Taxation (Annual Rates, Taxpayer Assessment and Miscellaneous Provisions) Bill

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

13 August 2001

Prepared by the Policy Advice Division of the Inland Revenue Department and the Treasury

CONTENTS

Interest deductibility

INTEREST DEDUCTIBILITY – OVERVIEW

Clauses 5, 21, 62, 63, 65, 92, 95, 107, 112, 157

Introduction

The proposed changes ensure that interest incurred by most companies is deductible, subject only to the existing thin capitalisation and conduit interest allocation rules. The companies affected are all companies other than qualifying companies and companies that derive certain forms of exempt income (for example, charities and local authorities). The bill proposes applying this clarification from the 2001-02 income year.

Two remedial amendments are also being made to overcome any doubt inadvertently created by amendments to the Income Tax Act's core provisions in 1997. The first amendment is to ensure that the rule that allows companies to deduct interest on borrowings used to capitalise subsidiaries that are at least 66 percent owned is fully effective. The second remedial amendment confirms that interest incurred is generally timed under the accrual rules and is not retimed by any other timing rules in the Act. These remedial amendments are to be backdated to the application of the Taxation (Core Provisions) Act 1996, that is, from the 1997-98 income year.

The bill also makes consequential reference changes affecting sections FG 8, FG 9, FH 5, HB 2, HG 9 and LF 7.

Overview of submissions

Seven submissioners commented on the bill's interest deductibility provisions. All supported the general thrust to clarify and make certain the rules on the deductibility of interest, acknowledging the compliance cost savings.

The most common theme in submissions related to the application dates of the proposals.

TIMING APPLICATION

Issue: Effective date of core interest deductibility proposal

Clause 21

Submission
(3 – Rudd Watts & Stone, 7 – Corporate Taxpayer Group, 9 – Deloitte Touche Tohmatsu, 8 – Institute of Chartered Accountants of New Zealand, 4 – New Zealand Law Society)

These submissions propose that the core interest deduction proposal:

- be made retrospective to the 1996-97 income year, when the thin capitalisation rules became effective *(Rudd Watts & Stone and New Zealand Law Society)*; or
- be made retrospective to the 1997-98 income year, when the core provisions became effective *(Deloitte Touche Tohmatsu, and Corporate Taxpayer Group)*; or
- should extend to all open year tax returns *(Institute of Chartered Accountants of New Zealand).*

Comment

Notwithstanding that from a policy perspective it is agreed that interest incurred by companies should be deductible, submissioners wanted to ensure that there would be no dispute about past interest deductions, given the uncertainty surrounding the application of the existing law. This uncertainty has been increased by the two issues papers on interest deductibility circulated by Inland Revenue's Adjudication and Rulings division. Submissioners have, therefore, proposed that the application of the new rules should be backdated.

We accept that there are grounds for backdating the core proposals to increase certainty. Not doing so runs the risk of structures previously thought valid being overturned. Any past date is arbitrary. However, it seems that accepting the suggestion of going back to the start of the 1997-98 income year, when the core provision changes took effect, is appropriate. It would cover the period of four years in which the Commissioner could normally reassess a taxpayer's position.

We believe there is little, if any, fiscal, compliance or administrative cost associated with this retrospectivity. However, the certainty gained by taxpayers appears to be significant.

Recommendation

That the core interest deductibility rule be made retrospective to the 1997-98 income year, when the core provisions of the Income Tax Act were made effective.

Issue: Timing of interest deductions

Clauses 62, 63, & 65

Submission
(3AW – Rudd Watts & Stone)

The proposed rule to ensure that interest expense as timed by the accrual rules is not retimed by any other timing rule (such as the revenue account property rule) should not be retrospective and should not apply to proposals for which commitments have been made, particularly in relation to film expenditure.

Comment

Following the rewrite of the Act's core provisions, which took effect from the 1997-98 income year, it has been arguable that interest associated with a project is a cost of that project and, therefore, is not deductible until the income from the project is realised. As we understand it, general taxpayer practice is to deduct interest as a period expense, in the period in which it is timed by the accrual rules. The proposed amendment in the bill confirms this practice and is, therefore, taxpayer-friendly as it removes any doubt about having to defer the deduction.

