

OVERVIEW

STATUS OF THIS DOCUMENT

This exposure draft has been prepared by the project team responsible for rewriting New Zealand's Income Tax Act 1994. It contains a full rewrite of Parts A to E of the Act, together with some provisions from other Parts that we consider should be brought into this framework or are consequential changes that need to be done at the same time. Public submissions are invited on this work, with the closing date for submissions being 30 November 2001. Submissions should be made to:

The Rewrite Project
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON.

The electronic address is policy.webmaster@ird.govt.nz

Please note submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with the Act. If you feel any part of your submission could be properly withheld under the Act (for example, for reasons of privacy), please indicate this clearly in your submission.

We are rewriting the law as it currently stands.¹ Changes to the law, other than minor ones in the interests of clarity or simplicity, will continue to be handled through the normal legislative programme. The presence or absence of provisions in the rewritten legislation does not indicate any future change in tax policy. The exceptions to this approach have already been subject to public scrutiny through discussion documents and issues papers. For example, the August 1998 discussion document *Legislating for self-assessment of tax liability* proposed the removal of various discretions given to the Commissioner of Inland Revenue and, when appropriate, their replacement with a set of criteria. The draft incorporates this change.²

¹ The draft includes all changes resulting from taxation amendment Acts up to, and including, the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001, which came into force on 27 March 2001.

² For the full implications of self-assessment, see the Taxation (Annual Rates, Taxpayer Assessment and Miscellaneous Provisions) Bill, introduced in April 2001.

HOW TO USE THIS DOCUMENT

This document is in 3 volumes.

Volume 1 provides an overview and is divided into 5 chapters.

Chapter 1 provides a background on the rewriting of the Income Tax Act.

Chapter 2 outlines some important aspects of our approach to the work.

Chapter 3 provides a background on the proposed structure of the rewritten Parts C, D, and E of the Act and the interaction of Parts A and B (the core provisions) with other key rules such as timing.

Chapter 4 summarises the proposed rewrite changes. These are minor changes that are intended to improve the legislation. They fall into 4 main types:

- changes in approach or concepts but not in underlying law;
- changes to the law and policy;
- changes to the law but not to policy (such as when the law does not reflect policy); and
- removal of unnecessary material.

Rather than present the changes according to these categories, however, we have presented them according to subject matter. So, for example, the changes in relation to dividends are presented with a background on dividends. This provides a lead-in to the detailed legislation and commentary in the next volume.

Chapter 5 presents further notes on the drafting of the rewritten provisions.

Volume 2 contains the rewritten Parts A to E, together with detailed commentary. The commentary is provided in boxes below each draft section. Also in each box is a list of the defined terms used in the section as well as the equivalent current legislative reference.

Volume 3 contains:

- the consequential amendments to the definitions in section OB 1;
- notes on the consequential amendments to the rest of the Act;
- a summary of the cross-references in a table of destinations; and
- a table identifying which of the current Z provisions have been rewritten.

CHAPTER 1: INTRODUCTION

Background

New Zealand's Income Tax Act is a very old piece of legislation, dating back to 1891. In the intervening period the Act has expanded significantly to become a more comprehensive measure of income and to reflect the changing nature of business in New Zealand. The Act had been recast on several occasions but not until the 1990s was it comprehensively reviewed from a fundamental structural and presentational perspective.

Over the past decade various reports and papers have discussed the rewriting of the Income Tax Act. There have been reports by 3 bodies – the Consultative Committee on the Taxation of Income from Capital (the Valabh Committee), the Working Party on the Reorganisation of the Income Tax Act 1976, and the Organisational Review of the Inland Revenue Department – as well as government discussion papers and issues papers prepared by government officials.

The first significant report was that of the Valabh Committee in 1990. The committee highlighted various weaknesses in the numbering, formatting and reorganisation of the legislation, including:

- the core provisions not being properly integrated with each other and the rest of the Act;
- the scheme and purpose being difficult to discern;
- the structure of the Act and the ordering of its sections not being logical;
- the organisation not adequately reflecting the Act's role, that role being to quantify taxable income, to impose the tax liability on that income and to set out the process of assessment and collection; and
- inconsistent drafting styles, redundant wording, cumbersome sections, and repetitive provisions.

To resolve these problems the Valabh Committee proposed:

- the division of the existing legislation into separate Acts;
- the division of those Acts into parts and subparts;
- the reorganisation of the legislation into a more logical and coherent scheme;
- the consolidation of certain legislation;

- the use of purpose clauses and extra-statutory references; and
- a commitment to modern drafting techniques and to plain language.

Following on from the recommendations of the Valabh Committee, the Working Party on the Reorganisation of the Income Tax Act recommended in 1993 that the Act be reordered, reorganised and progressively rewritten. The report of the Organisational Review of the Inland Revenue Department in 1994 also supported the rewriting of the Act.

Some of these recommendations have been implemented. The substantive reordering of the Income Tax Act 1976 and the Inland Revenue Department Act 1974 was completed in 1994. This produced the Income Tax Act 1994 and the Tax Administration Act 1994. New core provisions for the Income Tax Act 1994 were enacted in 1996, with effect from the 1997-98 year. As a result, the Income Tax Act is now organised by parts based around a set of core provisions under an alphanumeric numbering system, there has been some consolidation of material by topic, and the definitions have been brought together in one section.

Work over the last few years has focussed on refining the new structure and progressively redrafting Parts A to E of the Act using plain language techniques. The exercise began in 1997 and has now reached the exposure draft stage. During that time, the following documents have been issued for discussion:

- a discussion document on the possible structure and content of Parts C, D, and E and their relationship to the new core provisions (published in September 1997); and
- two issues papers identifying policy issues that had arisen in the course of rewriting (published in March 1998 and June 1998).

New Zealand has not been alone in seeing the need for rewriting its tax legislation. Similar rewrites have begun in Australia and the United Kingdom.

Our purpose

The key aim of the rewrite is to produce tax legislation that is clear, uses plain language and is structurally consistent.

Rewriting the Income Tax Act has always been seen as integral to increasing voluntary compliance with the tax laws. This is because legislation that is clear, uses plain language and is structurally consistent should make it easier for taxpayers to identify and comply with their income tax obligations.

Tax laws that are easier to understand reduce compliance costs for taxpayers and administrative costs for Inland Revenue in the following ways:

- *Lower compliance costs.* There should be less need for taxpayers to seek expert advice and, when advice is sought, the cost should be less. Fewer disputes should need to be resolved by litigation and, when litigation is necessary, the cost of the legal process should be less. There should also be less likelihood of economically desirable transactions not proceeding because of uncertainty about tax implications.
- *Lower administrative costs.* It should be easier for Inland Revenue to interpret the law and collect income tax.

We will have succeeded if:

- The rewritten legislation is accepted by all main users as clearer and easier to apply and as preserving the effect of the present legislation, apart from the agreed changes in policy.
- The lessons learnt from rewriting the legislation are used as a best practice guide for future tax legislation.

CHAPTER 2: MAIN FEATURES OF THE REWRITE PROJECT

Project structure

The Rewrite is run on project lines. Our project team comprises law drafters, policy analysts, and a tax professional who has been contracted from the private sector. The Parliamentary Counsel Office has also been involved in drafting some of the legislation.

The project has been overseen by an advisory panel chaired by Mr Colin Blair. In addition to the independent chair, the panel comprises one representative each from the New Zealand Law Society, the Institute of Chartered Accountants of New Zealand, the Treasury and Inland Revenue. The panel's core functions have been to ensure that a procedure is in place to identify any policy issues that might arise (and to refer them to Ministers with relevant comments) and to act as a 'steering committee' to monitor progress and adherence to agreed processes.

The advisory panel has met on an 'as needs' basis.

Consultation

Consistent with New Zealand's generic tax policy process, we are committed to proceeding with our work on the basis of full consultation at every stage.³ As drafts of segments have been completed they have been referred to the advisory panel for comment. Also in the lead-up to public consultation, we have subjected the drafts to quality assurance by seeking feedback from specialists both within and outside the Inland Revenue Department.

Following consideration of submissions on the exposure draft, we will put together a tax bill specifically for the rewritten legislation. Interested parties will have another opportunity to comment as the bill goes through the parliamentary process.

Techniques

We use a number of techniques when rewriting the legislation. These are all different ways of meeting our paramount objective of making the legislation easier for the reader to understand, while preserving its technical accuracy. The rewrite cannot, however, eliminate all the complexity and inconsistency

³ The generic tax policy process is the process by which policy changes to the tax laws are made. The process builds in consultation at key stages of policy development before the legislative stage.

of tax law because the subject matter is inherently complex. The challenge is to ensure the complexity results from the concepts rather than from the way the information is presented. Even then, the least complex way of expressing the concepts should be found.

Structure of the legislation

By far the most useful of these techniques is to establish the correct structure for the purpose of the legislation.⁴ This process involves the detailed analysis of all the existing material on a particular topic, including case law and original policy documents, followed by a reconstruction of the propositions in a more logical order. This restructuring has proven to be much harder and more time-consuming than originally anticipated.

The restructuring at a detailed level is complemented by the restructuring of Parts C, D, and E at a broad level. This restructuring is explained in Chapter 3.

Drafting style

We have used the propositions set out in the discussion document *Rewriting the Income Tax Act – objectives, process, guidelines* (December 1994) in conjunction with the Parliamentary Counsel Office drafting manual as the basis for drafting style.⁵ In certain areas we have also developed a set of guidelines to achieve greater consistency of style. It becomes particularly important to maintain consistency when several drafters are involved.

We have used colloquial English wherever we can, adopting shorter sentences that use the active, rather than the passive, voice and grammar that is more consistent with normal usage. We have replaced archaic expressions with more modern ones, taking care not to change the law inadvertently by rewriting words or expressions that have a well-understood meaning. In some cases we have used new terms when a term has a meaning that varies from its ordinary non-tax meaning. However, some terms have had to be retained because there is a depth of case history behind them, and more simple words of equivalent meaning cannot be found.

We have tried to harmonise definitions throughout the Act where possible, and then make it easier to find defined terms. The detail of definitions specific to particular provisions has been relocated from section OB 1 and

⁴ While the purpose of the Act has always been to tax income, what has been defined as income has changed over time. For example, the introduction of comprehensive rules for financial arrangements.

