and an imputation penalty tax of 10% of the amount is also imposed.

GREATER FLEXIBILITY IN COMMUNICATING RESIDENT WITHHOLDING TAX INFORMATION

(Clauses 62 and 65)

Summary of proposed amendment

Interest payers are to have greater flexibility in how they communicate resident withholding tax (RWT) information to interest earners, including greater control over the format of RWT deduction certificates and how these certificates are to be provided. This measure is designed to simplify RWT information requirements for banks and other interest payers by allowing communication of RWT information through existing customer interfaces and electronic means.

The threshold for providing an RWT deduction certificate is also to be increased from \$20 to \$50 of gross withholding income.

Application date

The amendment to simplify RWT information requirements for interest payers will apply from 1 April 2002 to all RWT deduction certificates provided on or after this date that relate to withholding income earned and tax deducted in the 2001-02 and subsequent income years.

The amendment to increase the RWT notification threshold from \$20 to \$50 will apply from the 2002-03 income year, in relation to withholding income earned and tax deducted in that and subsequent income years.

Key features

Section 25 of the Tax Administration Act 1994 is being amended to:

- remove the Commissioner of Inland Revenue's prescription as to the form of RWT deduction certificates;
- require RWT deduction certificates to provide the interest earner with the amounts of withholding income earned, the amounts of RWT deducted, the year to which the income and tax deductions relate and whether the withholding income is interest or specified dividends;
- allow interest payers to furnish RWT deduction certificates electronically, if an interest earner agrees to this; and
- increase the RWT notification threshold from \$20 to \$50 of gross withholding income under which a RWT deduction certificate does not need to be provided to an interest earner.

Consequential amendments are being made to section 51 of the Tax Administration Act 1994.

Background

Interest payers (generally banks and other financial institutions) are required to provide RWT deduction certificates to interest earners in respect of the withholding income earned and RWT deducted from that income, in a given income year. The Commissioner of Inland Revenue is required to approve the form of RWT deduction certificates – that is, what information is to be provided and how.

This requirement does not take into account technological changes in the financial services industry that have made customer contact more readily achievable by electronic means. Nor does it take account of the fact that most interest payers can provide RWT information using existing customer interfaces instead of as a separate document at the end of each income year.

The amendment will allow banks and other interest payers to use these interfaces to communicate RWT information to interest earners. Interest payers have commented in submissions that new media for communicating RWT information could include bank and financial statements, e-mail and interest payers' web sites. The amendment will reduce the compliance costs imposed on interest payers from not being able to provide RWT information in a manner that is consistent with other communications with their customers.

Detailed analysis

Section 25(1) of the Tax Administration Act 1994 is being amended to remove the requirement for the Commissioner of Inland Revenue to approve the form of RWT deduction certificates. The amendment will reduce compliance costs associated with providing prescriptive and inflexible RWT deduction certificates to interest earners. Although the Commissioner's approval will no longer be required for RWT deduction certificates, the information provided will still need to comply with the legislation and be reasonably accessible to interest earners.

Changes are also being made to the content of RWT deduction certificates. Interest payers have indicated that the cost of communicating RWT information could be minimised by reducing the information that needs to be provided under section 25(6) of the Tax Administration Act 1994. The information that is of most importance to interest earners would seem to be the amount of withholding income earned in an income year, the RWT deducted, and the type of withholding income. Section 25(6) of the Tax Administration Act 1994 is, therefore, being amended to require that only this information be provided in RWT deduction certificates. The amendment will ensure that the information required by interest earners for use in their tax affairs is still provided but at lower compliance costs to interest payers.

Section 25(7) of the Tax Administration Act 1994 is being amended to raise from \$20 to \$50 the withholding income threshold under which a RWT deduction certificate does not need to be provided.

Section 25(10) of the Tax Administration Act 1994 is being amended to allow RWT information to be provided electronically. At present, RWT deduction certificates must be provided either in person or by post to interest earners, which specifically excludes any electronic medium of provision. The amendment will allow interest payers to provide RWT information to interest earners using an electronic format such as a web site if interest earners agree to receive their RWT information in this way and know that the information is available electronically.

Consequential amendments are being made to section 51 of the Tax Administration Act 1994. Under section 51 interest payers are required to provide an RWT deduction reconciliation statement to Inland Revenue in respect of withholding income paid out and RWT deducted in a relevant income year. Interest payers are also required to attach copies of all RWT deduction certificates provided to interest earners that relate to that income year.

With the amendment to section 25(6) of the Tax Administration Act 1994, interest payers will no longer have to provide ancillary information such as the name of the interest earner or the person's Inland Revenue number in RWT deduction certificates. While this information is not particularly useful to interest earners, Inland Revenue uses it for cross-matching taxpayer information. Under the proposed amendments this will be even more important for administrative purposes. For example, if a taxpayer is audited, the onus will be on Inland Revenue to confirm that any withholding income assessed or declared relates to that taxpayer.

The amendment to section 51 of the Tax Administration Act 1994 will ensure that Inland Revenue still receives the relevant taxpayer-specific RWT information from interest payers for each income year. The information will have to be provided in a form that is acceptable to the Commissioner of Inland to comply with Inland Revenue's existing RWT reconciliation processes. For interest payers, this will simply mean continuing with current RWT information reconciliation practices in terms of the information provided to Inland Revenue and how it is provided.

RAISING THE USE-OF-MONEY INTEREST THRESHOLD

(Clauses 72, 55(17) and 55(29))

Summary of proposed amendment

The threshold under which a provisional taxpayer is not subject to the use-of-money interest rules is to be increased from \$30,000 to \$35,000 of residual income tax. This will reduce the risk of having to pay use-of-money interest for more provisional taxpayers.

Application date

The amendment will apply from the start of the 2003-04 income year to allow time for operational implementation.

Key features

Section 120K(4)(b) of the Tax Administration Act 1994 is being amended to increase from \$30,000 to \$35,000 the residual income tax threshold under which the use-of-money interest rules do not apply. A consequential amendment is being made in section OB 1 of the Income Tax Act 1994 in the definition of “new provisional taxpayer” to increase the threshold for becoming a provisional taxpayer accordingly.

Background

Provisional taxpayers who are individuals and who calculate their provisional tax using a previous year’s residual income tax liability plus an uplift of 5 percent are eligible to be removed from the application of the use-of-money interest rules if their residual income tax liability in the current income year is less than \$30,000. The amendment will increase this maximum to \$35,000.

This “safe harbour” from use-of-money interest exists to mitigate the fact that many taxpayers find the provisional tax rules hard to understand and difficult to comply with. Increasing the threshold should reduce the risk of having to pay use-of-money interest and provide greater certainty for a larger number of provisional taxpayers.

NO VALUATION REQUIRED FOR TRADING STOCK LESS THAN \$5,000

(Clauses 22, 55(23) and 55(32))

Summary of proposed amendment

Taxpayers who reasonably estimate that they have less than \$5,000 worth of trading stock at the end of an income year are to be allowed not to value it or include any change in the value in their calculation of income. The amendment will apply to taxpayers that have taxable supplies for GST purposes of less than \$1.3 million in an income year. This tax simplification measure will reduce compliance costs and the risk of penalties for taxpayers with small amounts of trading stock at the end of the year.

Application date

The amendment will apply from the start of the 2002-03 income year.

Key features

A new section EE 2A is being added to the Income Tax Act 1994 to allow taxpayers with taxable supplies for GST purposes of less than \$1.3 million to use the value of their opening stock as the value of closing stock if they reasonably estimate their closing stock to be less than \$5,000.

Background

Under the trading stock valuation rules, trading stock must be valued regardless of how little stock is held or how small the change in value is over the year. The amendment will reduce compliance costs associated with valuing and making adjustments for small amounts of trading stock at the end of the year. It will also reduce the risk of penalties and interest applying for not valuing trading stock less than \$5,000 accurately.

Other policy changes

UNIT TRUSTS: EXCESS IMPUTATION CREDITS

(Clause 5)

Summary of proposed amendment

A proposed amendment will ensure that when unit trust managers redeem units with the unit trust in the ordinary course of their business, they will not obtain excess imputation credits when the dividend received merely reflects their purchase cost of the units. This is a revenue protection measure announced by the Government on 6 November. It is designed to prevent unit trust managers using section CF 2(15) to achieve an unintended windfall gain.

Application date

This amendment will apply retrospectively from 1 April 1996, the date the current unit trust manager rules were put in place. The amendment will not apply, however, to unit trust managers who claimed a credit of tax for the imputation credits in a return of income or by using the disputes procedures in Part IVA of the Tax Administration Act 1994 before 6 November 2001 (the date of announcement of the proposed amendment). This savings provision applies only in respect of transactions before 6 November 2001.

Key features

A new section CF 7A is being introduced into the Income Tax Act 1994. Its purpose is to ensure that when a unit trust manager redeems units with the unit trust in the ordinary course of his or her business, the dividend derived by the manager (and anyone nominated by the manager) does not include any imputation credits attached to the dividend if it constitutes a recovery of the purchase price. For the purposes of certainty, where this provision applies, section FC 3 of the Income Tax Act will not apply.

As the example in the next section illustrates, this ensures that unit trust managers do not gain excess imputation credits following the simple redemption of units.

Background

Investors in unit trusts often dispose of their units by selling them back to the unit trust manager at market value. The manager then redeems them at the same time with the unit trust. This is usually a straightforward operation in which the manager does not make a cash gain or loss.

The unit trust manager is considered to receive taxable dividend income to the extent that the amount received on redemption exceeds the original amount the redeemed units were issued for. The unit trust generally attaches imputation credits to the dividend.

Some unit trust managers consider that section CF 2(15) of the Income Tax Act 1994 applies to such transactions. That section reduces the gross income of a taxpayer by the amount of any dividend (excluding imputation credits).

If the unit trust manager has made no cash gain or loss, applying section CF 2(15) following redemption with the unit trust gives rise to excess imputation credits for the unit trust manager. Managers are using these excess imputation credits to offset the tax on their other income.