From a tax policy perspective, interest should be regarded as a periodic expense, not a project cost, as the project's value does not vary merely because it is debt financed rather than equity financed. In any case, as the Government discussion document on interest deductibility points out, it is frequently not possible to trace borrowings and, therefore, interest expense to their end use. Thus rules which would regard interest as a project expense would largely be ineffective.

Backdating the change is necessary to ensure that past treatment of the interest as a periodic expense is not overturned. Accordingly, the first part of the submission is not appropriate.

The second part of the submission asks that interest that forms part of a film's cost be excluded from the new rule when commitments have already been entered into. Again, the issue is one of ensuring that when interest has been regarded by taxpayers as a periodic expense, it should not be retrospectively changed. Officials doubt that anyone will be able to offer an assurance that no film-maker has regarded interest as a periodic cost.

However, it seems reasonable that when taxpayers have not regarded, or were not intending to regard, interest as a periodic expense, whether in relation to films or any other type of project, that they should be able to choose to defer the deduction if they want to. Among other things, this will ensure that tax returns do not have to be re-opened when interest has been regarded as a project cost.

Accordingly, taxpayers should be allowed, as a transitional arrangement, to regard interest as a cost subject to the timing rules in the following circumstances:

- if they have filed tax returns on that basis; or
- if in respect of unfiled 2000-01 and 2001-02 returns, they file on that basis.

There seems to be no point in going through a more formal election basis, or requiring them, say, to have a commitment to file on that basis. Almost all taxpayers will be quite happy to presume that interest is a periodic expense. Those that could be adversely affected would, however, have a choice.

Recommendation

That the submission be declined, but when taxpayers have filed on the basis that interest is a project cost, not a periodic cost, that position be grandfathered, and when, in respect of unfiled 2000-01 and 2001-02 returns, they file on a project cost basis, this be acceptable. This arrangement would not be confined to film expenditure.

DEFINITION OF "COMPANY"

Issue: The deriving of tax-exempt income from treasury stock

Clause 21

Submission
(7 – Corporate Taxpayer Group, 9 – Deloitte Touche Tohmatsu, 10 – PricewaterhouseCoopers, 4 – Institute of Chartered Accountants of New Zealand)

Company taxpayers who derive exempt income from the on-sale of treasury stock should not be excluded from using the core interest deductibility rule.

Comment

Companies are allowed, under the Companies Act 1993, to buy and sell their own shares – when they hold their own shares this is called treasury stock. Tax law makes the sale proceeds exempt income whether the shares are sold at a profit or a loss. The bill proposes that the core interest deductibility rule would not apply when a company derives exempt income other than exempt dividends.

The holding of treasury stock, while not being an everyday commercial event, should not, from a tax policy perspective, cause interest deductions to be limited. Therefore we agree with the submission.

However, the submission raises wider issues about whether there are other forms of exempt income that should qualify. What, for example, if another company in the group of companies derives the exempt income, or if the exempt income is an ancillary part of a taxable business, such as a horse stud deriving race winnings?

From a tax policy perspective, the first question raises significant issues, which we have discussed with the submissioners. The issue is that in a corporate group it is often not possible to trace borrowings to their eventual use. Indeed this is the reason for the proposed core rule. However, the core rule means that one group company can claim the interest deduction while another derives the exempt income. The exempt income limitation on the rule should, therefore, be extended to all group companies when one group company derives exempt income.

The second question can be specifically dealt with. When the race prize money is an ancillary part of a wider associated business, say a breeding operation, the core rule should apply; otherwise it should not.

We have considered all other income that the Income Tax Act exempts and are not concerned that this other income gives rise to any problems.

Recommendation

1. That the submission be accepted;

2. that when prize money is won as an ancillary part of a breeding operation, the core interest deductibility rule should apply; and

3. when a group company derives inappropriate exempt income, the core rule should not apply to any group company.