⁵ Key parts of the Parliamentary Counsel style include:

- the use of introductory sections to help readers understand what groups of sections are about;
- the clear identification of ideas and the setting out of those ideas in their own right, for example:
 - the arrangement of material in such a way as to aid understanding;
 - the use of one idea per subsection, paragraph, or subparagraph;
 - the use of short sections, except when dividing material would make an artificial break;
 - the use of plenty of headings.

placed within the relevant provisions, although a reference to the definition has been retained in section OB 1.

We group similar rules together in one place, and make greater use of signposts to guide the reader to other relevant provisions.

Format and layout

The way the text is presented on the page can make an important contribution to the overall clarity of the legislation. We have developed a new format for the exposure draft, although we are constrained for the purposes of the legislation to the style used by the Parliamentary Counsel Office. We have made no changes to the numbering system but we have limited the number of levels, going down only as far as subparagraphs.⁶

Readers' aids

For the purposes of the exposure draft, we have included detailed commentary in the boxes below each section. The boxes also contain the current section cross-references and a list of the defined terms in the section. These boxes will not be included in the final legislation, but the lists of defined terms will be retained. Also, draft Part B continues to use flow charts.

Although the exposure draft does not use any other readers' aids, it is intended that the final legislation will use readers' aids more widely.

Technical accuracy

To achieve our overall aim the rewritten legislation has to be not only clear, but also technically accurate. It must reproduce the effect of the existing legislation, except when we have made minor changes in the interests of clarity or simplicity or to reflect intended policy or when we are proposing policy changes. As part of our process of ensuring accuracy, the exposure draft has been scrutinised by internal and external experts before its public circulation.

Minor changes in the current law typically involve clarifications, or dropping material from the current legislation that has become unnecessary or obsolete. Many of the issues have already been raised through issues papers or discussion documents. In some cases, however, the first public exposure of the issue is through this exposure draft. These issues are noted, together with an explanation, in this commentary. We are, therefore, providing the opportunity for each change to be fully examined before it is incorporated into the bill. The main changes are highlighted in Chapter 4.

⁶ We have, however, made some changes to the sequence of the subparts; see Chapter 5.

Only one change is proposed that is potentially more than a clarification. This is an adjustment to the Act's dividend provisions so that the value of services supplied by a company to one of its shareholders, beyond what the shareholder supplies by way of consideration, is treated as a dividend in the shareholder's hands. A similar rule currently applies to supplies of property. We specifically invite comment on this change.

CHAPTER 3: PROPOSED STRUCTURE OF PARTS C, D, AND E

Introduction

The structure of the revised Act has been the subject of much discussion from the time of the Valabh Committee report, culminating in the September 1997 discussion document on Parts C, D, and E. That document set out a detailed structure for the 3 parts. The importance of the three as a group is that, together, they define the elements that determine net income.

The discussion document recognised that creating a clearer scheme for the Act requires a logical organisation of the material that takes into account both the function of provisions and their subject matter. Accordingly, improving the structure has been a key aim of the rewrite project.

The core provisions enacted in 1996 gave the Act a more consistent scheme, establishing the notion that each part of the Act has a specific function. The rewrite applies this notion across Parts C, D, and E and also clarifies the interaction of those parts with the core provisions. Therefore the exposure draft also contains rewritten core provisions.

General structural principles used have been:

- *Organising from the general to the specific.* Parts, subparts, and sections generally begin with more widely used rules and conclude with less widely used rules.
- *Using general rules to perform a pivotal role.* General rules have been used to overarch more specific rules. The general deductibility provision in Part D is a prime example. This approach helps to identify the inter-relationships between the provisions and any common policy intent.
- *Minimising overlap.* An aim has been to make the categories used to group items as self-contained as possible.
- *Grouping like with like.* Like functions or subject matter have been grouped for the reader's convenience and to put provisions within a context.
- *Reducing repetition.* An aim has been to minimise duplication. Applying common sets of rules is one technique that has been used to achieve this.
- *Using a consistent format.* This aids accessibility by improving the flow of the text.

- *Providing a link back to the core provisions.* Purpose provisions have not been inserted into subpart A on the basis that the title, structure, index and sub-indexes should adequately clarify the role of the Part.⁷ Instead, for Parts C and D, subpart A sets out the general rules that link back to the core provisions. Part E does not have a similar set of general rules because it contains a disparate set of regimes.
- *Placing terminating provisions into a separate subpart at the end of each part.* This is a continuation from the current Act but we have significantly culled the contents of subparts CZ, DZ, and EZ because many of the provisions are either spent or, as noted in issues papers, are unlikely to have future relevance. Deleting these provisions does not remove their application to relevant past situations, but it does reduce the size of the Act.

Structure in detail

Core provisions

A consequence of rewriting the legislation in phases is that the rewrite of later parts can necessitate changes to previously rewritten parts. This is true of the core provisions. The exposure draft largely follows the existing core provisions but with the following key changes:

- (i) Terminological changes that use plainer language – mainly:
 - ‘Gross income’ has become ‘income’ and ‘annual gross income’ has become ‘gross income’ (see draft section BC 2). ‘Gross income’ was a useful term to emphasise the change from a net to a gross basis as part of the core provisions but we consider that this change has now been sufficiently understood and embedded to allow the simpler term ‘income’ to be used. Also, some items of ‘gross income’ are, in fact, net concepts and the term is, therefore, inaccurate.
 - A new concept of ‘counted income’ distinguishes amounts of income that are taxable from amounts, such as exempt income, that are not (see draft section BD 1 (4)). The term ‘counted income’ is used both in the core provisions and in cases where the current term ‘gross income’ needs to be read as excluding exempt income – for example, when deductions are authorised. (Work is continuing on identifying other areas when the use of the narrower term is appropriate.)

⁷ When the Act was restructured in 1994, subparts CA, DA and EA were reserved for provisions setting out the purpose of the relevant part (as recommended by the *Second Report of the Working Party on the Reorganisation of the Income Tax Act 1976*, page 16).

- We consider that this approach preserves current law, under which references to ‘gross income’ must be read as excluding exempt income (see further discussion on issues related to ‘counted income’ on page 14).
- ‘Annual allowable deduction’ has become ‘gross deduction’ (see draft section BC 3). Likewise, ‘allowable deduction’ has become ‘deduction’ (see draft section BD 2). This does not imply any change to the apportionment rules (currently contained in section BD 2). The discussion document on Parts C, D, and E argued that apportionment would not be necessary if expenditure rather than the deduction was reduced, but this issue has been left until the rewriting of Part F.
- ‘Taxpayer’ is replaced by ‘person’. The Act currently applies these terms without any uniformity – some subparts refer to taxpayers while others refer to persons. We have chosen to apply ‘person’ across the board because the subtleties of the definition of ‘taxpayer’ are not evident from the term. Against this, there may be a question of whether readers understand that the term ‘person’ includes companies.
- ‘Tax year’ has been defined as the period from 1 April to 31 March. ‘Income year’ has been retained in recognition that individual taxpayers may have assessment periods that end other than on 31 March.

These terminological changes also apply more generally throughout the rewritten parts.⁸

- (ii) Definitions of ‘derived’ and ‘incurred’ have been included, based on practice and case law (see draft sections BD 3 (3) and BD 4 (3)). We specifically invite comment on these definitions. An amount needs to be derived or incurred to take on the quality of income or expenditure. These concepts also determine the income year in which the amount in question should be recognised. Common law recognises income when it is derived and allows deductions when expenditure is incurred, although some provisions override the common law in specific cases. We have retained this status quo.
- (iii) The deduction rules in current section BD 2 have been shifted to Part D (see draft section BD 2). This change was signalled in the discussion document on Parts C, D, and E. That document had also signalled current sections BD 3 and BD 4 being moved to Part E. This is no longer proposed because Part E is no longer to have the role of being a comprehensive set of all the timing rules in the Act.

⁸ Other terminological changes are discussed in Chapter 5.

- (iv) The rules on allocating income and deductions (draft sections BD 3 and BD 4) acknowledge that there are sets of rules that are not general timing regimes but nevertheless allocate amounts to income years other than simply on a derived and incurred basis, as understood by the common law (see draft sections BD 3 (2) and BD 4 (2)). The discussion document on Parts C, D, and E proposed that these timing regimes be included in non-exhaustive definitions of ‘derived’ and ‘incurred’, on a deemed basis. The reason for not adopting the discussion document approach is that we considered it would be easier for readers if we kept the timing rule and the associated income/deduction provision together, as many of the timing aspects are ancillary minor modifications and closely linked with their respective income and deduction provisions.
- (v) Certain provisions have been omitted. Section AA 2, which attempts to identify whom the Act covers, has been omitted because of its inaccuracy. Section AA 3 (1) has also been omitted because it duplicates an equivalent provision in the Interpretation Act 1999. Even though the discussion document had noted the benefit of section AA 2 as an indication to readers as to whether they are covered by the Act, it is too inaccurate as a general statement and would become too detailed if made accurate.

Overall, the core provisions retain their role of stating the principal rules on what is income, what is a deduction, and how that income or deduction is timed. Parts C, D, and E then provide the associated detail.

Issues related to ‘counted income’

We are seeking comment from readers on certain outstanding issues related to the concept of ‘counted income’.

First, in view of the overriding effect of the prohibition on deduction of amounts incurred in deriving exempt income, it may be unnecessary for the general permission authorising a deduction for amounts incurred in deriving income to refer to the narrower concept of ‘counted income’, rather than simply to ‘income’.

Second, we are considering introducing a provision to clarify explicitly that the category of ‘excluded income’ (as distinct from ‘exempt income’) consists of items that do not have any adverse effect on the ability of a person to deduct expenditure. A possible alternative is to eliminate the ‘excluded income’ category entirely and make all such amounts ‘exempt income’; the deductibility issue would, however, require consideration.

Third, although the non-New Zealand income of non-residents is currently simply not taxable rather than being exempt, we are proposing that it be treated as exempt income to remove any implication that a deduction can still arise for related expenditure.

Net regimes

As signalled in the discussion document on Parts C, D, and E, it has not been feasible to put the rules for some areas on a gross basis. Those areas are the financial arrangement rules (current subpart EH), the international rules (controlled foreign companies and foreign investment funds – current subpart CG) and the life insurance rules (current subpart CM). These are specialist, self-contained areas that produce a net amount that is either income or a deduction. Hence, even though these regimes have not been rewritten on a gross basis, they still fit within the general scheme of the rewritten Act.