Excess imputation credits in this situation are inconsistent with the economic reality of the transaction and would provide an unintended windfall gain to the unit trust manager.

Example of use of section CF 2(15)

The following example illustrates how excess imputation credits can arise when section CF 2(15) is applied. It also shows that the effect of the proposed amendment is to ensure that the dividend does not include the imputation credits.

1. X purchases 100 units from the trustees of a unit trust at \$1 a unit – that is, the original cost or available subscribed capital.
2. X later redeems the 100 units with the unit trust manager for their market value of \$1.20 per unit. (Strictly speaking, X sells to the unit trust manager.)
3. The unit trust manager then redeems the units with the trustees of the unit trust at \$1.20 per unit. Full imputation credits of \$10 are attached to the dividend portion of the redemption.
4. The consideration received by the unit trust manager is \$120. Applying section CF 2(15), the gross “sale” proceeds of the unit trust manager is the consideration reduced by the amount of any dividends (exclusive of any imputation credits) – \$120 received on redemption minus the \$20 dividend = \$100 gross “sale” proceeds.
5. Adding back the dividend received (inclusive of imputation credits), the gross income of the unit trust manager is \$130. Deducting the \$120 cost of the units gives rise to taxation of \$3.30 on \$10 net income and excess imputation credits of \$6.70. These can be converted to a \$20 tax loss for the unit trust manager, even though the economic effect of the transaction is that the unit trust manager has neither a cash gain nor a loss.

| | <i>Problem</i> | <i>Proposed solution</i> |
|--|----------------|------------------------------|
| Consideration received for cancellation of units | \$120.00 | \$120.00 |
| Less dividend portion exclusive of credits | 20.00 | 20.00 |
| Therefore gross "sale" proceeds | 100.00 | 100.00 |
| Plus dividend (including imputation credits) | 30.00 | 20.00 |
| Gross income of unit trust manager | 130.00 | 120.00 |
| Less manager's cost of units | 120.00 | 120.00 |
| Net income | 10.00 | 0.00 |
| Taxation thereon | 3.30 | 0.00 |
| Less imputation credits | 10.00 | 0.00 |
| Surplus imputation credits | 6.70 | 0.00 |
| Losses created from surplus imputation credits | 20.00 | 0.00 |

PENSIONS PAID BY PARTNERSHIPS

(Clauses 13, 14, 16 and 29)

Summary of proposed amendment

The law is being clarified to ensure that pensions paid by partnerships to former partners are deductible for tax purposes, thus removing uncertainty on the matter.

Application date

The amendment will apply from the beginning of the 2000-2001 income year.

Key features

New section DF 8A of the Income Tax Act 1994 provides a deduction for a pension paid by a partnership to a retired partner or a surviving spouse. The deduction will be allowed if the partnership paying the pension operates the same business as the partnership to which the retired partner belonged.

For the deduction to be allowed, the pension:

- must be payable as of right under a deed;
- must be in consideration for past services; and
- must be for life or a fixed period.

It can be paid to a surviving spouse on the same terms (for life or for a fixed period) or until any remarriage.

The partner involved must also have retired from the partnership and the partnership must not be an investment partnership.

A consequential amendment to section FF 17 ensures that the deduction is not disturbed if part of the pension is paid to a former spouse under a matrimonial agreement or order.

Background

Although there is uncertainty about whether pensions paid by partnerships to former partners and surviving spouses are deductible for tax purposes, there is no doubt that such pensions are taxable in the recipient's hands.

From a policy perspective, therefore, the pensions should be deductible, and the amendment clarifies the law.

TRANSFERS OF HOLIDAY PAY

(Clauses 9, 15 and 18)

Summary of proposed amendment

The law is being clarified to remove uncertainty as to the treatment of wage-related provisions when a business is sold and employees are transferred.

Under the proposed change, when a business is sold and employees are transferred, the vendor will be able to obtain a deduction for any wage-related provisions transferred, such as holiday pay, at the time the business is transferred. If a sale of a business is between associated persons, the vendor will not qualify for a deduction but the purchaser will be able to claim deductions for amounts that would have been deductible had the business not been sold, as they are paid.

Application date

The amendment will apply from the date of enactment.

Key features

New section DF 10 of the Income Tax Act 1994 will allow a deduction to the vendor of a business for the value of wage-related liabilities transferred to the new owner, whether those liabilities are contingent or actual, as long as certain conditions are met. Provisions that could qualify for the deduction include those for holiday pay, long service leave, retiring allowances and redundancy payments. The deduction will be allowed at the time the business is transferred.

Conditions that must be met are:

- the vendor and the purchaser must agree the quantum of the wage-related provisions transferred; and
- the vendor and purchaser must not be associated persons.

When the wage-related provision assumed is understated, the purchaser will be able to claim a deduction for the balance when it is paid. When the provision assumed is overstated, the excess will be treated as gross income in the hands of the purchaser at the time generally accepted accounting practice requires an adjustment to be made in the financial accounts of the business.

When the transaction is between associated persons, deductions for wage-related expenditure will be allowed to the purchaser on an “as paid” basis, if a deduction would have been allowable to the vendor.

Consequential changes are being made to sections DF 5 (Retiring allowances payable to employees). The first change removes the timing element. Section DF 5 currently provides a deduction for a bonus, gratuity or retiring allowance on the occasion of the retirement of any employee. Under the new rules, the timing of such deductions will be governed by section EF 1.

The other change is that no deduction will be allowed to an employer under section DF 5 to the extent that the liability was assumed as part of the purchase of the business and the transfer of employees, and a deduction has been allowed to the vendor. This prevents a double deduction by both the vendor and purchaser of a business.

Background

Under general principles wage-related provisions are usually on revenue account and should be deductible. The Income Tax Act 1994 defers the deduction until such time as amounts are actually paid out to the employees.

Following the Privy Council decision in *CIR v NZ Forest Research Institute Ltd* [2000] 3 NZLR 1 it is clear that when a business and its employees are transferred, the purchaser does not currently obtain a deduction when the wage-related provisions are eventually paid out. In many cases the vendor is also unable to obtain a deduction.

The anomaly is being corrected, for arm's length sales, by allowing the vendor a deduction for the wage-related provisions, as it is the vendor which bears the economic cost of the provisions transferred.

TAX DEDUCTIONS FOR BRIBES

(Clause 19)

Summary of proposed amendments

Bribes paid to foreign or domestic public officials in the conduct of business are to be made explicitly non-deductible for tax purposes, thus aligning New Zealand's tax law on this matter with that of other OECD member countries.

Application date

The amendment applies from the date of enactment.

Key features

Section DJ 22 is being inserted into the Income Tax Act 1994 to ensure that bribes paid or promised in the conduct of business are not deductible.

A person that corruptly gives, offers or agrees to give a bribe to a domestic or foreign public official, whether directly, or indirectly through another person, will be denied a deduction for the bribe. However, the provision does not apply if the bribe was paid to expedite the performance of a routine government action and the value of the benefit is small.

The amendment is closely aligned with the provisions of the Crimes Act 1961, including recent amendments that criminalise active bribery of foreign public officials.

Background

The New Zealand Government became a signatory to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions in December 1997. An associated OECD initiative urges member countries that allow tax deductions for bribes paid to foreign public officials to re-examine such treatment.

The proposed amendments will fulfil New Zealand's obligations to the OECD and align New Zealand's approach with the international standard.

PETROLEUM MINING DEDUCTIONS

(Clauses 10, 11, 20, 55(5), 55(20) and 57(1))

Summary of proposed amendments

The petroleum mining tax rules are being amended to prevent petroleum miners from using the current rules relating to disposals of controlled petroleum mining entities (CPME) to gain unintended tax benefits by obtaining deductions exceeding 100 percent of their investment. This is a revenue protection measure.

Application date

The revenue protection measure will apply from the date of introduction of the bill.

The remedial amendment to the definition of “petroleum licence” will apply from the date of enactment.

Key features

Section DM 6 of the Income Tax Act 1994 currently allows a deduction for the cost of ownership interests in a CPME. This section is amended to prohibit a deduction for the cost of these ownership interests.

Consequential amendments are required in sections CJ 6 and CJ 7 to ensure that consideration from the disposal of interests in a CPME is not taxed when the cost of those interests is not an allowable deduction.

Further consequential cross-referencing amendments relating to the amendments to sections CJ 6 and DM 6 are made to sections OB 1 and OD 8.

Background

The current petroleum mining legislation taxes the net proceeds from the sale of ownership interests in a CPME. These rules were intended to support the overall policy of taxing all disposals of petroleum mining assets through:

- including all consideration from disposal of ownership interests in a CPME as gross income (section CJ 6); and
- allowing a deduction on disposal of a CPME for the costs of the ownership interests in that entity (section DM 6); and
- limiting the taxable gain on disposal of a CPME to the increase in value of the ownership interests from 1 October 1990 for the interests held at that date (sections CJ 7(1)(a) and CJ 7(2)).

It is now clear that these rules are not achieving their policy objectives. Contrary to the original policy intent, petroleum miners are using these rules to obtain deductions in excess of 100 percent of their capital invested in petroleum mining development and exploration expenditure.

The amendment repeals the current rules and replaces them with provisions that will treat future disposals of ownership interests in a CPME as being on capital account. This will remove the ability for petroleum miners to claim unintended deductions.

Consequential cross-referencing amendments

It is also necessary to amend sections OB 1 and OD 8 as a result of the amendments to sections CJ 7 and DM 6.

The amendment to the definition of “consideration” in section OB 1 omits the cross-reference to DM 6. The amendment to section OD 8(1) omits references to sections CJ 6 and DM 6.

A remedial amendment is also necessary to the definition of “petroleum licence” as this incorrectly refers to section DM 6. The cross-reference is being amended to refer to section DM 4.