Issue: The timing of deriving gross income

Clause 21

Submission
(7 – Corporate Taxpayer Group, 9 – Deloitte Touche Tohmatsu)

The timing of the derivation of exempt income needs to be made more explicit by stipulating that the deriving of exempt income is "in the year in which the relevant interest deduction is being taken".

Comment

Clause 21 stipulates that "a company does not include a qualifying company or a company that derives exempt income, unless all of the exempt income is from dividends". The submissions are concerned that this wording is too loose. Does the deriving of exempt income in any year result in exclusion, or does the test apply on an annual basis? If the test is not on an annual basis, the submissions suggest that it may be impossible to substantiate that a company will never derive exempt income other than dividends.

Trying to tie the incurrence of interest expense to any particular income stream is not feasible. This is a driving force behind the reforms in the bill that remove the need to link the interest expense to the deriving of income. The same tracing problem arises with exempt income.

The wording in the bill presumes an on-going flow of exempt income, such as with a local authority, in which case whether the test is applied annually or otherwise, the result is the same. But, if the exempt income stream is variable, then the timing aspect becomes important. Our view is that the wording in the draft bill would apply the test to the income year in question, which is what the submissions want to achieve, rather than being open-ended. Therefore the additional wording proposed by the submissions is unnecessary.

Applying the submissions' argument for the extra wording would mean that other implicit tests in the legislation would need to be qualified by reference to income years. For example, the test of whether an entity is in fact a "company" applies on an income year basis, but the submissions have not proposed additional wording in relation to other tests.

Recommendation

That the submission be declined.

Issue: Non-resident companies

Clause 21

Submission
(Matter raised by officials)

The definition of 'company' in the new core interest deductibility rule should be qualified to confirm that for a company based outside of New Zealand which undertakes business in New Zealand, interest can only be deducted in relation to its New Zealand business.

Comment

Many entities operate in New Zealand as branches of overseas companies, those branches being legally part of the overseas companies. For tax purposes, such companies are treated as non-resident companies because they are neither incorporated in New Zealand, have their head offices in New Zealand, nor are controlled from New Zealand. New Zealand taxes non-resident companies on their New Zealand business and allows deductions for expenses, such as interest, only in relation to that business.

In changing the interest deductibility rule for companies, we are not intending also to allow non-resident companies to deduct their interest expenses in relation to their non-New Zealand activities. Such a move could have significant fiscal implications. The bill as introduced, however, leaves the issue open to doubt.

To remove this doubt we propose to explicitly exclude non-resident companies from using the new core interest deductibility rule by amending the definition of 'company' in clause 21. The definition would be amended to exclude non-resident companies except to the extent they incur interest associated with their business in New Zealand run through a fixed establishment in New Zealand or in relation to property they own in New Zealand.

Recommendation

That the submission be accepted.

DRAFTING ISSUES

Issue: Override of the exempt income prohibition

Clause 5

Submission
(4 – New Zealand Law Society)

Section BD 2(2)(b) (the provision that excludes the deduction of expenditure incurred in deriving exempt income) should be expressly overridden in the same fashion as section BD 2(2)(e) (the provision that allows certain capital expenditure to be deductible).

Comment

Clause 5 of the bill achieves this so no further change is necessary.

Recommendation

That the submission be declined.

Issue: Separate provision for interest rules

Clause 21

Submission
(8 – Institute of Chartered Accountants of New Zealand)

There should be a separate section for the interest deduction provisions. This would also necessitate a review of the consequential amendments proposed in the bill.

Comment

Currently, the provisions relating to the deductibility of interest are located in section DD 1 (investment income expenditure). The section also covers property rental expenses and losses incurred on the demolition or destruction of premises.

We agree that the interest rules are a sufficiently significant aspect to warrant a section of their own in the Income Tax Act. This issue is, however, more appropriately handled as part of the rewriting of the Act, as a core objective of the rewrite is the better reorganisation of the Act. Legislation resulting from that rewrite is planned for late this year or early next year. Reorganising the Act for the interest provisions as part of this bill would, therefore, be an unnecessary temporary fix causing a series of consequential amendments.