Proposed structure of Part C

The proposed function of Part C is to define ‘income’ and to identify the taxpayer to whom the income belongs. It also defines amounts that would be income but are, nevertheless, exempted or excluded from income. The structure of Part C largely follows that set out in the discussion document on Parts C, D, and E, taking into account the submissions on that document; for example, business income has been given greater prominence than proposed in the discussion document.

There are 4 general categories of income under the proposed structure:

- income from business or trade-like activities;
- income from holding property (divided into 2 subparts – equity and other);
- income from employment; and
- government entitlements (such as pensions and grants).

There is no overlap between these categories. They are brought to account through the draft subpart CA and are detailed, respectively, in draft subparts CB, CC, CD, CE, and CF.

In addition, there are a number of specific regimes that give rise to income:

- Income from controlled foreign companies and foreign investment funds, life insurance, superannuation funds, petroleum mining, and mineral mining are respectively contained in draft subparts CQ, CR, CS, CT, and CU. Provisions that quantify and time when the income is recognised have been moved to Part E.
- Entity specific rules for group companies, primary producer cooperatives and crown research institutes are contained in draft subpart CV.

Income can also arise through draft subpart CG. This subpart brings together the separate provisions throughout the Act relating to recoveries and adjustments for the purposes of either:

- negating the effect of a deduction previously allocated to an income year, such as in the case of a recovered bad debt; or
- limiting the effect of a deduction in the year to which it is allocated, such as trading stock adjustments or when a government grant or suspensory loan is provided under current subpart DC.

A catch-all provision has been included in draft section CA 1 to pick up any amounts outside these categories that would be income under ordinary concepts.

Amounts that are exempt income or excluded income are, respectively, specified in draft subparts CW and CX. Exempt income covers amounts that would normally be considered to be income but are exempted by virtue of the nature of the income or who receives the income. The exemption is achieved by way of specific exemption. Excluded income covers those other amounts that the statute excludes from tax other than by specific exemption, such as an amount recoverable by an insurer in current section CC 1, as well as those items, such as fringe benefits, that are equivalent to income or would be income were it not for the fact that someone else pays the tax.

The discussion document on Parts C, D, and E proposed putting items charged with taxes other than income tax into a separate subpart in Part C on the basis they were equivalent to income or would be income were it not for another person being charged with tax. Rather than follow that approach, at this stage, we propose simply that there be 'flags' signalling, say, that an exempt dividend is subject to a foreign dividend withholding payment.

Draft subpart Y notes that there are provisions in other parts of the Act that make items income. Likewise, Part D contains a comparable subpart DY for deductions elsewhere in the Act. The placement of the provisions outside Parts C and D will be revisited as the other Parts of the Act are progressively rewritten.

Subpart Z has been retained for terminating provisions.

Proposed structure of Part D

The purpose of Part D is to define amounts that are deductions.

The discussion document on Parts C, D, and E proposed dividing deductions into 3 categories:

- deductions for expenditure or loss that satisfy the requirement of the general deductibility rule for a link with deriving gross income;
- deductions for expenditure or loss that expand on the general deductibility rule; and
- supplementary deductions created by statute.

A deduction can be denied if a general or specific limitation applies. The non-deductibility of private or domestic expenditure is an example of a general limitation, whereas the non-deductibility of bad debts, unless they are written off (current section DJ 1), is an example of a specific limitation. A general limitation can also be overridden, such as with depreciation amounts, that are allowed even though they breach the capital prohibition. A deduction for depreciation is a deduction in relation to a capital asset.

The principle behind the discussion document's approach was to make explicit whether a specific rule narrows or expands the general deductibility rule and to clarify the relationship between expansions and limitations; for example, expansions are usually subject to the general limitations.

The draft legislation adopts aspects of this approach. A general deductibility rule, entitled 'general permission', is set out in draft section DA 1. The rules in the current section BD 2 are also brought into Part D (via draft section DA 2) as 'general limitations' to the 'general permission', and draft section DA 3 provides that specific rules may override the general rules.

Specific deduction provisions are contained within subparts DB to DF and DN to DX, which cover the limitations to the general deductibility rule, a range of specific entity regimes, and supplementary deductions.

There is no further grouping of the rules, however, according to whether they expand or limit the general rule. Instead, we have taken on board the thrust of submissions that favoured the retention of a subject-based approach. This approach was seen as giving taxpayers greater comfort that, once they have dealt with the provisions in a discrete block, there are unlikely to be other provisions elsewhere that also need to be taken into account. Nevertheless, there is still a need to identify which rules override which. Hence, each section that allows a deduction concludes with a provision identifying its relationship with other deduction rules.

General deductibility rule

The general deductibility rule is an amalgam of the current section BD 2 (1)(b)(i) and (ii). These provisions allow deductions for expenditure incurred by the taxpayer either in deriving gross income or in the course of carrying on a business for the purpose of deriving the taxpayer's gross income. We have retained the 'in the course of business' test at this stage but have reservations about whether it materially extends the 'deriving gross income' test.

The discussion document proposed that the general rule also include section BD 2 (2)(e), which precludes deductions for capital expenditure (unless specifically allowed in the Act). The capital prohibition has not been included in the general deductibility rule but has instead been included in the general limitations (as the capital limitation). Grouping it with the other limitations was seen as a more appropriate location.

General limitations

The general limitations set out in draft subpart DA are, therefore, expenditure or loss:

- of a capital nature (the capital limitation);
- of a private or domestic nature (the private limitation);
- incurred in deriving exempt income (the exempt income limitation);
- incurred in deriving income from employment (the employment limitation);
- incurred in deriving schedular gross income subject to final withholding (the withholding tax limitation); and
- that is recoverable under insurance or a right of indemnity (see current section DJ 1 (c)) (the indemnity limitation).

Some items are not subject to the general limitations.

Deductibility of interest

An advantage of restating the general deductibility rule in Part D is that rules merely replicating the general rule can be deleted. The prime example of this, cited in the discussion document on Parts C, D, and E, is the interest deductibility rule in current section DD 1 (b)(i) and (ii).

Since that discussion document, the Government has proposed clarifying the law in relation to interest deductions claimed by companies, which would have a material impact on section DD 1. Those proposals are being dealt with through the 'business as usual' legislative process. Hence, in the interim and for the purposes of the exposure draft, the draft legislation does not include the proposed changes.

Subject-based approach to rest of Part D

Following the decision to group the specific deduction provisions according to subject matter, draft subparts DB to DF and DN to DX cover specific subjects. Draft subpart Y notes that there are provisions in other parts of the Act that make items income, and draft subpart Z covers terminating provisions.

Proposed structure of Part E

The purpose of Part E has varied somewhat over time and has been subject to further review in the course of preparation of this exposure draft.

The discussion document proposed dividing the rules in Part E into 3 categories: valuation rules, retrospective allocation rules, and legislative extensions of 'derived' and 'incurred'. This approach would have brought all timing rules together in Part E. The discussion document envisaged a general valuation rule covering trading stock, depreciable assets, revenue account property, unexpired accrual expenditure, and deferral of gross income. The rule was to be based on that currently applied to trading stock, which effectively produces an adjustment for the difference between opening and closing values.

Submissions did not favour a wide valuation rule, particularly in relation to depreciation and the proposed treatment of depreciation clawback on realisation of a depreciable asset.

After further consideration, our proposed general approach to Part E is now to revert to the Working Party on the Reorganisation of the Income Tax Act's concept of Part E as a home for sets of rules that have a predominant focus on matching or allocation. As a number of the existing sets of such rules deal with quantification, it seems appropriate to signal this in the title of the Part.

Given that Part E, under this approach, would contain a range of provisions and sets of rules with differing operative effects, we do not propose at this stage to have some general opening provisions. To some extent, such rules are already contained in the core provisions.

Nor do we propose that every element of a specific provision that has a timing aspect, such as a simple rule that clarifies for the avoidance of doubt when an amount is derived or incurred, should be shifted to Part E. This is because splitting every provision would provide difficulties, from a reader's perspective, as many provisions are closely linked with their respective income and deduction provisions.

We propose, instead, that ancillary timing rules remain with the specific provision creating income or a deduction. Necessarily, there has had to be an exercise of judgment as to what is 'ancillary', bearing in mind that the ultimate aim is to achieve an enhancement in the ease with which the target audience can find its way to the correct conclusion on application of the legislation.

In addition to the rules on depreciable assets, trading stock and revenue account property, the draft Part E also contains regimes within which the timing, income and deduction rules cannot easily be separated, such as the accrual rules, the international rules and the life insurance rules. However, these groups of rules have been drafted to preserve, for Parts C and D, the actual provisions that make the timed and quantified amount either income or a deduction.

Specific timing rules

Specific timing rules may defer all or part of the income or deduction to one or more subsequent income years or, conversely, permit the income or deduction to be allocated to an earlier income period. Some timing rules do not allocate income or deductions, as such, but merely have the effect of modifying the allocation that would otherwise occur. A good example is the trading stock valuation rules, which make adjustments separate from the actual deduction claimed for the cost of the trading stock.

The key specific timing rules are:

- accrual expenditure (current section EF 1);
- revenue account property (current section EF 2);
- depreciation (current subpart EG);
- financial arrangement rules (current subpart EH); and
- valuation of trading stock (current subparts EE, EL, and EM).

Derived and incurred

In the absence of specific timing rules, timing is determined on a derived or incurred basis. The discussion document on Parts C, D, and E referred to this as the ‘default rule’. What is meant by ‘derived’ and ‘incurred’ is supported by case law, and the rewritten core provisions contain a definition of ‘derived’ based on case law. ‘Derived’ is defined as:

- when the income earning process is complete, if the income is from business activity (other than a cash basis profession); or
- in all other cases, the earlier of when it is received by the person and when it is credited in the person’s account or, in some other way, dealt with in the person’s interest or on the person’s behalf.

Other structural changes

We have moved a number of administrative rules to the Tax Administration Act 1994.

CHAPTER 4: PROPOSED REWRITE CHANGES

This part summarises the proposed rewrite changes, which are minor changes intended to improve the legislation. They fall into 4 main types:

- changes in approach or concepts but not in underlying law;
- changes to the law and policy;
- changes to the law but not to policy (such as when the law currently does not reflect policy); and
- removal of unnecessary material.