DEBT FORGIVENESS FOR TRUSTS

(Clauses 25 and 27)

Summary of proposed amendments

The proposed amendment clarifies the operation of the existing debt forgiveness rules for trusts. The main purpose of the amendment is to ensure that resettlements of a forgiven amount to a new trust will be subject to existing debt forgiveness rules for trusts. As such, a trust that resettles will not be subject to tax if the beneficiaries of the new trust were family members for whom the creditor has natural love and affection and charities.

Application date

The amendments apply from the date of enactment.

Key features

New sub-sections EH 5(2A) and EH 52(2A) ensure that the clawback rules do not apply to some resettlements. If a trust qualifies for the natural love and affection concession, a resettlement of this trust to another trust will not trigger the clawback rules if the beneficiaries of the new trust are also beneficiaries for whom the creditor has natural love and affection or are charities.

The term “distribution” in section EH 5(2) and EH 52(2) is being clarified to include an amount that constitutes beneficiary income. A distribution of such an amount to beneficiaries that do not qualify for the concession could give rise to beneficiary income (under the ordinary trust rules) and further income for the trustees (under the clawback rules).

However, gross income arising to the trustee solely because a distribution was made to non-qualifying beneficiaries would not give rise to further tax liabilities for the beneficiaries. This is clarified by inserting new sub-sections EH 5(3A) and EH 52(3A).

Further amendments to sections EH 5(3)(b), EH 5(4), EH 52(3)(b) and EH 52(4) clarify that the clawback could apply only to amounts forgiven that had previously qualified for the natural love and affection concession.

Background

Existing family trusts that qualify for a natural love and affection concession are discouraged from resettling into a new trust because it may create additional, unintended tax liabilities. Allowing the existing natural love and affection concession for family trusts to apply in resettlements recognises that resettlements are often necessary in practice.

Two other remedial amendments are necessary to clarify the existing clawback rules. First, it is currently unclear whether, and how, the clawback rules could apply in conjunction with the ordinary application of the trust rules. Second, the current wording of the clawback provision suggests that all amounts forgiven by creditors, including amounts forgiven that had already been taxed as remission income, could be clawed back. This is contrary to policy intention and should be remedied.

INCREASE IN BLOODSTOCK DEPRECIATION RATES

(Clause 28)

Summary of proposed amendment

The depreciation rate for broodmares is to be increased by allowing mares to be fully depreciated by age 11. This amendment will ensure that the broodmare depreciation rate is consistent with the economic realities of the bloodstock industry.

Application date

The amendment will apply from the date of enactment to all broodmares that first become eligible for depreciation or are purchased on or after 1 April 2001.

Key features

A new section EM 1(4)(d) is being added to the Income Tax Act 1994 to allow broodmares to be fully depreciated by age 11. For bloodstock, depreciation can begin from the first income year in which it is first used for breeding purposes, is purchased with the intention of breeding, or is owned with the intention of being bred from at a later date. Section EM 1(4)(d) will apply to a broodmare if the first income year in which one or more of the tests above are satisfied is an income year beginning on or after 1 April 2001.

Background

The amendment has arisen out of a government review of bloodstock depreciation rates. The review was undertaken to ensure that bloodstock depreciation rates accurately reflect the average breeding cycle of mares and stallions. Currently, broodmares used for breeding purposes are allowed to be depreciated from age two (or higher) to age 15. The review has shown, however, that on average broodmares finish breeding by age 11.

Detailed analysis

A new section EM 1(4)(d) is being added to the Income Tax Act 1994 to allow broodmares to be fully depreciated by age 11 if section EM 1(1)(ab) applies in relation to those mares.

Section EM 1(1)(a) of the Income Tax Act 1994 allows depreciation for bloodstock from the first income year in which a bloodstock breeder:

- first uses the bloodstock for breeding purposes; or
- purchases the bloodstock with the intention of using it for breeding purposes; or
- owns the bloodstock if he or she intends to use the bloodstock for breeding purposes at some future date.

A new section EM 1(1)(ab) is being added to the Income Tax Act 1994 for broodmares if the first income year in which one or more of these tests are satisfied is a year beginning on or after 1 April 2001.

Under the proposed changes, broodmares that first become eligible for depreciation on or after 1 April 2001 will be allowed to be depreciated from the age of the respective mare at the end of the income year in which it becomes eligible for depreciation (being an income year starting on 1 April 2001 or later) to age 11.

***Example 1:** A broodmare first begins breeding on 1 July 2001, thereby first becoming eligible for depreciation in the 2001-02 income year. At the end of the 2001-02 income year the broodmare will be age four and, once the amendment is enacted, can be depreciated over seven years beginning in that income year.*

Similarly, broodmares purchased on or after 1 April 2001 can be depreciated from the age of the mare at the end of the income year of purchase (again being an income year starting on 1 April 2001 or later) to age 11.

***Example 2:** A broodmare is purchased on 1 February 2002 by a bloodstock breeder with a standard balance date. The broodmare is age six at the date of purchase but will be age seven on 1 March 2002. Given the taxpayer's balance date, the broodmare will be age seven at the end of the 2001-02 income year and, once the amendment is enacted, can be depreciated over four years beginning in that income year.*

Under section EM 1(4)(d) if a broodmare first becomes eligible for depreciation at age eight or older or is that age at the end of the income year of purchase, she will be depreciated over a period not exceeding three years.

***Example 3:** A broodmare is purchased on 31 March 2002 by a bloodstock breeder with a 30 June balance date. The broodmare is age 12 at the date of purchase and is the same age at the end of the taxpayer's 2001-02 income year. Once the amendment is enacted, the mare will be depreciated over three years, beginning in the 2001-02 income year.*

The table highlights the effect of the amendment on broodmare depreciation rates, generally, and for the purposes of the examples above.

EFFECT OF CHANGE ON DEPRECIATION RATES

| Broodmares first eligible to be depreciated or purchased before 1 April 2001* | | Broodmares first eligible to be depreciated or purchased on or after 1 April 2001** | |
|---|--|---|--|
| <i>Age</i> | <i>Yrs of Depreciation (excluding loading)</i> | <i>Age***</i> | <i>Yrs of Depreciation (excluding loading)</i> |
| 15 | 3 | 15 | 3 |
| 14 | 3 | 14 | 3 |
| 13 | 3 | 13 | 3 |
| 12 | 3 | 12 | 3 |
| 11 | 4 | 11 | 3 |
| 10 | 5 | 10 | 3 |
| 9 | 6 | 9 | 3 |
| 8 | 7 | 8 | 3 |
| 7 | 8 | 7 | 4 |
| 6 | 9 | 6 | 5 |
| 5 | 10 | 5 | 6 |
| 4 | 11 | 4 | 7 |
| 3 | 12 | 3 | 8 |
| 2 | 13 | 2 | 9 |

* Under section EM 1(4)(c) of the Income Tax Act 1994

** Under new section EM 1(4)(d) of the Income Tax Act 1994

*** At end of income year in which broodmare is first eligible for depreciation or purchased

CHARITABLE DONEE STATUS

(Clause 40)

Summary of proposed amendment

The Akha Rescue Ministry Charitable Trust is to be given charitable donee status.

Application date

The amendment will apply from the 2002-03 income year.

Key features

The Akha Rescue Ministry Charitable Trust is being added to section KC 5 of the Income Tax Act 1994, which lists the organisations that qualify for charitable donee status.

Background

The trust, whose moneys can be used outside New Zealand, is being added to the list of organisations that qualify for charitable donee status. Its main activity at present is the rescue of children from the mountain tribes in Northern Thailand who are in danger of being sold or kidnapped into prostitution. The trust has established a hostel to accommodate the children it has rescued.

Donations to qualifying organisations entitle individual taxpayers to a rebate of 33 1/3% of the amount donated, to a maximum for all donations of \$500 per annum. Donations by non-closely held companies qualify for a deduction from net income. The amount allowable as a deduction depends on the company's net income.

OVERTAXATION OF QUALIFYING UNIT TRUSTS AND CATEGORY A GROUP INVESTMENT FUNDS

(Clauses 49(2), (3), (5) and 51)

Proposed new provisions prevent the over-taxation of qualifying unit trusts and Category A group investment funds. This occurs as a result of the loss of the non-taxable status of unit-holders' paid up capital in certain circumstances. The issue is a major one for the unit trust industry.

Application date

The new provisions will apply from the 2002-03 imputation year, which begins on 1 April 2002 and ends on 31 March 2003.

Key features

Overview

New subpart MJ is being added to the Income Tax Act 1994 for qualifying unit trusts (which by definition include widely held unit trusts) and Category A group investment funds who use the "slice rule". These funds may choose to keep a supplementary available subscribed capital account to record available subscribed capital (ASC) that is lost. ASC is the paid-up capital an investor invests in the fund.

Operation of supplementary ASC account

Over the imputation year funds that choose to operate a supplementary ASC account will record the ASC lost on redemption of units. If an investor receives an amount on redemption which is less than the ASC per share, ASC will be lost. This amount may be recorded in the supplementary ASC account.

At the end of an imputation year or immediately before the qualifying unit trust ceases to use an imputation credit account (ICA) the trust may use the balance of the supplementary ASC account to set off a debit in its ICA. The conversion rate will be the relevant company tax rate. The trust may set off credits only to the extent of a debit balance in its ICA.

Opening balance of supplementary ASC account

Funds can choose to calculate an opening balance for their supplementary ASC account based on the actual ASC lost if there are records to support this, or if not, on a notional wind-up calculation. If a fund chooses not to use either of these options it may still operate a supplementary ASC account using an opening balance of nil.

The legislation will provide that the actual calculation or the notional wind-up calculation can be done as at a date anywhere in the period from the date of enactment to 31 March 2003. The result of this calculation will be used to determine the opening balance of the supplementary ASC account, from the date of the calculation.