Recommendation

That the submission be declined, but the concept of a separate interest provision be addressed in the rewrite project.

Issue: Renumbering of section DD 1

Clause 21

Submission
(8 – Institute of Chartered Accountants of New Zealand)

The renumbering of section DD 1 as DD 1(1) should be made explicit in the bill with effect from the date of the new subsection (2).

Comment

In clause 21, additional provisions are being added to section DD 1. Because section DD 1 currently contains only one subsection, the new provisions are numbered DD 1(2) and DD 1(3), with DD 1 becoming DD 1(1).

The renumbering of DD 1 as DD 1(1) occurs automatically during the compilation stage of the legislation process. This is standard practice. It is, therefore, unnecessary for clause 21 to have a separate provision explicitly dealing with this.

Recommendation

That the submission be declined.

INTEREST DEDUCTIONS FOR PARTNERSHIPS

Submission
(8 – Institute of Chartered Accountants of New Zealand)

The issue of interest deductions for partnerships should be addressed as part of the tax work programme project on partnerships.

Comment

The provisions in the bill cover certain companies only. Extending the proposals beyond companies would require significant work because of concerns about the private/business boundary. The tax policy work programme includes a project on aspects of the tax treatment of partnerships, and interest deductions could be considered in that context as requested.

Recommendation

That the submission be accepted.

Research and development

RESEARCH AND DEVELOPMENT (R&D) – FRS 13 PROPOSAL

Clause 39

Overview

The bill introduces into the Act new sections DJ 9A and DJ 9B. The purpose of the new provisions is to reduce the uncertainty taxpayers experience in classifying R&D expenditure as either "revenue" expenditure, which is immediately deductible (provided certain conditions are met), or "capital" expenditure, which is deductible over time or may not be deductible at all. The provisions enable taxpayers to adopt the accounting classification of revenue/capital for tax purposes.

Broadly, section DJ 9A provides that R&D costs that are expensed for accounting purposes under Financial Reporting Standard 13 are not expenditure "of a capital nature" for the purposes of the Income Tax Act. This will enable R&D costs that are expensed under FRS 13 to be deductible immediately for tax provided this is allowed under general rules (that is, where there is a nexus with income, and the deduction is not otherwise prohibited).

Costs that are automatically expensed under FRS 13 because they are immaterial, however, are not automatically classified as revenue for tax purposes. The criteria in paragraphs 5.3 and 5.4 of FRS 13, which determine whether costs are revenue or capital for accounting, must be applied to such expenditure for tax purposes.

There were six submissions on the proposals. Submissions generally supported the introduction of the rules, although there were concerns about certain requirements and implementing the rules by way of a cross-reference in the Income Tax Act to an accounting standard. The Institute of Chartered Accountants noted those aspects of the provisions with which it agreed. However, we have referred in our report only to submissions seeking change.

INCONSISTENCY BETWEEN DRAFT LEGISLATION AND EXPLANATORY NOTE

Clause 39

Submission
(1 – New Zealand Law Society)

The explanatory note is inconsistent with the drafting of the new provisions. The explanatory note states that taxpayers will be able to deduct for tax R&D expenditure that they expense for accounting. As currently drafted, the new provision would not have the effect of automatically making this expenditure deductible. All it does is remove the application of the capital prohibition rule to such expenditure. Also, expenditure that is expensed for accounting because it is immaterial is not automatically deductible.

Comment

Officials agree that the explanatory note is not strictly consistent with the provisions in the bill. That is, R&D expenditure that is expensed for accounting under financial reporting standard 13 (FRS 13) will not be automatically deductible. For example, expenditure that is expensed for accounting because it is immaterial is not automatically deductible. Also, a deduction could be denied if there was not a sufficient nexus with the derivation of income, or if one of the exclusions in section BD 2(2) of the Income Tax Act applied, for example if:

- the expenditure was of a private or domestic nature, or
- the expenditure was incurred in deriving exempt income, or
- the expenditure was incurred in deriving income from employment.

Although this more detailed analysis is not set out in the explanatory note, a full explanation of the provisions, including the above matters, is contained in the separate *Commentary on the Bill*.