The changes are not categorised by these types but rather by subject matter. Many of the changes have been presented in earlier policy documents such as issues papers 1 and 2 and discussion documents and, therefore, take into account the submissions received on those documents. Rather than repeat all those proposals, we have mostly confined our discussion to additional policy changes or decisions not to proceed with previously signalled changes. The other changes are covered in the detailed comments that accompany the rewritten draft legislation (see volume 2).

Depreciation

<i>Current references</i> subpart EG	<i>Subject matter</i> Depreciation
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Background

These provisions cover the various methods that are currently available for calculating depreciation for tax purposes. Depreciation is unusual from a legislative perspective in that it provides a deduction for a capital item and, therefore, overrides the capital prohibition rule.

Depreciation represents an estimate of the wasting of an asset over its useful life. An asset's value reflects its ability to generate a future income stream. For many assets this income stream is expected to reduce over time. This reduction can occur for various reasons: the asset becomes obsolete, or naturally wears out, or simply has a fixed life.

When the progressive loss in economic value occurs in generating income, a deduction is provided for depreciation even though it is a non-cash expense relating to a capital asset.

Given that the deduction is only an estimate, in most cases an adjustment is done at the time an asset is sold to square up deductions with the actual change in value.

A major revision of the tax treatment of depreciation was carried out in the early 1990s following the recommendations of the Valabh Committee that tax depreciation should:

- be claimable as of right (rather than at the discretion of the Commissioner);
- reflect economic rates; and
- extend to intangible property that has a finite life.

An interim regime was put in place during the early 1990s pending the calculation of economic rates for the various asset classes.

Because of these changes, the legislation has to address the various permutations that are possible, depending on when an asset was purchased and what type of asset it was.

The legislation also covers a range of options designed to lower compliance costs:

- a pooled depreciation method that enables low-value assets of a similar type that are difficult to identify separately to be collectively, rather than individually, depreciated;
- a write-off of assets that are no longer used;
- a write-off of low-value assets; and
- an option not to claim depreciation.

The remaining provisions essentially cover what happens on the disposal of assets that have been depreciated, such as an adjustment when the depreciation that has been claimed is higher than the actual loss, and how to value assets when they are transferred between associated parties.

Approach used in the draft

To be consistent with the approach adopted for other sets of rules in Part E, the depreciation rules are drafted so as to preserve for Parts C and D the role of specifying what is income or a deduction. Hence, the focus of the depreciation rules is now on the quantification of an amount of depreciation loss. The general rules in Part DA must then be applied to identify whether or not a deduction is allowed for the loss (but with a specific override of the

limitation preventing deductions for capital amounts). This approach also clarifies the relationship between the depreciation rules and the general rules relating to deductibility of expenditure and loss. It avoids duplication of wording designed to require a link with income production appearing in both the general rules and the depreciation rules.

In the draft, specific depreciation-related definitions have been brought into the body of the text. At present, the definitions are spread between subpart EG and section OB 1. The most important definition affected by this change is ‘adjusted tax value’.

We have also brought together the provisions relating to ownership, and have specifically allowed for joint ownership. At present, the only express acknowledgement of the possibility of joint ownership is in current section EG 19 (8), which refers to disposals by partnerships.

For reasons of clarity, we have also divided disposals between actual disposals and other events that are currently deemed to be disposals.

The approach we have used differs from that outlined in the discussion document on Parts C, D, and E in that the valuation rule⁹ is not applied, and depreciation is expressed as a net rather than a gross concept. On disposal, only the net gains or losses are taken into account rather than the consideration received being gross income and the book value of the asset being treated as a deduction.

Policy issues

The draft contains no significant policy changes. The treatment of improvements has been made explicit. At present, the practice is for improvements to be treated separately from the main asset in the year that they are made, and to be eligible for a part-year depreciation deduction. After the end of the income year, the improvement can either be incorporated into the main asset, or continue to be treated as a separate depreciable item. This practice is not, however, explicitly provided for in the current legislation.

If the improvement is a separate item, the draft treats it as separately depreciable. Otherwise, the expenditure is incorporated into the cost of the asset. In either case depreciation of the improvement begins from the time the improvement is made.

⁹ This rule would have required the identification each year of opening and closing values for depreciable assets and the subtraction of the closing value from the opening value to determine the amount of the depreciation loss for an income year.

The discretion of the Commissioner of Inland Revenue in current section EG 12 has been removed.

We have also included the proposed changes outlined in issues papers 1 and 2 for depreciation:

- the removal of terminating sections EZ 3 and EZ 8; and
- changing the reference in item ‘b’ in current section EG 19 (4) from ‘cost’ to ‘base value’.

Dividends

<i>Current references</i> subpart CF	<i>Subject matter</i> Dividends
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Because we have used a substantially different approach to presenting the dividend provisions from that in the current legislation, we provide a detailed explanation of our approach below.

Background

The dividend provisions in the Act are currently contained in subpart CF. Those provisions have a varied history. Before 1958, dividends were not taxed directly. From 1958 to 1988 both the company and the shareholder were taxed with, generally, no recognition of any tax paid by the company when an amount was distributed. In 1988 the imputation system was introduced. This system allows individual dividend recipients an offset for any New Zealand tax paid by the company on the distributed income.

Also in 1988, the definition of ‘dividend’ in the Act was rewritten because it had become unwieldy, not only as a result of incorporating imputation but also through the introduction of various withholding tax rules, fringe benefit tax, and a range of policy amendments. Those policy amendments essentially widened the dividend definition to bring in non-cash items.¹⁰

In the early 1990s the Valabh Committee reviewed the definition of ‘dividend’ and several changes were made as a result. The key change was the introduction of an explicit shareholder capacity test. This test limited the definition’s coverage to distributions arising from a shareholder’s ownership interest in a company.¹¹ Since then, the main change to the

¹⁰ For example, the remission of loans to shareholders, the acquisition of property at above market rates from shareholders, the making available of company property for the private use of shareholders and the provision of low interest loans to shareholders, and shares in lieu of dividends.

¹¹ A person may receive a payment from a company in many possible capacities – for example, as an employee (in the form of wages), or payment for the provision of other services (say as a contractor), or from the sale of an asset to the company. From the perspective of a dividend, what is important is that there is a link between the payment and a person’s shareholding in the company.

definition has been to provide for the tax consequences of company law reform that facilitated the buy-back of shares.

Case law

Key cases underlying the law on dividends are *Smout v CIR* (1982) 5 NZTC 61,158 and *CIR v Brierley* (1990) 12 NZTC 7,184. These cases found the definition of 'dividend' was a code and exhaustive of the primary taxability of transactions between a company and its shareholders. A code attempts to embody everything (including the common law and existing statutes) in a coherent piece of legislation. The presumption behind these 2 cases was that distributions from a company to a shareholder that were not dividends were capital in nature and were, therefore, not taxable elsewhere within the Act.

Changes to the law since these 2 cases limit their effect. Under current section CF 2 (15), for example, a share repurchase can give rise to gross income when held on revenue account, despite the fact that an amount is excluded from being a dividend. Other exceptions are the current paragraphs CF 3 (1)(g) and (h) which, respectively, relate to fringe benefits and certain monetary remuneration received by shareholders. Although these 2 items are not dividends, they are not excluded (that is, tax-free) income in the Act.

Approach underlying the rewritten provisions

The central idea behind the definition of 'dividend' is to encompass all corporate distributions to shareholders. Accordingly, the starting point for a rewritten definition is that a dividend is any (net) transfer of value that is obtained by virtue of a shareholder's ownership interest in a company. This underlies the concept of 'transfer of value' in the draft. But there are certain limitations to this wide coverage because not all transfers of value are treated as dividends. Certain additions are also necessary. And some items are included in the legislation to remove doubt as to whether they are dividends. The adjustments are summarised in the following table.

<i>Type of adjustments</i>	<i>Reason adjustment necessary</i>
Additions	
Imputation and DWP credits	Not of value to company but are of value to shareholder
Certain foreign tax credits and refunds of foreign tax	Is a benefit to the recipient but not paid by the company
Attributed repatriation by controlled foreign company	Is a notional non-cash adjustment and so no transfer is made by the company
Taxable bonus issue	No transfer of value as there is no distribution of property
Certain non-cash benefits of shareholder-employees	Is a transfer of value but not necessarily received in shareholder capacity
Subtractions	
Returns of capital – share cancellations, treasury stock etc	Are transfers of value but no net gain to shareholder
Capital distributions on liquidation	Are transfers of value but are capital rather than income in nature
Taxed elsewhere: subject to FBT, monetary remuneration, cash distributions in relation to notional distributions, FIF interest calculated under certain methods	To ensure no double taxation
Property from amalgamating company that does not exist after the amalgamation	Is conceptually not a transfer of value as the amalgamating company remains in existence as part of the amalgamated company
Property made available by flat-owning company	No real transfer of value as is merely a form of ownership
Use of associated company's property	De minimis rule applies and also exclusion for “downwards” transfers only caught because of breadth of “associated person” rules
Included in legislation to remove doubt	
Non-taxable bonus issues	No transfer of value as no property distributed. Share splits reduce the value of existing shares. Included in legislation to confirm that they are excluded income

The approach is similar to that outlined in the discussion document on Parts C, D, and E. One major exception is that the draft follows the present legislation in making the shareholder capacity test explicit.¹² We have also retained the indicative criterion for measuring shareholder capacity (that is, the payment is made on terms different from that applying to non-shareholder relationships) even though this is only one possible factor for assessing capacity.

¹² The reason for making the capacity test explicit rather than implicit is to put the application of the test beyond doubt. Making the test explicit also removes the need specifically to exclude payments by a company to its shareholders in relation to services provided to the company.

Key policy change

Conceptually, this approach would include not only benefits arising in relation to property but also benefits from services provided by the company to its shareholders for inadequate consideration. Consequently, we intend to extend the definition of dividend to cover services provided by all organisations, not just closely-held companies.¹³ This would be a change in the law.