The notional wind-up calculation must be based on an orderly realisation of assets in the ordinary course of business. The calculation requires a determination of a shortfall in imputation credits if the fund is wound up. That is an amount based on the imputation credits the fund will need to fully impute all distributions on wind-up. This shortfall will be adjusted to take account of distributions that should not be accompanied by imputation credits, such as non-taxable gains. The resulting shortfall in imputation credits will be converted to ASC (by using the relevant company tax rate) for the purposes of the opening balance of the supplementary ASC account.

Background

The unit trust industry has expressed concern about an issue referred to as the “negative dividend issue”, affecting unit trusts and Category A group investment funds. The issue arises from the operation of the company tax rules to unit trust-type vehicles.

At the heart of the so-called negative dividend issue is the loss of ASC. Under current company tax rules, ASC can generally be returned to unit-holders without a tax cost. As a consequence of losing the ASC, funds are currently overpaying their tax in order to shelter redemption proceeds paid to unit-holders.

Two aspects of the ordinary operation of a unit trust vehicle are likely to give rise to the problem. In both cases units in the fund are redeemed for an amount less than the amount subscribed for those particular units (or for all units subscribed to the same unit-holder) – that is, redemption for less than the ASC.

The two cases are when:

- the fund has experienced losses in the period between subscription and redemption of those units; or
- part of the subscription price of the unit represented accumulated income of the fund that is subsequently paid out to the unit-holder, thus bringing the unit price down below the subscription price (in other words, subscription price is effectively cum dividend).

In the first situation, an exiting unit-holder is being paid out the tax benefit associated with the reduction in the value of the fund. Although that benefit will manifest itself in the fund to the extent that it can shelter tax on future increases in fund value, such subsequent increases in fund value are gains that the remaining and future unit-holders will expect to be fully imputed. However, the trust will pay no tax on those gains as they are merely a reversal of previous losses (and are thus naturally “sheltered” from tax).

In the second case, ASC is effectively re-characterised and paid out as a taxable dividend to which imputation credits have been attached. The result is that the unit-holder paying the cum-dividend subscription price receives imputation credits on a distribution that is not sourced from taxable income and, therefore, any attached imputation credits do not represent tax paid or payable by the fund.

CARRY FORWARD OF LOSSES AND CREDITS AFTER A “SPINOUT”

(Clause 56)

Summary of proposed amendments

The proposed amendments provide a new, concessionary ownership-tracing rule for companies that have been transferred to a new holding company after a “spinout” restructuring process. A “spinout” is a process whereby a holding company transfers its subsidiary businesses to another holding company.

The proposed amendments ensure that the ownership tracing rules do not adversely affect companies involved in a spinout if there is no change in underlying economic ownership as a result of the spinout. After a spinout, the new holding company will be treated as holding the ownership interests previously held by the old holding company on behalf of small shareholders, to the extent that there is a common interest in the old and the new holding companies.

Key features

New subsections OD 5(6A) to OD 5(6F) are being inserted into the Income Tax Act 1994 to provide a new ownership-tracing rule on a spinout. Section OD 5(6A) provides that the new rule will apply when a company (Company A) spins out its subsidiary businesses (Company B and Company C). A spinout can happen in a number of ways and the proposed legislation envisages that Company A could spin out its subsidiary businesses by transferring or distributing to its shareholders the shares it owns in Company B or by issuing to its shareholders new shares in Company B.

Section OD 5(6A) also contains a number of conditions that have to be met before a company involved in a spinout could use the proposed tracing rule. Firstly, the proposed rule will be available only if Company A is a limited attribution company at all relevant times (from the date tax losses or credits arose until the date of the spinout). Company B is also required to be a limited attribution company at all relevant times (from the date of the spinout until the date tax losses or credits are used). The term “at all relevant times” is defined in section OD 5(6C). A “limited attribution company” is already defined in section OD 5(10).

Secondly, Company B must be 100 percent owned by Company A before the spinout. There is no requirement, however, that Company B must exist for the entire period since the tax losses or credits arose. Company B could potentially be a newly incorporated company that was established for the purpose of the spinout. Company A need not own 100 percent of all the spun out businesses (since other shareholders could own part of Company C). If Company A spins out a partly owned subsidiary business the amendment will apply only in proportion to Company A’s interests in Company C before the spinout. Company C is the company with tax losses or credits.

Finally, Company A must be treated as holding voting or market value interests in Company C on behalf of its small shareholders under section OD 5(6)(b) before the spinout. Company B must also be treated as holding voting or market value interests on behalf of its small shareholders under section OD 5(6)(b) after the spinout.

When the proposed rule can be applied, section OD 5(6B) provides that Company B will be treated as holding the ownership interests in Company C that were, before the spinout, deemed to be held by Company A on behalf of the small shareholders. However, the rule will apply only to the extent that there is a common interest in both Company A and Company B immediately after the spinout. It will also apply only for the purposes of applying the continuity provisions after the spinout.

The new sections OD 5(6D), (6E) and (6F) provide the rules for determining common interests in Company A and Company B. A person's common interests in Company A and Company B is defined, for the purpose of this provision, as the lowest voting or market value interests that the person holds in both companies. To determine the common interests in Company A and Company B, it is necessary to trace through all legal shareholders (such as nominees or companies) in Company A and Company B to the natural person beneficial owners in accordance with sections OD 3 and OD 4. However, the legal shareholders could be treated as holding the voting or market value interests on behalf of a small beneficial owner if the beneficial owner has less than 10 percent voting or market value interests in Company A or Company B.

Application date

The proposed amendments will apply to a spinout occurring on and after 1 March 2002.

Background

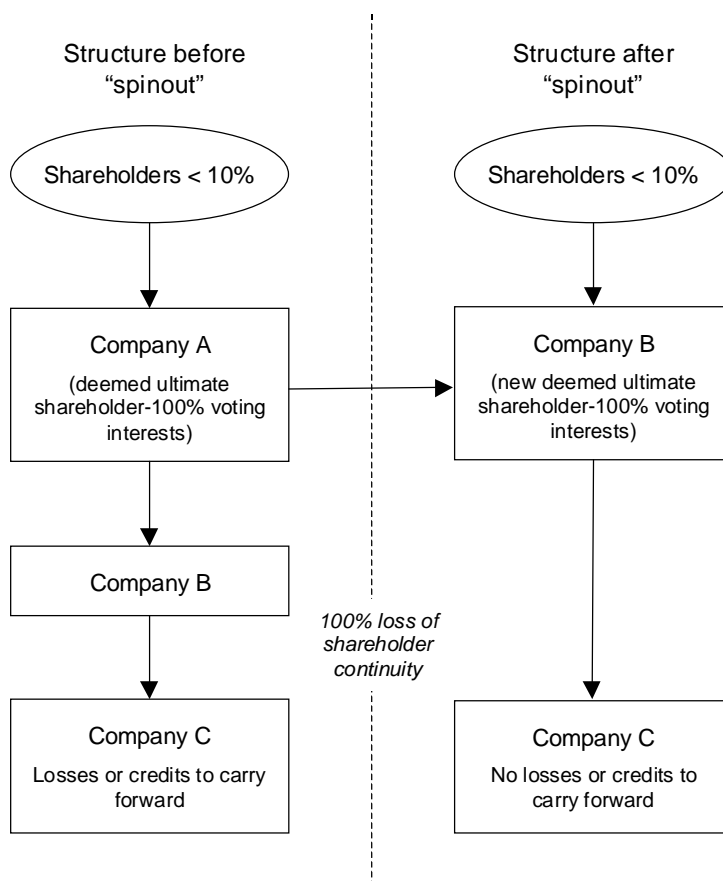
The proposed rule is necessary to ensure that the ownership-tracing rules do not adversely affect the companies involved in a spinout to the extent that there is no underlying change in the economic ownership of the spun out businesses.

A spinout of subsidiary businesses may result in a change in holding company for the businesses. There may well be no change in the underlying economic ownership of the subsidiary businesses after the spinout. However, when a holding company is treated as holding a substantial proportion of ownership interests in the subsidiaries on behalf of small shareholders, a change of holding company could create a substantial change of ownership interests and may prevent the carry forward of tax losses and tax credits in the subsidiary businesses.

Example 1 shows the effect of a spinout without the proposed amendments. In this example, Company A spins out its interests in Company B and Company C. Before the spinout, Company A holds all voting interests in Company C on behalf of its small shareholders (in accordance with section OD 5(6)(b)). After the spinout, Company B holds these same interests in Company C on behalf of the same small shareholders. From an economic perspective, there is no change in the ownership of Company C. However, if Company B wishes to apply section OD 5(6)(b) after the spinout, there will be a 100 percent change of ownership interests in Company C under the current

legislation. In such cases, Company B could resort to the core tracing rules in sections OD 3 and OD 4 to satisfy the shareholder continuity tests. Company B will incur additional compliance costs in doing so, however, and it may not be practical for Company B to use the core tracing rules if it is a widely held, listed company.