Recommendation

No recommendation is required.

REFERENCE IN INCOME TAX ACT TO FRS 13

Clause 39

Issue: Incorporation of FRS 13 into the legislation

Submission
(1 – New Zealand Law Society, 3 – Rudd Watts & Stone)

The approach in the bill of incorporating FRS 13 into the Income Tax Act by cross-reference (rather than reproducing the relevant parts of FRS 13 in the Act) may lead to uncertainty if and when the standard changes. This is because it is unclear whether a court, when interpreting an amended FRS 13, would adopt a "static" or "ambulatory" approach. (Broadly, if the court adopted a "static" approach it would apply the version of FRS 13 that was current when the legislation was enacted. If the court adopted an "ambulatory" approach, it would apply the version of FRS 13 that was current at the time the court was interpreting the provisions.)

Incorporation by reference effectively enables the Accounting Standards Review Board (via sections 24 and 28 of the Financial Reporting Act) to amend tax law. It cannot have been Parliament's intention to give the Board the power, without consultation, to alter the scope of tax law without reference to Parliament.

The appropriate parts of FRS 13 should be reproduced in full in the legislation.

Comment

Officials consider that there are significant advantages in the proposed approach, which adopts the relevant parts of FRS 13 in tax legislation by way of cross-reference to FRS 13 rather than by reproducing the relevant parts in the legislation. If the appropriate parts of FRS 13 were reproduced in the Income Tax Act, a court might interpret the words differently than if it were interpreting FRS 13 itself. This is all the more likely because the relevant paragraphs in FRS 13 are interpreted in the light of an accompanying commentary. As the proposal is intended to clarify the capital/revenue boundary for tax purposes by linking it to the asset recognition criteria used for accounting purposes, departures from the accounting standard should be kept to a minimum.

In addition, officials consider that one of the strengths of incorporation by reference is that the tax law can automatically follow accounting practice in the area of R&D without the need to amend the tax legislation. While this would seem to provide the Accounting Standards Review Board with the power to alter the scope of tax law in this area, we understand that amendments to Financial Reporting Standards only take place after extensive consultation. This will allow changes to be monitored in time to allow a government to determine the effect of such changes and Parliament to change the tax law if necessary.

This approach of cross-referencing in the Income Tax Act to a financial reporting standard already applies in relation to the trading stock provisions, which refer to FRS 4 (Accounting for Inventories). As far as officials are aware, this has not caused any difficulty.

Officials do, however, agree that, if FRS 13 should change, it may be unclear whether the original or new version of the standard applies. As taxpayers generally should be able to track accounting practice in this area, it is appropriate that the provision refer to the latest version of FRS 13. This is the approach adopted in the trading stock rules which refer to FRS 4, or an equivalent standard issued in its place.

Recommendation

That section DJ 9A be amended to make it clear that the reference to FRS 13 is a reference to the latest version of FRS 13.

Issue: Accounting principles should not be imported into the tax law

Submission
(5 – Rudd Watts & Stone)

While it is recognised that compliance costs can sometimes be reduced by aligning accounting and tax principles, it is not desirable to import a reference to generally accepted accounting principles (GAAP) in the manner proposed. Accounting standards are prepared without the precision necessary for importing into tax law. Also, accounting standards are prepared for a different purpose than tax legislation – for example, the application of accounting standards generally understates income.

There is also an issue of knowledge – not all taxpayers will necessarily have ready access to FRS 13, or be able to be sure that they have the most recent version of it.

Comment

Officials accept that financial reporting standards and tax legislation are written with different purposes in mind. Financial reporting standards are written to ensure that accountants following the standards provide their stakeholders with a "true and fair view" of the entity's economic position for the period in question. Tax rules, on the other hand, are written to provide an accurate reflection of taxpayers' income for an income year.

While these purposes are clearly different, certain aspects of financial reporting standards are useful for tax law purposes. For example, the asset-recognition criteria in FRS 13 can be usefully adopted for tax purposes. This is because the tests provide useful guidelines for approximating when a capital asset has been created for tax purposes – an area that is currently very uncertain.