Benefits of this approach

The main benefits of defining ‘dividend’ generically followed by specific adjustments are that it:

- allows readers to tell at an early stage whether they need to delve further into the subpart;
- focuses on the essence of a dividend, which is a net transfer of value from the company to the shareholder in the capacity of shareholder;
- simplifies the presentation by removing the need to list all possible instances when a distribution is a dividend. ‘Transfer of value’ covers the current section CF 2 (1)(a)-(k) (apart from ‘taxable bonus issues’ in (f)); and
- facilitates future changes to the definition, since they can more readily be accommodated through changes to the adjustments.

Specific drafting style

The approach used in the draft legislation differs from the current legislation in a number of main areas.

Terminology – Use of ‘company’, ‘share’ and ‘shareholder’

These defined terms have been rewritten and rationalised. The aim is to have a consistent set of words defining when non-standard entities, such as unit trusts, category A group investment funds and producer boards, are treated as companies. Although this stretches the natural meaning of the terms ‘company’ and ‘share’, it is necessary to use a single defined term which is not so generic as to be meaningless to readers, and the relevant entities are generally ‘bodies corporate’ in nature.

The various explanations and qualifications that relate to the individual adjustments to the general rule are now located with the adjustments, and detailed calculation rules are dealt with subsequently and separately.

¹³ It can be argued that current paragraph CF 2(1)(j) captures services in relation to closely-held companies.

The current legislation is divided between what is a dividend (section CF 2 (1)) and what is not a dividend (section CF 3 (1)). Following each of these subsections is a series of provisions found both in the rest of subpart CF and elsewhere within the Act. The reader needs to go through these provisions to establish whether there are any limitations to an item specified in either section CF 2 (1) or section CF 3 (1) or, alternatively, how to calculate the amount that is, or is not, a dividend. These additional rules have generally either now been located alongside their relevant lead provision or else shifted (to avoid obscuring the basic rules) into a separate segment containing detailed calculation rules.

Complex and directly relevant definitions are incorporated back into the rules

At present, key definitions are spread between subpart CF and section OB 1. The definition most affected by this is ‘available subscribed capital’. To assist readers, complex and inter-linked definitions have generally been converted into sections located in the relevant segment of draft subpart CD.

Employment

<i>Current references</i>	<i>Subject matter</i>
section CB 5	Pensions, benefits and other compensation
section CB 6	Allowances and fees exempt
section CB 7	Public offices’ exempt income
section CB 9	Other exempt income
section CB 11	Pay of service personnel in operational areas
section CB 12	Expenditure on account of an employee
section CC	Compensation, benefits, and other payments
subpart CH	Employment-related income
subpart CI	Fringe benefits
section CL 1	Employer superannuation contributions
section DE 1	Depreciation for asset used in employment
subpart DF	Employment expenditure
subpart DG (and schedule 6A)	Entertainment tax
section EO 1	Employer superannuation contributions

Provisions relating to employee remuneration and benefits have been reordered.

- Amounts that employees are required to account for as income are brought together in draft subpart CE. This includes amounts currently included in the definition of ‘monetary remuneration’ and benefits under share purchase agreements.
- Amounts that employees would ordinarily be required to account for as income, but that are specifically exempted, are brought together in an ‘Employee or contractor income’ division of draft subpart CW (Exempt income).

- Fringe benefits are identified in a ‘Fringe benefit’ division of draft subpart CX (Excluded income).
- The specific deduction provisions for employers, currently in subpart DF, now appear in draft subpart DC (Employee and contractor expenditure). The provisions’ relationship to general deductibility rules has been made clearer.
- The rules limiting deductions for expenditure on entertainment, currently in subpart DG and schedule 6A, now appear in draft subpart DD (Entertainment expenditure).

Policy issues

Several policy issues arise in this segment. All the issues were raised in issues papers 1 and 2, and most of the changes proposed in the papers have been given effect in the draft legislation. In a few cases, however, the changes proposed by the issues papers have not been introduced following the receipt of submissions and further consideration of the issues.

- Current section CC 2 (payments to employees or former employees while on naval, military, or air service) has not been rewritten. Its repeal was proposed in issues paper 2, page 4.
- The rules about deductibility of expenditure on food and beverage if provided or consumed in an area of the taxpayer’s premises reserved for senior staff and their guests have been clarified. Currently, part A (4)(c)(ii) of schedule 6A suggests that expenditure on food and beverage is subject to the limited deduction effect of current section DG 1 only if provided or consumed in an area of the taxpayer’s premises reserved for senior staff and their guests. Draft section DD 4 in subpart DD now provides that the limited deduction rule applies regardless of whether guests are involved. This was the original policy behind the current provision, and the clarification was proposed in issues paper 2, page 22.
- Current section DF 2 (Contributions to employees’ benefit funds) has been retained and rewritten as section DC 7 of the draft. Its removal was proposed in issues paper 1, page 45, in the context of ensuring that all employer contributions to employee benefit funds, not just the sick, accident and death funds currently identified in section CI 1 (e), were subject to fringe benefit tax. The provision has been retained because of the proviso that a deduction for employer contributions is allowed only if the rights of employees to receive benefits are fully secured.
- The first part of current section DF 3 (1) (Contributions to employees’ superannuation schemes) has not been rewritten. In allowing a deduction for employer superannuation contributions, it merely replicates the general deduction rule. The part of subsection (1) that allocates the deduction to the time when the contribution is made has

been combined with current section EO 1 in a new, comprehensive timing rule for employer superannuation contributions (see draft section EK 19). Subsection (2), which denies a deduction for employer superannuation contributions to schemes that are not superannuation funds or companies has not been rewritten either. The denial pre-dates, and is now superseded by, the current foreign investment fund rules, and its removal was proposed in issues paper 1, page 46. Subsection (3), which directs a reversal of earlier deductions allowed for employer contributions to a superannuation scheme if the employer receives a benefit from the scheme, has been replaced by an income provision (draft section CG 7). This change is consistent with proposals in the discussion document on Parts C, D, and E and was specifically proposed in issues paper 1, page 46. The current limitation to contributions made in the preceding 12 months has also been removed, as proposed in the issues paper.

- Current section DF 4 (1) (Pensions payable to former employees) has been retained and rewritten as section DC 2. Its removal was proposed in issues paper 1, page 47, but the provision has now been retained to counter doubt that expenditure incurred in paying pensions to former employees has sufficient connection with deriving income or with carrying on the employer's business to satisfy the general deductibility rule.
- Current section DF 6, which allows employers a deduction of up to \$8 a week for payments made to employees or former employees called up for service in the armed forces, has not been rewritten. Its repeal was proposed in issues paper 2, page 21.

Farming and forestry

<i>Current references</i>	<i>Subject matter</i>
section CC 3	Forestry encouragement grants
section CJ 1	Income from minerals, timber, or flax
section DJ 13A	Cost of minerals, timber, or flax
subpart DL	Forestry expenditure
subpart DO	Primary sector expenditure
subpart EI	Income equalisation
section EJ 1	Spreading on disposition of timber
section EJ 2	Compensation for scrapie
section EK 1	Apportionment of fertiliser expenditure

Policy issues

Several policy issues arise in this segment. In most cases, the changes proposed in either issues papers or discussion documents have been given effect in the draft legislation. In a few cases, the proposed changes have not been introduced following the receipt of submissions and further consideration of the issues involved.

The changes that have been included are:

- Current section CC 3 (forestry encouragement grants) has not been rewritten because grants are no longer available. Repeal of the provision was proposed in issues paper 1, page 14.
- The reference to ‘flax’ in current section CJ 1 has not been rewritten. Removal of the reference was proposed in issues paper 2, page 19, on the grounds of redundancy. Amounts derived from a disposition of flax will continue to be identified as income, when appropriate, by current sections CD 3 (Business) and CD 4 (Personal property). Expenditure incurred in deriving such income will continue to be deductible under general deductibility rules.
- Current sections DO 3 and DO 4 have been rewritten as sections DO 1 and DO 4, and the current overlap between the 2 provisions has been removed. Currently, section DO 3, introduced in 1991, allows certain expenditure on assets to be deducted in the year of incurrence. At the same time, current section DO 4, an older provision, continues to direct that some of the same expenditure is to be recognised over the life of the assets under a depreciation-type scheme. The draft now provides that the expenditure in question should be deducted in the year of incurrence. This is the preferred treatment and was the intention when section DO 3 was introduced. The clarification was proposed in issues paper 1, page 32.
- Current section DO 6 allows lessors of farm land a deduction for expenditure identified in current section DO 3, which they are able to claim if they, rather than their tenants, are carrying on a farming business on the land. It has been rewritten as section DO 5, and now extends to expenditure of the type identified in current section DO 4. The change was proposed in issues paper 1, page 33.
- Current section EJ 2 has not been rewritten. The provision recognises as income compensation paid in connection with an outbreak of scrapie and allows the gross income to be spread back to the year in which the relevant animals were slaughtered. Repeal of the provision was proposed in issues paper 2, page 36.
- Current DJ 13A, which provides a specific deduction for the cost of minerals, timber, and flax (and times the expenditure), has not been rewritten. The provision essentially duplicates the general deductibility rule and revenue account property rules.

- Consistent with the principles of self-assessment outlined in the discussion document *Legislating for self-assessment of tax liability*, in particular Chapter 4, ‘Commissioner’ discretions have been removed from several provisions. An example is the requirement in current section DO 4 (4) for the Commissioner to be satisfied that vines or trees have ceased to exist or be used in the derivation of gross income (see draft section DO 4 (6)).

Films

<i>Current references</i>	<i>Subject matter</i>
section CJ 2	Income derived from films
section CN 2	Non-resident film renters
section DK 1	Limitation of deduction for certain film expenditure to amount at risk
sections EO 3	Costs acquiring any film or any right in any film
section EO 4	Cost of producing films
section EO 4A	Arrangement for expenditure on film and sale of property
section EO 4B	No time bar for adjustment resulting from EO 4A
section FB 6	Apportionment of film expenditure
section GC 11	Anti-avoidance provisions relating to section EO 3
section GD 12	Other film related anti-avoidance rules

Background

The structure of the law currently contained in the film expenditure provisions in sections EO 3 and EO 4 generally follows that outlined in the discussion document on Parts C, D, and E. The discussion document preceded the enactment of the film expenditure reimbursement provisions contained in current sections EO 4A and EO 4B.

The main structural changes made by the rewritten draft are to separate the allowable deduction and timing elements of the current film expenditure provisions in current sections EO 3 and EO 4 and move them to Parts D and E respectively. The rewritten film expenditure provisions reduce the current overlap between the film expenditure rules and arrange them in a more logical order.