EXAMPLE 1:
LOSS OF SHAREHOLDER CONTINUITY IN THE ABSENCE
OF LEGISLATIVE AMENDMENT

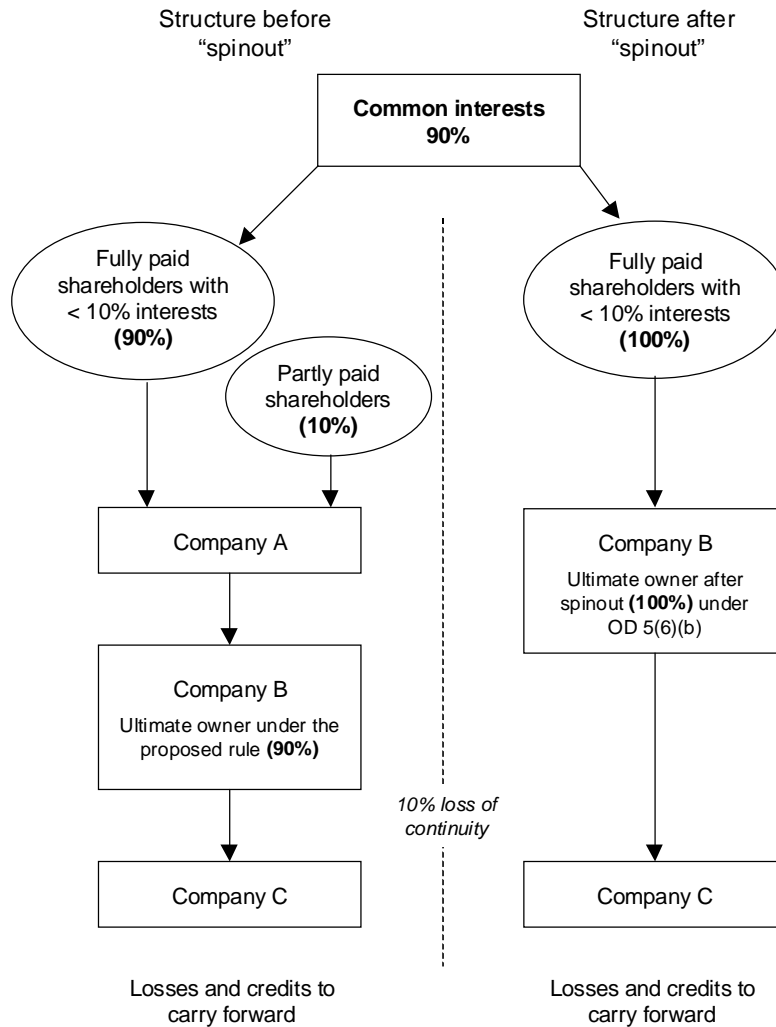


Examples of proposed new rule

When the proposed rule is applied after a spinout, Company B will be treated as holding the ownership interests in Company C that were, before the spinout, deemed to be held by Company A on behalf of the small shareholders. However, the rule will apply only to the extent that there is a common interest in both Company A and Company B immediately after the spinout. As such, the proposed rule will reflect any change in underlying economic ownership resulting from the spinout.

Example 2 illustrates the effect of the amendment. In this example, Company A holds 100 percent of voting interests in Company C on behalf of its small shareholders before the spinout. However, a group of partly paid shareholders in Company A will not receive any interest in Company B as a result of the spinout. Therefore there is only a 90 percent common interest in Company A and Company B after the spinout.

**EXAMPLE 2:
EFFECT OF PROPOSED LEGISLATIVE AMENDMENT**



Under the proposed rule, Company B will be treated as holding 90 percent of the ownership interests in Company C previously held by Company A on behalf of its small shareholders. The proposed rule does not affect the other interests of 10 percent. Therefore, under the proposed rule, the ownership interests in Company C are as follows:

| <i>Before the spinout</i> | | <i>After the spinout</i> | |
|---------------------------|-----|--------------------------|------|
| Company B | 90% | Company B | 100% |
| Company A | 10% | | |

These ownership interests will apply for the purpose of determining shareholder continuity after the spinout. There is a 90 percent continuity over the entire period since Company B holds at least 90 percent of Company C over that period. The proposed rule will override existing ownership tracing rules in sections OD 3(3)(d), OD 4(3)(d) and OD 5(6)(b) for the purpose of applying the continuity provisions after the spinout. However, the rule does not affect losses or tax credits that have been used before the spinout.

In summary:

- Before the spinout, in respect of Company C's losses or tax credits arising and used before the spinout, continuity in Company C would be determined under the existing rules. Company A would be regarded as holding 100 percent if reliance is placed on paragraph OD 5(6)(b).
- After the spinout, in respect of losses or credits arising in Company C before the spinout but not yet used, Company B will now be treated as having held 90 percent in Company C from the dates the losses or credits arose until the spinout. Company B would hold 100 percent voting interests in Company C from the date of the spinout if reliance is placed on paragraph OD 5(6)(b).
- After the spinout, in respect of losses or credits arising in Company C after the spinout, Company B would hold 100 percent voting interests in Company C if reliance is placed on paragraph OD 5(6)(b).

Spinout of partly owned subsidiaries

Example 3 shows a spinout of a partly owned subsidiary. In this example, Y owns 20 percent of Company C and Company A spins out its 80 percent stake held through Company B. However, only fully paid shareholders, which constitute 90 percent of Company A's total shareholders, receive interests in Company B.

Under the proposed rule, Company B will be treated as holding interests previously held by Company A (80 percent), but only to the extent that there is a common interest in Company A and Company B after the spinout (90 percent). As such, Company B will be treated as holding 72 percent of voting interests in Company C (90 percent of 80 percent) previously held by Company A.

Under the proposed rule, the ownership interests in Company C are as follows:

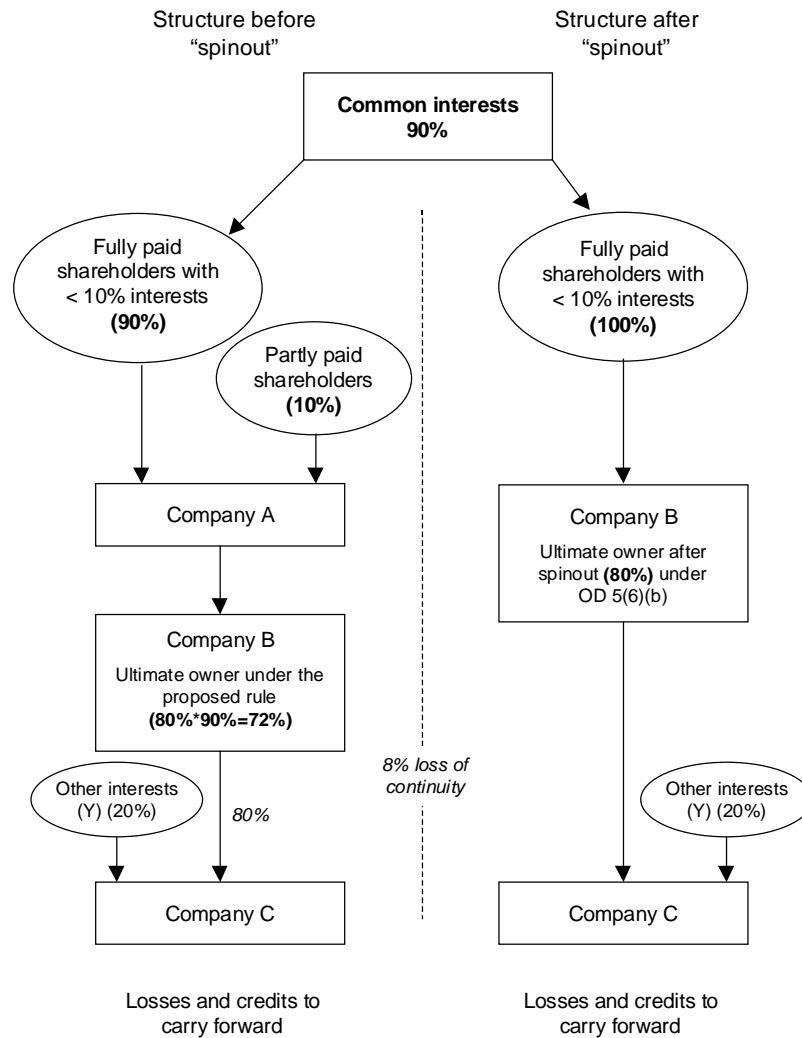
| <i>Before the spinout</i> | | <i>After the spinout</i> | |
|---------------------------|-----|--------------------------|-----|
| Y | 20% | Y | 20% |
| Company B | 72% | Company B | 80% |
| Company A | 8% | | |

In summary:

- Before the spinout, in respect of Company C's losses or tax credits arising and used before the spinout, continuity in Company C would be determined under the existing rules. Company A would be regarded as holding 80 percent if reliance is placed on paragraph OD 5(6)(b). Y would be regarded as holding the other 20 percent.
- After the spinout, in respect of losses or credits arising in Company C before the spinout but not yet used, Company B will now be treated as having held 72 percent in Company C from the dates the losses or credits arose until the spinout. Company B would hold 80 percent voting interests in Company C from the date of the spinout if reliance is placed on paragraph OD 5(6)(b).

- After the spinout, in respect of losses or credits arising in Company C after the spinout, Company B would hold 80 percent voting interests in Company C if reliance is placed on paragraph OD 5(6)(b).