Policy issues

The policy proposals flagged in the issues papers have been incorporated in the draft. Several additional policy changes have also been included, as set out below.

The following changes were proposed in issues paper 2 and have been given effect to in the draft legislation. No opposing submissions on these changes were received.

- The overlap between current sections EO 3 and EO 4 for expenditure incurred in producing a film has been removed (by removing the rules in section EO 3 relating to film production). This simplification of the legislation should not result in a substantive change in policy because section EO 3 is subject to section EO 4. Currently, a film owner who incurs expenditure in producing a film must use section EO 4 to deduct that expenditure.
- The draft provisions that replace section EO 4 provide that they are the only provisions under which ‘film production expenditure’ can be deducted.
- Broadcasters have been excluded from the rewritten film production expenditure provisions.
- We have clarified that broadcasters who incur production expenditure on a film are excluded from the film expenditure rules only if the film is produced mainly for the purpose of being broadcast in New Zealand.
- The anti-avoidance provision, current section EO 4 (12), relating to expenditure that is deemed to be incurred at the time of payment, has been relocated to Part G.

The following changes have not previously been signalled but are included in the draft:

- The reference to ‘right’ as an amount that is dependent on or calculated by reference to income from the sale, use, rental or other exploitation of a film (currently contained in section EO 4A (2)(a)(ii)) has been incorporated into the replacement provisions for sections EO 3 and EO 4. As a result, these sections constitute a code for all film-related expenditure incurred by persons who own a right in a film. This change simplifies the drafting of the replacement provisions to sections EO 4A and GD 12.
- As a result of removing the film production rules in current section EO 3, the associated anti-avoidance provisions (in subsections GC 11 (3) and (4)) have also been omitted. (The corresponding provisions for the film expenditure rules in current section EO 4 to sections EO 4 (12), GD 12 (1) and (1A) have been retained).
- Current section FB 6, which deals with the apportionment of expenditure in the acquisition of a film if the film is acquired together with other property, has been omitted because we consider it to be unnecessary.

Ancillary issues

- We have confirmed that the film expenditure rules override the matching rules for the cost of revenue account property (current section EF 2). Because all amounts received from the disposal of a film are income, films would come within the definition of ‘revenue account property’. The same issue arises with mining.
- The discussion document on Parts C, D, and E proposed relocating a number of administrative rules in the film expenditure provisions (such as section EO 4 (10), which allows the New Zealand Film Commission to revoke any provisional or final film certificate) to the Tax Administration Act 1994. However, we have retained these rules in the Income Tax Act because we consider they are integral to what is allowed as a deduction.

Financial arrangements rules

<i>Current references</i> subpart EH	<i>Subject matter</i> Financial arrangements
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Policy issues

The rules for calculating and allocating income and expenditure under financial arrangements were revised in 1999. The 1999 revisions were implemented by making the sections in subpart EH into division 1 and adding a division 2. Some minor amendments were made to division 1, but essentially it was left unchanged so as not to disturb the law under which existing financial arrangements had been made. We see no advantage in departing from that approach and rewriting it now. The draft is, therefore, a rewritten version only of subpart EH, division 2. Division 1 will be shifted to subpart EZ in the bill that implements the rewrite.

Issues paper 2 contained several suggestions for changes but they were of relevance only to division 1. Accordingly, the changes have not been made in this rewrite.

The only change that may have had some flow-on to division 2 was the proposed repeal of current section EH 1 (9)(c)(i) (EH 1 (8)(c)(i) at the time issues paper 2 was published (see page 31)). The effect of the section’s repeal would have been to remove from trustees of personal injury trusts their exemption from accounting for financial arrangements of the trust under the accrual rules. This change was not favoured by submissions and no change has been made in respect of either division 1 or division 2 arrangements.

International

<i>Current references</i>	<i>Subject matter</i>
subpart CG	Attributed foreign income
subpart DP	Attributed foreign losses and foreign investment fund losses

The structure of these provisions has been altered in a number of ways:

- Provisions relating to both the controlled foreign company (CFC) rules and the foreign investment fund (FIF) rules have been re-ordered.
- Provisions that merely create the income amount or deduction amount have been included in, respectively, draft subparts CQ (Attributed income from foreign equity) and DN (Attributed losses from foreign equity). This is consistent with the structural approach in the exposure draft. Each of these subparts is subdivided to deal separately with the CFC and FIF rules. Each subpart has a section listing the criteria that must be satisfied for amounts to be attributed under either the CFC or FIF rules. These provisions cross-refer to the relevant provisions in Part E that detail the specific rules in the CFC and FIF regimes.
- The remaining detailed rules within the CFC and FIF regimes have been shifted from Part C, where they are currently located, into Part E. Because the rules apply equally to the calculation of income amounts and loss amounts, it is inappropriate to put them in Part C. Also, because the rules deal in significant part with both timing and quantification aspects, Part E is a more appropriate location.
- Some very detailed definitions have been shifted from section OB 1 into the body of the operative provisions in the new subpart EI. For example, the definition of ‘interest in an employment-related foreign superannuation scheme’ is so detailed that it best appears as a specific provision in draft subpart EI.
- Some spent provisions have been omitted, and in one case a terminating provision (relating to FIF interests held on 1 April 1993) has been shifted to Part EZ.
- Provisions in the FIF rules that deem non-market transactions to take place at market value have been shifted into Part G, subpart GD, on the basis that the Act’s structure requires subpart GD to be used for circumstances when transactions are deemed to take place at market value. However, a ‘flag’ is left in subpart EI directing readers to the relevant provision in subpart GD.

- In draft subpart EI the detailed rules of the CFC and FIF regimes have been restructured and subdivided to make it easier to understand how the detail of those regimes functions to produce a result in terms of income or loss for a taxpayer.
- Some new terminology has been introduced. In particular, the term ‘attributing interest’ has been used in the FIF rules to avoid having to use the existing term ‘interest in a foreign investment fund’ to define both what constitutes a fund and what constitutes an interest that gives rise to FIF income or loss. Also, to reduce verbosity, the acronyms CFC and FIF are used widely.

Policy issues

The issues papers raised no policy issues in relation to the international rules.

As in other areas, various discretions of the Commissioner of Inland Revenue that are, in substance, objective tests have been drafted as objective tests. This is consistent with the principles of self-assessment.

Investments

<i>Current references</i> subpart CE	<i>Subject matter</i> Investment and land income
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Policy issues

Several issues were raised in the issues papers in relation to current subpart CE. Most of those proposals have not been proceeded with.

- Issues paper 1, page 15, proposed that section CE 1 (1)(b) not be rewritten on the basis that it was redundant, given the accrual rules. After further consideration, we have retained section CE 1 (1)(b) for 2 reasons. It covers the timing issue for cash basis persons in relation to benefits that are received that would not otherwise be taken into account until a base price adjustment is made. It also covers certain arrangements that are exempt from the accrual rules altogether. For example, short-term agreements for the sale and purchase of property or services are not within the accrual rules. If a benefit is received as part of such an agreement, current section CE 1 (1)(b) would be needed to treat the amount as income.

- Issues paper 1, page 17, proposed that section CE 3 (1)(a) be repealed on the basis that a separate provision is not necessary for the amount received on redemption of a commercial bill, and instead such redemptions be included in the definition of interest. On further consideration, we decided that this approach was not appropriate and have retained current section CE 3 (1)(a).
- Issues paper 2, page 7, proposed treating investment society dividends under the definition of interest (with accrual rules implications) rather than separately under section CE 1 (1)(a). Again, after further consideration and in light of submissions, this has not been done. Not all investment society dividends are truly interest.
- Issues paper 2, page 8, proposed that section IE 1 (4) should be repealed and the general rule in section CE 4 relied on instead; the effect of the ordering rule in section IE 1 (4)(d) should be relocated to section CE 4 and the deduction for post-remission payments in section IE 1 (4)(g) should be relocated to Part D. We have incorporated the proposal into draft sections CG 2 and DB 35.
- Issues paper 2, page 8, proposed that when amounts of expenditure or loss for which a deduction has been allowed in one year are remitted in a subsequent year, the remitted amount be treated as income and allocated to the year in which the remission occurs. Currently, the remitted amount is treated as income but is backdated to the year the original deduction was taken, requiring an amendment to the tax return for that year. We have incorporated the proposal into this draft. Therefore there is no need to refer to the Commissioner having a power to amend returns to adjust for any remission amounts (current section CE 4 (3)).

Life insurance, general insurance and superannuation funds

<i>Current references</i>	<i>Subject matter</i>
subpart CM	Life insurer income
sections CN 3 to 5	Non-resident and resident insurers
sections DK 3 to 3E and DK 5	Life insurer deductions and general insurers' Reserves
section CL 2	Superannuation fund income from life policies
section DI 3	Superannuation fund expenditure

Background

These provisions deal with sections of the Act that specifically relate to the taxation of life insurers, general insurers and superannuation funds. The main structural changes relate to the life insurance provisions. These have been put into a more systematic format in Parts C, D, and E.

Policy issues

Various issues were raised in issues paper 2, pages 16, 20 and 57 to 71. Submissions on a number of points were received, and the following changes have been incorporated:

- The definition of ‘superannuation scheme’ has been changed to align it with that in the Superannuation Schemes Act 1989. This provides for consistency between the Acts.
- The transitional provisions relating to non-life insurers contained in the current section CZ 6 have been omitted as they are no longer applicable.
- Current section CL 2 provides that the trustees of investing superannuation funds are not taxed on the proceeds of life insurance policies that have been issued in New Zealand. The section has been rewritten as draft section CX 36 and altered to extend coverage to life insurance policies offered or entered into in New Zealand. This makes the provision consistent with the other parts of the life insurance tax regime.
- Current section CM 2 treats annuity business as though it were life insurance business. This section has been absorbed into the definition of ‘life insurance’.
- Current section CM 18 deals with the transfer of life insurance business between companies in a wholly owned group. The provision has been rewritten as draft section EG 42, and a change has been made to make it clear that both companies in a wholly owned group must be in the same group at the time of that transfer rather than at any time during the year.
- Current section CM 18 sets out the opening balance of the actuarial reserves that a transferee must use in performing the policyholder base income or loss calculation under section CM 15. It is the ‘aggregate of the actuarial reserves of the life insurer in respect of all policies of life insurance for which the life insurer was the insurer immediately after the transfer’. A change has been made to make it clear that the pre-existing life insurance business of the transferee is also included in the opening actuarial reserves figure.
- Current section CN 3 (2) makes it clear that non-life insurance business of a life insurer is taxed under the normal provisions of the Act. This provision was used under the former schedular approach to the taxation of life insurance. It has not been rewritten because it is no longer needed under the global/gross approach.