**EXAMPLE 3:
SPINOUT OF PARTLY OWNED SUBSIDIARIES**



Ownership changes after a spinout

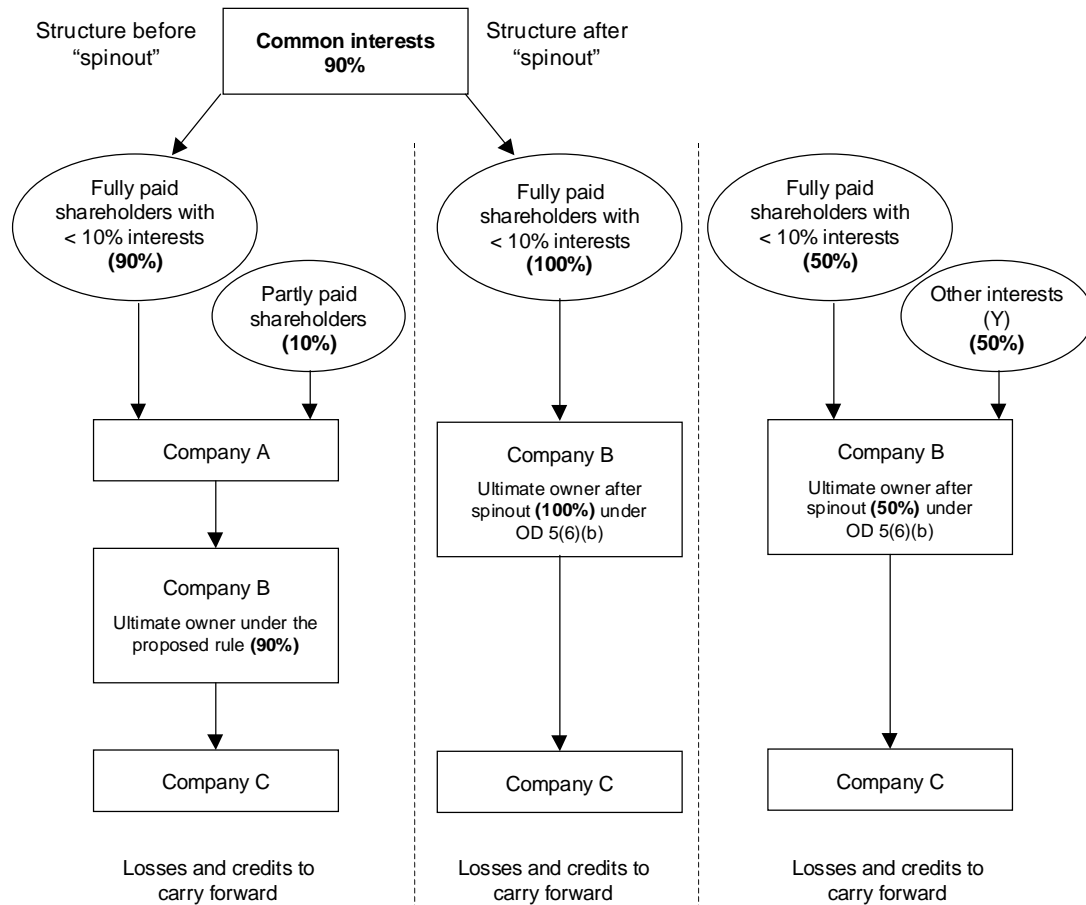
Example 4 shows the effect of the proposed rule if a change of ownership occurs after the spinout. This example is the same as example 2, except that a natural person, Y, acquires 50 percent of Company B from its small shareholders after the spinout.

Under the proposed rule, the ownership interests in Company C are as follows:

| <i>Before the spinout</i> | <i>After the spinout</i> | <i>Subsequent Takeover</i> | |
|---------------------------|--------------------------|----------------------------|------|
| Company B | 90% | Company B | 100% |
| Company A | 10% | Company B | 50% |
| | | Y | 50% |

Since Company B owns at least 50 percent of Company C over the entire period, a subsequent change in ownership of 50 percent would not adversely affect the ability of Company C to carry forward its losses. However, pre-spinout credits could not be carried forward after Y acquires 50 percent of Company B.

EXAMPLE 4
CHANGE OF OWNERSHIP SUBSEQUENT TO THE SPINOUT



PUBLIC BINDING RULINGS ISSUED FOR AN INDEFINITE PERIOD

(Clauses 69, 70 and 71)

Summary of proposed amendment

The binding rulings legislation is being amended to allow public rulings on the Commissioner's view of the application of the tax law to particular transactions to be issued by the Commissioner for an indefinite period. The amendment will improve taxpayer certainty by reducing the risk of substantial time delays between a ruling lapsing and its reissue and will allow Inland Revenue to allocate its resources more effectively.

Application date

The amendment will apply from the date of enactment.

Key features

Sections 91DA, 91DC and 91DE of the Tax Administration Act 1994 are being amended to allow Inland Revenue to issue public binding rulings that apply indefinitely until they are either formally withdrawn or the taxation law on which they are based materially changes.

If a public binding ruling issued for an indefinite period is withdrawn, it will continue to apply to an arrangement entered into before the date of withdrawal, for three years from the date on which the ruling is withdrawn.

The amendment does not alter the Commissioner's ability to issue finite period public rulings. Whether a public ruling is issued for a finite period or an indefinite period is at the Commissioner's discretion.

Background

Binding rulings are intended to reduce uncertainty for taxpayers about the tax implications of business decisions, and assist taxpayers in complying with the tax law.

Public binding rulings are rulings that are publicly available and can be applied by all taxpayers for the particular tax matter(s) and arrangement(s) covered by the ruling. The binding rulings legislation currently requires that these rulings be issued for a finite period.

As the number of finite period public rulings grows over time, reissuing them may become an increasingly resource consuming task for Inland Revenue. As a result, taxpayers may experience lags between the date a ruling expires and the date it is reissued, leaving both parties with a period of time in which the application of the law is unclear.

This erodes the effectiveness of the rulings system as it reduces taxpayers' certainty about the tax effect of transactions. The amendments address these issues.

GST – NON-PROFIT BODIES AND THE DEFINITION OF “INPUT TAX”

(Clause 81)

Summary of proposed amendment

An amendment clarifies the legislative basis for registered non-profit bodies to claim deductions of input tax by allowing deductions in relation to all activities except the making of exempt supplies. It will provide certainty for charities and other non-profit bodies in relation to their GST obligations and will reduce compliance costs.

Application date

The amendment will apply from the date of enactment.

Key features

The definition of “input tax” in section 3A of the Goods and Services Tax Act 1985 is being amended to clarify that GST registered non-profit bodies are entitled to claim input tax credits in relation to all their activities except the making of exempt supplies (such as the supply of donated goods and services, financial services or residential accommodation). The amendment will confirm that non-profit bodies are, for example, able to claim input tax credits in respect of the activity of collecting donations.

Background

For GST purposes, non-profit bodies are organisations established other than for the profit of their members and are prohibited from making cash or other distributions to their members. They may include, for example, sporting and other recreational clubs as well as charities.

The government discussion document *Tax and Charities*, released in June 2001, noted a possible inconsistency between current practice and the GST legislation in relation to claims for input tax credits by non-profit bodies.

Inland Revenue’s practice is to allow input tax credits to non-profit bodies in relation to all their activities, other than the making of exempt supplies. However, in considering the relevant legislation, the discussion document expressed doubt as to whether input tax credits were available in relation to activities that did not involve the supply of goods and services in exchange for payment such as, for example, donation gathering activities.

The discussion document therefore proposed to clarify the legislation in line with practice in order to provide certainty to non-profit bodies. Many of those who made submissions on the discussion document welcomed this change.

GST – TREATMENT OF WARRANTY PAYMENTS FROM NON-REGISTERED OFFSHORE WARRANTORS

(Clauses 82 and 84)

Summary of proposed amendment

The supply of services to a non-registered offshore warrantor, in relation to goods sold in New Zealand, is being zero-rated for GST purposes.

The amendment relieves the impost of GST on non-registered offshore suppliers arising from an inability to recover GST on the cost of warranted repairs which has been included, either directly or indirectly, in the purchase price of the goods.

Application date

The amendment applies from the date of enactment.

Key features

The supply of services to a non-registered offshore warrantor, in relation to goods subject to GST on importation that are covered by a warranty agreement, will be zero-rated under new section 11A(1)(ma) of the Goods and Services Tax Act 1985. The consideration paid by the warrantor (including any amount attributable to the full or partial replacement of parts) is regarded as relating to the supply of such services.

The term “warranty” is defined as an undertaking given as part of the terms of supply to remedy defects that appear during a certain period, or following a specified level of use, after the goods are supplied.

The term “supply” is also clarified to ensure that a supply of services to which new section 11A(1)(ma) applies is regarded as the only supply for the consideration provided by the offshore warrantor.

Background

In *Suzuki New Zealand Limited v Commissioner of Inland Revenue*¹ the Court of Appeal held that certain payments in respect of repairs to motor vehicles under warranty were subject to GST. Although the repairs in question were carried out by a dealer under a separate contract with a local New Zealand importer of the vehicles, the nature of the warranty arrangement between the New Zealand importer and the offshore manufacturer of the vehicles also required the importer to supply the repair services to the offshore manufacturer. The payment by the offshore manufacturer was viewed as consideration for services provided to the offshore manufacturer rather than

¹ (2001) 20 NZTC 17,096.

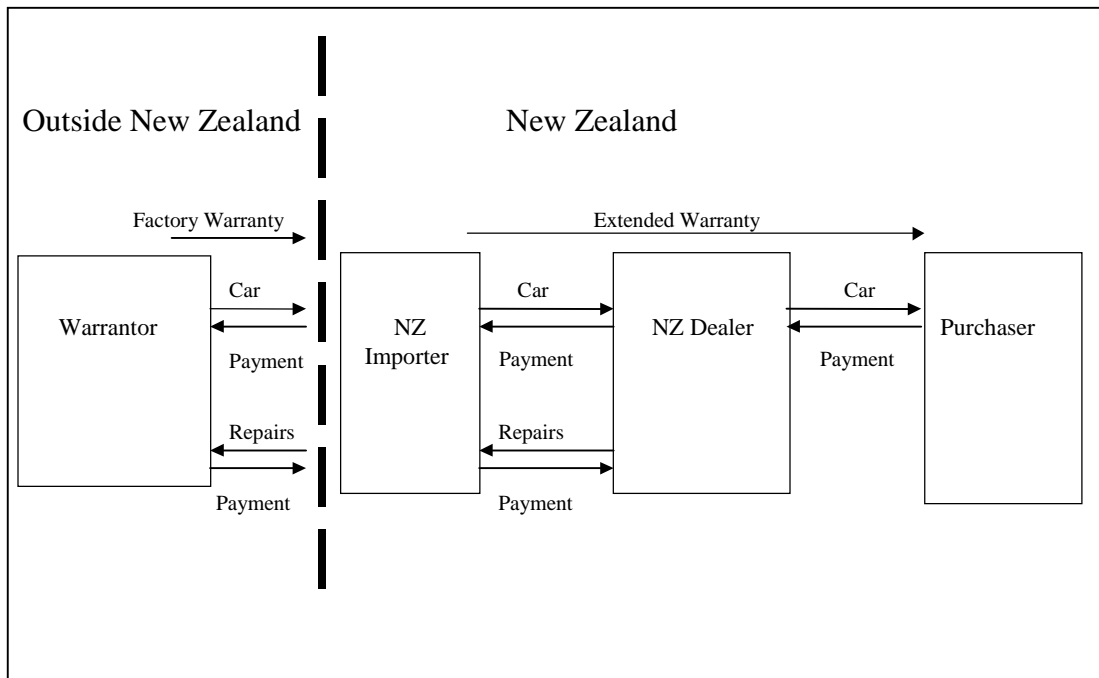
compensation for breach of warranty. A diagram illustrating the arrangements at issue follows.

The effect of the decision in *Suzuki* is to give rise to a double impost of GST – once on importation of the goods, the value of which includes the cost of the warranty, and again on the supply of services to the non-registered offshore warrantor.

An input tax credit is available to the offshore warrantor for the GST cost on the services if they are registered for GST in New Zealand. Registration is, however, not always practicable as the offshore warrantor must establish that it makes taxable supplies in New Zealand in order to claim an input tax credit.

The amendment therefore relieves non-registered offshore warrantors from the GST cost arising from their inability to recover GST on the cost of services that was directly or indirectly included in the purchase price of the goods.

WARRANTY ARRANGEMENTS – AN EXAMPLE



Remedial amendments

EXEMPTION FROM SUPERANNUATION FUND WITHDRAWAL TAX

(Clause 12)

Summary of proposed amendment

The legislative exemption from superannuation fund withdrawal tax is being aligned with the intended policy. If an employee has ceased employment with an employer and the employer has made contributions to a superannuation fund on behalf of the employee, the employee is allowed an exemption from superannuation fund withdrawal tax when withdrawing these contributions. This exemption should be available only if employers do not make superannuation fund contributions in excess of 150 percent of the previous year's contributions in the income year of cessation of employment and in both of the two preceding income years.

Application date

The amendment will apply from the date of enactment.

Key features

Section CL 8(2) of the Income Tax Act 1994 is being amended so that the exemption from superannuation fund withdrawal tax applies only if employer contributions in the income year of cessation of employment and in each of the two preceding income years do not exceed 150 percent of the contributions made in the previous year.

Background

The rules governing the tax treatment of withdrawals from superannuation funds were introduced in the Taxation (FBT, SSCWT and Remedial Matters) Act 2000. One such rule allows an exemption from superannuation fund withdrawal tax (5% of the withdrawn amount) for employees if an employee making that withdrawal is no longer in the service of the employer to whom the superannuation contributions being withdrawn relate.

The exemption is designed to apply under the following conditions. First, an employee must have been employed for two or more years by the relevant employer. Second, the employer's contributions to the superannuation fund, on behalf of the employee, must not exceed 150 percent of the previous year's contributions. The second condition applies to the annualised contributions made in the income year in which employment is ceased and in the preceding two income years.

The legislation, however, is contrary to this policy intention as the 50 percent cap on increases in employer contributions over the previous year applies to only one of the two income years preceding the year in which employment is ceased. In effect, an employer can make contributions in excess of 150 percent of the previous year's contribution in one of those two income years and the exemption from withdrawal tax would still apply. The amendment will ensure that the relevant exemption from superannuation fund withdrawal tax applies only if employer contributions do not exceed 150 percent of the previous year's contributions in both of the income years preceding that in which employment is ceased.

THIN CAPITALISATION

(Clause 30)

Summary of proposed amendment

A minor remedial amendment is being made to the thin capitalisation rules to allow taxpayers to include the depreciated value of assets under a finance or specified lease in the definition of “assets” for thin capitalisation purposes when they are excluded for accounting purposes. The amendment will make the application of the rules more consistent and fairer to taxpayers who have specified or finance leases.

Application date

The amendment will apply to measurement dates from the date of introduction of the bill.

Key features

Section FG 4(3)(ca) is being added to the Income Tax Act 1994 and section FG 4(4) of the Act is being amended. The changes allow the adjusted tax value of a lease asset under a specified or finance lease to be included in the total assets of a New Zealand group if the lease asset is not recognised as an asset under generally accepted accounting practice.

Background

The thin capitalisation rules are designed to limit interest deductions if the debt/asset ratio of a New Zealand operation, controlled by non-residents, exceeds a certain threshold. Tax practitioners have identified that in some cases there is an unintended overstatement of the New Zealand group’s debt/assets ratio owing to a difference between the tax definition and the accounting definition of “finance” and “specified leases”.

The thin capitalisation rules define what an “asset” is and what is “debt” for the purposes of calculating the debt/asset ratio. Under the rules, an asset must be calculated under generally accepted accounting practice. A debt is defined as a financial arrangement, which includes a loan.

For tax purposes, a finance or a specified lease is treated as a sale of the leased asset with a loan from the lessor to the lessee. The loan from the lessor to the lessee will always be included in the lessee’s calculation of the debt/asset ratio. The asset itself will not necessarily be included because the debt/asset ratio follows the accounting treatment of the asset. Under generally accepted accounting practice the definition of a finance lease is narrower than the definition of either a finance or a specified lease for tax purposes. Therefore, under the thin capitalisation rules, the asset definition

will not capture all the deemed assets, whereas it will capture all the deemed loans. This will in some cases, contrary to the original policy intent, overstate the debt/asset ratio and possibly require taxpayers to limit their tax deductions.

The proposed amendment will allow taxpayers to include the asset cost less accumulated depreciation (“adjusted tax value”) of the finance or specified lease asset in the definition of “asset” for thin capitalisation purposes but only if that asset has not already been included in the taxpayer’s financial accounts.

UNIT TRUSTS: DEBITS TO IMPUTATION CREDIT ACCOUNT

(Clause 50)

Summary of proposed amendment

A proposed amendment prevents a unit trust's imputation credit account being double debited. This can occur when there is both a debit resulting from a significant change to the shareholding of the unit trust and a debit of the imputation credits received when a unit trust manager redeems units with the unit trust. This is a remedial amendment designed to resolve a double taxation problem that arises through the interaction of two different provisions.

Application date

The amendment will apply from 1 April 1996, the date that section ME 41 of the Income Tax Act 1994 came into effect.

Key features

Section ME 41(2) of the Income Tax Act is to be amended to ensure that the amount of the imputation credit account debit made under section ME 41 does not include any imputation credits received from the unit trust during the relevant income year that have previously been debited under section ME 5(1)(i) because of a continuity breach.

Background

Section ME 41 provides that the imputation credits received when unit trust managers redeem units with the unit trust in the ordinary course of their business are offset by a debit to the unit trust manager's imputation credit account. This debit occurs on the date the income tax return is filed for the income year in which the dividends are derived.

When a unit trust manager breaches the shareholding continuity rules, section ME 5(1)(i) requires a unit trust manager to debit the imputation credit account of those credits in the account at the date of the shareholding change. The imputation credit account balance at the date of the shareholding change will include the imputation credits received on redemption that have not yet been offset by a section ME 41 debit. The debit that occurs as a result of the change in continuity does not remove the requirement under section ME 41 to debit the imputation credit account at the time of filing an income tax return, for the full amount of imputation credits received on redemption in that income year.

As a result, unit trust managers are effectively required to make a double debit to their imputation credit account for imputation credits received on redemption that have not previously been offset by a section ME 41 debit at the time of a shareholding continuity breach.

MULTI-RATE FBT – LOW-INCOME REBATE AND THE MULTI-RATE CALCULATION

(Clause 52)

Summary of proposed amendment

The definition of “tax on cash remuneration” is being amended to ensure that the full low-income rebate applies in the multi-rate calculation, irrespective of the employee’s residence status. The amendment ensures that employers are not required to ascertain an employee’s residence status in calculating the tax on the employee’s cash remuneration.

Application date

The amendment applies to fringe benefits provided:

- on or after 1 April 2000 for employers who pay fringe benefit tax on a quarterly or an annual basis; and
- during the 2000-2001 or a subsequent income year for an employer who pays FBT on an income year basis.

Key features

Section ND 5(1) of the Income Tax Act 1994 is being amended to ensure that in calculating the tax payable on an employee’s cash remuneration, as part of the multi-rate calculation, the low-income rebate is calculated as if the employee were resident in New Zealand for the full income year. In other words, employers do not have to apportion the low-income rebate based on the individual periods of residency in New Zealand of their employees.

Background

The Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001, enacted early this year, included an equivalent amendment to section ND 5(2) of the Income Tax Act. However, as a result of an oversight, section ND 5(1) was not amended at the same time. This proposed amendment corrects this oversight.

THE MINOR BENEFICIARY RULE

(Clauses 33, 34, 55(22) and (31))

Summary of proposed amendments

Four minor remedial amendments are proposed to the minor beneficiary rule, which requires certain distributions of beneficiary income to a minor to be taxed at 33%. The purpose of the amendments is to ensure that the legislation more clearly reflects the original policy intent.

Application date

The proposed amendments will apply to beneficiary income derived in relation to the 2001-02 and subsequent income years (the application date of the minor beneficiary rule), except if the trustee has filed a return for the 2001-2002 income year on the basis of the current legislation, before the introduction date of the amending legislation into Parliament.

Key features

- Section OB 1 of the Income Tax Act 1994 is to be amended to provide certainty that the definition of “settlement”, for the purpose of the minor beneficiary rule, has the corresponding meaning to the definition of “settlor” which was amended by the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.
- The second amendment will ensure that section HH 3D, which provides an exclusion from the rule will apply only to “mixed trusts” as intended. A mixed trust is one that has both a settlement that is caught by the rule and a settlement which is excluded from the rule.
- The third amendment, also to section HH 3D, is to clarify that the \$1,000 threshold for application of the minor beneficiary rule relates to the value of the loan(s) provided to the trust, not to the value of the interest forgone on the loan(s).
- Section HH 3F is to be amended to clarify that in determining whether a beneficiary is a “minor”, the age of the minor should be determined on the balance date of the year in which the income is earned by the trust.

Background

Amendments to the Income Tax Act 1994 enacted in March 2001 introduced the minor beneficiary rule. This rule ensures that distributions of beneficiary income from a trust to a child under the age of 16 years will be taxed at 33% as if it were trustee income.