Livestock

<i>Current references</i>	<i>Subject matter</i>
subpart EL	Valuation methods for livestock including high-priced livestock
subpart EM	Valuation of bloodstock

Background

These provisions set out the options available to owners and bailees of livestock for valuing livestock on hand at the end of the year. Taxpayers are required to elect a particular valuation option. As with trading stock, the purpose of valuing the livestock on hand is to establish the extent to which an adjustment needs to be made to ensure that what is claimed as a deduction is only the cost of the goods that are sold. But, in the case of the herd scheme, the adjustment serves a different purpose – to ensure that any change in an animal’s average value does not have a tax impact.

At present, the livestock valuations fit into the general trading stock rules (through current section EE 2) by subtracting the opening value from the closing value to produce a valuation adjustment. Livestock is specifically included within the definition of ‘trading stock’.

In the exposure draft, ‘livestock’ is separated from the definition of ‘trading stock’. The reason for not treating livestock as trading stock is that ‘livestock’ is an amalgam of ‘plant’ and goods produced for sale.¹⁴ Despite this separation, livestock will continue to be on revenue account.

We considered moving the bloodstock and high-priced livestock schemes to the depreciation rules as their effect is very similar. The effect of the depreciation rules is also to produce an annual valuation adjustment. But we have left them with the other livestock valuation methods, on the basis that all livestock are treated as revenue account property, even though some livestock may not be procured for the purpose of being sold at a profit. This has led us to merge bloodstock into the new subpart ED rather than, as at present, have it as a separate subpart.

In contrast, the depreciation rules cover capital assets. For most depreciable assets, the clawback of any gains on sale is limited to the amount of depreciation, whereas for bloodstock and high-priced livestock there is no equivalent limit.

¹⁴ The herd scheme option for valuing livestock for tax purposes is provided in recognition that animals can be on hand to produce other goods (such as offspring, wool and milk) rather than merely as goods in their own right.

We have not attempted to define ‘livestock’ and, because we wish to treat livestock as much as possible under a general trading stock-type framework, we have not defined ‘cost price, market value, or replacement price’.

Policy issues

The policy changes incorporated in the draft are minor. They are detailed below.

The draft also includes a further proposal to clarify that a valuation election applying to a partnership does not also apply to a partner’s other interests. Otherwise, the general rule is that an election covers all of the taxpayer’s livestock. This new provision merely gives effect to the policy intent.

The issues raised in the issues papers that have been incorporated are:

- clarification of the treatment of bailment deficiencies under the herd scheme (issues paper 2, page 46), for which only a minor modification to the current section EL 5 (4) seemed necessary; and
- the removal of the spent provision EZ 1, relating to the spreading of 1992/93 income (issues paper 1, page 37).

Current subsection EL 10 (7) has also been removed on the basis that it is no longer relevant. That subsection set out the method of valuing livestock that were classified as high-priced livestock under the previous livestock valuation rules. Our expectation is that none of that livestock will still be on hand when the rewritten legislation comes into force.

There is also a question as to whether current section EZ 4 should also be eliminated as it is a transitional provision pertaining to bailments in place on 2 September 1992. At this stage it has been rewritten as draft section EZ 23.

The issues pertaining to the inter-relationship between bloodstock and trading stock (issues paper 2, pages 43 and 44) have been addressed through excluding livestock from trading stock.

Partnership elections separate from other interests

To overcome confusion as to whether a valuation election applies to all activities of a taxpayer when that taxpayer has an interest in a partnership as well as other interests, we have included a provision that makes it clear that the partnership interest is to be treated separately.

The standard rule is that an election applies to all the taxpayer’s livestock. But the intention was that taxpayers could make a separate election for the partnership interest from that of their individual interests.

Therefore, taxpayers who own their own farm and are also a partner in another farming venture do not have to apply the same valuation method chosen for the partnership to livestock on their own farm.

Ancillary issues

- The exposure draft explicitly refers to livestock having to be used in a business to qualify. This is not a change as the test is implicit in the current legislation through the general trading stock rules referring to ‘a taxpayer that carries on or owns a business’.
- There are minor terminology changes. The titles of the livestock blocks have been changed – ‘specified livestock’ has become ‘listed livestock’ and ‘non-specified livestock’ has become ‘other livestock’. The names of the schemes are unchanged.
- Provisions setting out the procedures to make a valid valuation election have been relocated to the Tax Administration Act 1994.

Mining

<i>Current references</i>	<i>Subject matter</i>
sections CJ 3-CJ 7	Income in relation to petroleum mining
section DK 2	Deduction for expenditure or loss incurred by persons associated with petroleum miners
subpart DM	Petroleum mining expenditure
subpart DN	Mineral mining expenditure

Provisions relating to both petroleum and mineral mining have been reordered:

- Provisions identifying income from mining and related activity are brought together in draft subparts CT (Income from petroleum mining) and CU (Income from mineral mining). Much of this material is currently located in Part D.
- Provisions allowing deductions related to mining activity are brought together in draft subparts DT (Petroleum mining expenditure) and DU (Mineral mining expenditure).

Policy issues

The issues papers did not cover problems relating to mining. However, the exposure draft does contain 2 minor proposed modifications.

The first is to correct a cross-referencing error to reinstate the original policy intent. The error, which involves the current section DM 4, occurred when the Income Tax Act 1976 and the Inland Revenue Department Act 1974 were reordered into the Income Tax Act 1994 and the Tax Administration Act 1994.

Current section DM 4 (2)(a)(i) provides that excess expenditure incurred before 16 December 1991 is allowed as a deduction in accordance with section DM 1 (2). That reference, however, should have been to section DM 1 (3).

Current section DM 1 (3) allows petroleum mining development expenditure to be spread over 10 years, and that was the intended treatment for the excess expenditure. Section DM 1 (2), on the other hand, provides that exploratory expenditure can be written-off in the year it is incurred, and that development expenditure should be written-off over 7 years.

The second change is to remove sections DM 11 and DZ 6 as the Maui B project is now complete.

Ancillary issues

We have clarified that the specific petroleum mining deduction provisions override the revenue account property rules (current section EF 2). As amounts derived from the sale of petroleum are income, petroleum satisfies the definition of 'revenue account property'. To avoid this overlap, we have specifically excluded petroleum mining deductions from being covered by the revenue account property rule.

Property

<i>Current references</i>	<i>Subject matter</i>
section CD 1	Land transactions
section CD 2	Royalties
section CD 3	Business
section CD 4	Personal property
section CD 6	Property obtained without colour of right
section CE 2	Income from use or occupation of land
section DJ 6	Patent expenses
section DJ 14	Expenditure on acquiring land
section DJ 15	Expenditure incurred in acquiring personal property
section DJ 16	Expenditure incurred on acquiring commercial bills
section DJ 18	Expenditure incurred in restitution
section EN 1	Timing of payments received for non-compliance with covenant to repair
section EN 2	Timing of sums received from sale of patent rights
section EN 3	Spreading of income from assignment or grant of interest in copyright
section EN 4	Spread of income from acquisition of land by Crown

section EN 5	Timing of income derived from property obtained without colour of right
section EO 2	Deduction to lessee in non-specified lease
section EO 2A	Deduction to lessee under operating lease
section EO 5	Payment for non-compliance with covenant to repair

Provisions relating to property have been reordered:

- Income provisions that are currently grouped within single sections have been split into separate sections. For example, the 3 limbs of current section CD 4 (Personal property) now appear in 3 different sections, with their subject matter clearly signalled. The different rules in current section CD 1 (Land transactions) are similarly separated.
- Amounts that are royalties, but that are currently identified in the definition of ‘royalty’ in section OB 1, are brought into the substantive royalty provision in Part C.
- Provisions that allow a deduction for expenditure incurred following non-compliance with a covenant to repair, currently in sections EN 1 and EO 5, now appear in a ‘Premises costs’ division of draft subpart DB (Specific rules for expenditure types).
- Spreading options for income and expenditure appear in a ‘Land’ division of draft subpart EJ (Spreading of specific income) and a ‘Leases’ division of draft subpart EK (Spreading of specific expenditure). However, ancillary timing rules such as current section EN 5, which times income derived from stolen property, have been relocated with the income or deduction provision to which they relate.

Policy issues

Several policy issues arise in relation to property.

- The timing of the associated person tests in current section CD 1 (2)(b), (c), and (d) has been clarified. Draft sections CB 6, CB 7 and CB 8 make clear that the test of association applies when land is acquired or, in the case of builders, improved, rather than at the time of disposal. The proposed clarification was not raised in the issues papers but is consistent with the purpose and scheme of current section CD 1, the Commissioner’s view of the current law as expressed in Public Binding Ruling 00/05, and views expressed by the Tax Education Office.
- Changes to current section CD 2 proposed in issues paper 2 have not proceeded following the receipt of submissions.

- Current section CE 2 has not been rewritten. Its predecessor was introduced in 1939 at a time when farmers whose land had an unimproved value of £3,000 or less were not liable to pay income tax. The intention of the government of the day was to ensure that farmers would pay income tax on the same basis as other income earners. However, that policy objective is now achieved by the general business rule so section CE 2 is superfluous.
- Current section EO 2 has been rewritten as section EK 17 but the application dates in current subsection (2) have not been included. Their removal, on the grounds of obsolescence, was proposed in issues paper 2, page 37. A proposal that section EO 2 be subsumed into current section EF 1 (Accrual expenditure) has not proceeded.

Trading stock

<i>Current references</i>	<i>Subject matter</i>
subpart EE	Trading stock
sections FB 3 and FB 4	Disposals of trading stock

Background

These provisions set out the valuation rules for trading stock that are used to value stock on hand at year-end. This value is then compared with last year's closing value (equivalent to this year's opening value) to derive an annual valuation adjustment. The approach adopted in the draft is consistent with the approach outlined in the discussion document on Parts C, D, and E in that the adjustment feeds into either Part C or Part D rather than, as at present, the closing value being income and the opening value a deduction.