The minor beneficiary rule is intended to limit the ability of some families to pay considerably less tax than other families on similar incomes by meeting expenses of the children through the use of trust. The rule applies to all beneficiary income distributed to a minor from a trust unless a specific exception in the legislation applies.

The minor beneficiary rule applies to income derived in relation to the 2001-2002 and subsequent income years.

GST – PENALTY INTEREST

(Clause 85)

Summary of proposed amendment

The amendment clarifies that penalty interest charged under a statute or regulation is treated as consideration for an exempt supply for GST purposes. The amendment removes uncertainties with the GST treatment of penalty interest charged by statutory authorities.

Application date

The amendment applies from 10 October 2001, the date of enactment of the Taxation (GST and Miscellaneous Provisions) Act 2000, in which the rules relating to the GST treatment of penalty interest were substantively changed.

Key features

The amendment clarifies that section 14(3) of the Goods and Services Tax Act 1985 applies to treat penalty interest charged under an enactment as consideration for an exempt supply.

Background

As outlined in the government discussion document *GST: A Review* and as enacted in the Taxation (GST and Miscellaneous Provisions) Act 2000, penalty interest should not, in principle, be subject to GST. The change was largely a simplification measure to remove the uncertainty about the treatment of such payments. In most cases penalty interest is equivalent to the payment of interest on the outstanding balance of the purchase price. The charge therefore compensates for the time value of money, which arguably falls outside the scope of a consumption tax such as GST. The change included in the Taxation (GST and Miscellaneous Provisions) Act applies only to charges under contract but not under statute. This has created uncertainty for some statutory authorities.

The amendment does not apply to charges that do not vary with the period of non-payment such as set fees.

GST – CHANGE-IN-USE ADJUSTMENTS

(Clauses 87 and 88)

Summary of proposed amendment

The amendment clarifies when an adjustment for GST is required for assets with a value of less than \$18,000 if there is a change in use to making taxable supplies. The amendment confirms that the adjustment should be made once and in the taxable period in which the change in use occurs.

Section 21F(3) of the Goods and Services Tax Act 1985 is being repealed and a similar provision inserted in section 21G.

This is in keeping with the original policy intent of the legislation and administrative practice.

Application date

The amendment applies from 10 October 2001, the date of enactment of the Taxation (GST and Miscellaneous Provisions) Act 2000, in which the rules relating to change-in-use adjustments were changed.

BUSINESS TAX SIMPLIFICATION

(Clauses 17, 76 and 89)

Summary of proposed amendment

Two minor remedial amendments are proposed to business tax simplification reforms enacted by the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001.

Section 23A(2) of the Goods and Services Tax Act 1985 is being added to recharacterise the GST adjustment on fringe benefits as a payment of fringe benefit tax, rather than a payment of GST, for administrative purposes. A new section DF 9 is being inserted into the Income Tax Act 1994 to prevent the GST from becoming deductible for income tax purposes.

Section 139B of the Tax Administration Act 1994 is being amended to make it clear that some of the debt subject to compulsory deductions must be repaid for late payment penalties to be cancelled in relation to that debt.

Application date

The amendments will apply from the same time that the underlying reforms took effect.

OTHER MINOR TECHNICAL AMENDMENTS

A number of other minor technical amendments are being made to the tax Acts. None of these amendments results in a policy change.

Absolute assignments of a financial arrangement with deferred consideration

(Clause 26)

Section EH 46(4) is inserted into the Income Tax Act 1994 to clarify the policy intention that an absolute assignment of existing financial arrangements with deferred considerations will not terminate the financial arrangements. Thus, a base price adjustment will not be performed for the financial arrangements under these circumstances and the deferred considerations will not be brought to tax under the base price adjustment. Instead, the deferred considerations will be taxed, as originally intended, on an accrual basis over the term of the arrangements.

Non-standard income year provisional taxpayers

(Clause 46)

An amendment clarifies the law to ensure that taxpayers in a “non-standard income year” can elect to become provisional taxpayers under section MB 2A of the Income Tax Act 1994. The amendment will apply from the 1998-99 income year (the application date of the section being amended)

Inaccurate section headings

(Clauses 47 and 67)

The section heading of section MC 1 is: “Assessment and payment of terminal tax”. The assessment function of this provision (former subsection (1)) was repealed as part of the 1996 core provisions amendments. Accordingly, the section MC 1 heading is to be changed to: “Payment of terminal tax by provisional taxpayer” to more accurately reflect the section’s contents.

Section 61 of the Tax Administration Act 1994 is entitled: “Disclosure of interest in foreign investment fund”. This heading is inaccurate because section 61 requires disclosure of income interests and control interests in all foreign companies as well as interests in FIFs. Although there is some overlap between these two categories, there are many interests in foreign companies which are not FIF interests – for example, interests in grey list companies. (Exemptions from these disclosure requirements are made by the Commissioner under section 61(2).) Accordingly, the section 61 heading should be replaced by “Disclosure of interest in foreign company or foreign investment fund” to more accurately reflect the section’s contents.

Group investment funds' imputation credits

(Clause 49)

A minor drafting error in section ME 4(1)(a) is corrected to ensure that taxes paid by group investment funds on category A income would qualify for imputation credits. Category A income of group investment funds are taxed in accordance with company tax rules while category B income are taxed under the trust rules. Thus, only income taxes paid on category A income qualify for imputation credits. However, a drafting error in section ME 4(1)(a) meant that group investment funds are prohibited from claiming imputation credits on income taxes paid on category A income but are allowed to claim imputation credits on category B income since the 1997-1998 income year. The proposed amendment will correct this drafting error with retrospective effect from the 1997-1998 income year.

Charitable entity in receipt of foreign dividends

(Clause 53)

Section NH 1 is being amended to correct an error and clarify the law to ensure that a company or deemed company which is exempt from income tax under section CB 4 of the Income Tax Act 1994 (non-profit bodies' and charities' exempt income) is also exempt from dividend withholding payment obligations. The amendment will apply from the 1997-1998 income year (the application date of the core provision amendments).

Non-filing taxpayers

(Clause 55)

The definition of "non-filing taxpayer" in section OB 1 of the Income Tax Act 1994 is amended by replacing the reference to "natural person" with "person". This amendment would reinstate the position as it was before 1 April 1999, when the definition was inadvertently changed so that it referred to natural persons only. The current reference to "natural person" means that a non-resident company which derives only section NG 3-type non-resident withholding income (dividends, unrelated party interest and copyright royalties) does not come within the definition. As a consequence, such a taxpayer does not come within section BC 2, which provides that the income tax liability of a non-filing taxpayer is the total of the tax deductions required to be made from that taxpayer's gross income. As a matter of policy, this type of taxpayer should come within the definition of "non-filing taxpayer". The amendment will apply from 1 April 1999.

Definition of “disposition of property”

(Clause 55)

The definition of “disposition of property” in section OB 1 of the Income Tax Act 1994 is to be amended so that it also applies for the purpose of the definition of “settlor” (which is also contained in section OB 1). The term “disposition of property” is used in the definition of “settlor”. However, the definition of “disposition of property” does not state that it applies for the purpose of the definition of settlor, even though this is clearly the intention. The two definitions were clearly linked as parts of the trust taxation provisions in the Income Tax Act 1976. The connection was inadvertently broken when the Income Tax Act 1994 was enacted and should be reinstated.

Foreign tax credits

(Clauses 44 and 58)

Section OE 6 of the Income Tax Act 1994 is to be relocated to Part LC (relating to foreign tax credits) as new section LC 14A. Section OE 6 provides that a dividend paid by a non-resident company is deemed to be derived from that company’s country of residence for the purposes of a double tax agreement between New Zealand and that other country. The provision was originally enacted in 1960 as part of the foreign tax credit provisions and its purpose was to facilitate foreign tax credit claims by New Zealand residents. However, when the Income Tax Act 1994 was enacted this provision was incorrectly included in Part OE, as part of the provisions defining the classes of income deemed to be derived from New Zealand. The amendment would place the provision in the correct Part of the Income Tax Act 1994, which is Part LC concerning foreign tax credits.

Taxpayers not required to file income tax returns

(Clause 63)

Section 33A(1)(a) of the Tax Administration Act 1994 contains one of several conditions that must be satisfied before an individual is entitled not to file an income tax return. The condition is intended to be satisfied only if the person’s annual gross income is derived exclusively from certain types of income from employment, interest or dividends. The word “only” is to be inserted into this provision to ensure that its policy intention is more clearly stated. Also, the term “annual gross income” can be replaced with the more simple term “gross income” without changing the effect of the provision.

Trust income tax returns

(Clause 66)

Section 59(3) of the Tax Administration Act 1994 relates to income tax returns required to be filed by trustees of trusts. This provision is to be amended to clarify that a trustee is required to furnish a return of all income the trustee derives, whether the income is beneficiary income or trustee income. This has always been the policy intention of this provision. However, the legislation has not been clear on this issue since a core provisions-related amendment in 1996 which replaced a reference to “whole income” with “taxable income”. This amendment will replace the taxable income reference with a reference to all income derived by a trustee of a trust. The amendment will apply from the 1997-98 income year.

Amendment to Taxation (Taxpayer Assessment and Miscellaneous Provisions) Act 2001

(Clause 95)

Section 239(1) of the Taxation (Taxpayer Assessment and Miscellaneous Provisions) Act 2001 is to be amended by omitting the reference to section 90 of the Taxation (GST and Miscellaneous Provisions) Act 2000. Section 239(1) amends the voucher provisions in section 10 of the GST Act for the period between 1 October 1986 and 19 May 1999. Section 239(1) correctly refers to amending section 10 of the GST Act as it was before its amendment by section 79 of the Taxation (Remedial Matters) Act 1999, which amendment had effect from 20 May 1999. However, the reference in the same provision to section 90 of the Taxation (GST and Miscellaneous Provisions) Act 2000 is incorrect and should be omitted. The amendment will apply from 24 October 2001.