The definition of 'trading stock' has been incorporated into the draft. However, livestock has been excluded from the definition, as have bloodstock and excepted financial arrangements. This makes no practical difference as livestock and bloodstock already have their own subparts. The reason for excluding livestock from the definition of trading stock is explained in the section on livestock.

There are 2 reasons for our excluding excepted financial arrangements from the definition. The excepted financial arrangement provisions do not fit well with the trading stock rules because they apply to all excepted financial arrangements that are revenue account property, not just those that are trading stock. Moreover, excepted financial arrangements can be valued only at cost, whereas trading stock in general can potentially be valued at either its cost, market value or replacement price.

Even though livestock, bloodstock and excepted financial arrangements have been separated from trading stock, they are all put through the same process to calculate a combined annual stock adjustment (see draft section EB 1).

Policy issues

As the rules for valuing general trading stock were revised in 1999, the draft does not contain any substantive policy changes.

Partnership issues, such as whether all partners ‘dispose’ of their trading stock when a partner leaves the partnership, have not been addressed in the draft. These issues are to be handled separately, probably as part of a general review of the tax treatment of partnerships, rather than through the rewrite.

Miscellaneous

<i>Current references</i>	<i>Subject matter</i>
section CB 2	Non-residents’ exempt income
section CB 3	Public and local authorities’ exempt income
section CB 4	Non-profit bodies’ and charities’ exempt income
section CB 5	Exempt pensions, benefits, and compensation
section CB 6	Exempt allowances and fees
section CB 8	Exempt income from Niue
section CB 9	Other exempt income
section CB 14	Exempt income of aircraft operators
section CB 15	Exempt income on share cancellations
section CK 1	Group company income
section CK 3	Primary produce co-operative companies
section CK 4	Crown Research Institutes
section CN 1	Non-resident shippers
subpart DB	Deductions for taxes and levies
subpart DC	Government grants and suspensory loans
section DD 2	Testamentary annuities charged on property
section DD 3	Interest on borrowing to purchase shares in amalgamating company
subpart DH	Motor vehicle expenditure
section DI 1	Deductions of building societies
section DI 2	Deductions of Maori authorities
section DI 4	Group company deductions
section DI 5	Beneficiary income
section DI 6	Trustee expenditure
section DJ 1	Deductions for bad debts, share losses, and indemnities
section DJ 2	Estate deductions for book debts
section DJ 3	Chatham Island dues
section DJ 4	Gifts by companies not closely held
section DJ 5	Expenditure on determining tax liability
section DJ 7	Misappropriation by partner
section DJ 8	Misappropriation by employees and others

section DJ 9	Expenditure on scientific research
section DJ 10	Expenditure on preventing or combating pollution of the environment
section DJ 11	Expenditure on borrowing money or obtaining lease
section DJ 12	Acquisition and disposition by company of own shares
section DK 4	Expenditure by airport operators
subpart EC	Adjustment for incorrect accounting practice
subpart ED	Taxes and levies

Policy issues

- Current section CB 1 (1)(a), which provides a limited exemption for interest from Post Office National Development Bonds or New Zealand Savings Certificates, has not been rewritten. The provision is obsolete and its repeal was proposed in issues paper 1, page 2.
- Current section CB 2 (1)(c), which exempts personal services income earned by visitors to New Zealand if the visit ‘does not exceed a period of 92 days’ has been rewritten as section CW 15 and now makes clear that the day of arrival and the day of departure each counts as a whole day for the purpose of calculating the 92-day period. The change makes the provision consistent with section OE 1 (4), which directs part-days to be included when calculating the 183-day period for residence, and is a clarification proposed in issues paper 1, page 6.
- An adjustment to the exclusion contained in the second proviso to current section CB 2 (1)(c), proposed in issues paper 2, page 1, has not been made. The proviso currently says that personal service income of a visitor that would otherwise be exempt is not exempt, in an income year, if the visitor is present in New Zealand for more than 92 days in aggregate during that income year. The issues paper proposed excluding the exemption if the visitor is present in New Zealand for more than 92 days in aggregate in any twelve-month period. However, the change is not being made, pending further research.
- Current section CB 3 (b)(i), which exempts any amount derived by a local authority other than ‘an amount received in trust’, has been rewritten as section CW 29 and now makes clear that the amounts intended to be excepted from the exemption are amounts that a local authority receives as a trustee.
- Current section CB 3 (b)(ii) provides that amounts derived by local authorities from a local authority trading enterprise (LATE) or certain similar trading enterprises are exempt only if the amounts are rates. Issues paper 2, page 3, proposed widening the reference to rates to include any amounts derived from the local authority performing its ‘normal civic responsibilities’. Examples given were tip fees, water charges, and fees for consent applications. However, the change has not proceeded following the receipt of submissions.

- Current section CB 3 (d), which exempts the income of Geothermal Development Limited, has not been rewritten. The provision is obsolete, and its repeal was proposed in issues paper 1, page 9.

- The following current provisions:

CB 2 (1)(a)(ii)	Non-resident entertainers
CB 4 (1)(b)	Scientific research societies
CB 4 (1)(f)	Veterinary council and clubs
CB 4 (1)(g)	Herd improvement societies
CB 4 (1)(h)	Amateur sport promoters

have been rewritten as sections CW 16, CW 38, CW 39, CW 40 and CW 35. Each denies exempt status to income of an institution if the institution is carried on for the ‘private pecuniary profit of any proprietor, member, or shareholder’. However, the policy underlying that wording is defeated if any person, not just a proprietor, member or shareholder, is able to obtain a private pecuniary profit. The class ‘any proprietor, member or shareholder’ has, therefore, been widened to ‘any person’ in each case. The change was proposed in issues paper 1, page 5.

- Current section CB 5 (1)(d), which exempts certain retiring allowances of former public servants of the Cook Islands and Western Samoa, has not been rewritten. The payments identified in the provision are now deemed not to be income by section HH 3 (5), the provision that provides generally that distributions to beneficiaries from a qualifying trust are not income. The provision is, therefore, superfluous. Its repeal was proposed in issues paper 1, page 11.
- Changes to section CD 2 proposed in issues paper 2 have not been made following the receipt of submissions.
- Current section CK 2, which provides that certain amounts are income of energy trading operators, has not been rewritten. No energy trading operators remain in existence and so the provision is obsolete. Its repeal was proposed in issues paper 1, page 18.
- Current section CZ 3, which imposed fringe benefit tax in limited circumstances during the period April to October 1989, has not been rewritten. The provision is obsolete, and its repeal was proposed in issues paper 1, page 22.
- A rationalisation of current section CK 3 (2) (now rewritten as draft section CV 2) with the dividend rules, proposed in issues paper 1, page 20, has not proceeded at this stage.
- Draft section DE 2 allows Inland Revenue Mileage Rates to be used to measure business use of a motor vehicle. The change was proposed in issues paper 2, page 39.

- Current section DJ 4 (now rewritten as draft section DB 30), which allows a deduction for certain gifts made by companies not closely held, continues to apply just to companies not closely held. A proposal in issues paper 1, page 31 to extend its application to closely held companies that are listed on the Stock Exchange has not yet proceeded, but was included in the recent discussion document *Tax and Charities*.
- Current sections DZ 1 to DZ 4, and EZ 1 to EZ 3, and EZ 7 and EZ 8 have not been rewritten. Their repeal was proposed in issues paper 1, pages 34 to 41.

CHAPTER 5: FURTHER NOTES ON THE DRAFT LEGISLATION

Provisions presented as if law

The rewritten provisions are presented as if they were the law, not as if they were a bill. One consequence of this approach is that cross-references in the text are not in bold, a drafting device that readers may be used to seeing in bills. Another consequence is that the commentary in the boxes uses the terms ‘section’ and ‘subsection’ for material that, when it is in a bill, is referred to as a clause or a subclause.

Numbering

In Parts C and D, sections applying to all taxpayers occupy the top of the alphabet, and sections applying to particular groups of taxpayers occupy the bottom of the alphabet,¹⁵ leaving a gap in the middle. The gap allows drafters some leeway in future to avoid the use of subparts with 3-letter identifiers – for example, a subpart CEA inserted between subparts CE and CF.

Terminology

Terminological changes made in the draft, in addition to those outlined in Chapter 3, are:

- *Acquisition.* The rewritten provisions use ‘acquisition’ and ‘acquire’ in place of expressions such as ‘acquires or becomes possessed of’, ‘acquired or created’, and ‘purchase or creation’.
- *Disposal.* The rewritten provisions use ‘disposal’ in place of ‘sale or other disposition’, ‘sale or other transfer’, ‘alienation or transfer’, and similar expressions. The verb used is ‘dispose’.
- *Mainly.* The rewritten provisions use ‘mainly’ in place of ‘primarily and principally’ and similar expressions. The expression ‘primarily and principally’ was considered by Eichelbaum J in *Newman Tours Ltd v CIR* (1989) 11 NZTC 6,027 (High Court). The judge interpreted the expression as requiring that the purpose not only be the main one, in the sense of outweighing all the other purposes, singly or collectively, but also the primary one, that is, the first one. We consider that sufficiently similar connotations can be conveyed in the single word ‘mainly’.

¹⁵ Except for subparts CZ and DZ, which have been reserved for terminating provisions.

- *They.* The rewritten provisions use ‘they’ as the singular pronoun in place of expressions such as ‘the taxpayer’s’ or ‘the person’s’, the pronouns for which are, in traditional grammar, ‘his, her, or its’. ‘They’ as the singular pronoun is already used occasionally in the Act – see, for example, section EH 33 (4)(b); its use in the rewritten provisions achieves consistency.
- *Treated.* The rewritten provisions either omit ‘deemed’ or use the word ‘treated’ in its place.

Defined terms in boxes

The list of defined terms in the boxes below each section may contain terms that are not used in the text of the section in the form in which they are defined – for example, if a section uses ‘matures’ in the sense of the defined term ‘maturity’, ‘maturity’ is listed as a defined term. This approach is authorised by section 32 of the Interpretation Act 1999, which provides that ‘[p]arts of speech and grammatical forms of a word that is defined in an enactment have corresponding meanings in the same enactment’.