However, officials recognise that not all of FRS 13 is useful in this respect. This is why the new rules do not adopt every aspect of FRS 13. For example, the concept of materiality is important for accounting purposes because it ensures that the users of the financial reports are presented only with that information that is likely to influence their decisions or assessments. The accounting concept of materiality is not useful for tax purposes because amounts that are immaterial to a particular entity for accounting purposes may nevertheless be relevant in ascertaining a taxpayer's income for an income year. This is why the concept of materiality has not been adopted for tax purposes.

In relation to the criticism that not all taxpayers will have access to FRS 13, officials point out that the provisions are optional – taxpayers can use the existing law if they prefer. Taxpayers who do not want to use existing law must refer to FRS 13 – in that case the provisions require the application of FRS 13.

Recommendation

That the submission be declined.

OPTION TO USE CURRENT LAW OR NEW RULES

Clause 39

Submission
(8 – Institute of Chartered Accountants of New Zealand)

Section DJ 9A(7) should be repealed. This provision allows taxpayers who apply FRS 13 for accounting to opt out of the new rules for tax by notifying the Commissioner. There should be no requirement for a taxpayer to notify the Commissioner to prevent the provisions from applying.

It should be clear that taxpayers can choose whether they apply the current R&D rules or the proposed deduction accounting rules based on FRS 13.

(10 – PricewaterhouseCoopers)

The proposed provisions should be amended to clarify whether the requirement to give notice under the proposed section DJ 9A(7) is optional or mandatory for taxpayers. If the requirement to give notice is mandatory, the provision should be removed on the basis that it is not necessary. If the provision is still considered necessary, the company tax return should be amended to provide taxpayers with a reminder to meet the opting out requirement.

Comment

The new R&D rules are intended to be optional. Section DJ 9A(7), as currently drafted, assumes that the new rules are the default and that taxpayers must opt out of them into the general deductibility rules by giving notice to the Commissioner.

We agree that notification imposes a compliance cost on taxpayers and propose that section DJ 9A(7) be replaced with a provision that retains the optional status of the new section without the need to notify the Commissioner so that neither the general deductibility rules nor the new rules apply as a default.

Recommendation

That the submissions be accepted and section DJ 9A(7) be replaced with a provision that acknowledges the optional status of the new section without the need to notify the Commissioner.

FOLLOWING FRS 13 IN ITS ENTIRETY

Clause 39

Submission
(8 – Institute of Chartered Accountants of New Zealand)

If taxpayers choose to use the new R&D rules they should be able to apply FRS 13 for tax purposes with no adjustment. One of the stated benefits of the new provisions was a reduction in compliance costs. To require taxpayers to adjust their R&D accounting calculation for tax purposes compromises many of the stated compliance benefits.

Comment

The purpose of the new R&D rules was not to mirror the accounting rules. The purpose was instead to clarify the R&D capital/revenue boundary by using the tests that accountants employ to establish whether an asset with sufficiently certain future economic benefits has been created. There are a number of aspects of FRS 13 that are not useful to ascertaining this boundary. For example, paragraph 2.3 of FRS 13 (which allows non-material R&D to be automatically expensed) is not concerned with this issue.

Recommendation

That the submission be declined.

APPLICATION OF PARAGRAPHS 5.14 AND 5.15 OF FRS 13

Clause 39

Submission
(8 – Institute of Chartered Accountants of New Zealand)

The write-off and write-down provisions in paragraphs 5.14 and 5.15 of FRS 13 should apply for tax purposes.

In policy terms, there is no difference between section DJ 9A(2), which allows a deduction for an amount not capitalised under paragraph 5.4, and a provision that would allow a deduction for an amount written-down or written-off under paragraphs 5.14 or 5.15. To deny taxpayers the benefit of these paragraphs also perpetuates the "black hole". ("Black hole" refers to expenditure that is neither immediately deductible nor deductible over the economic life of the asset to which the expenditure relates.)

Comment

The problem that the FRS 13 proposal is addressing is a lack of certainty over the capital/revenue boundary. Using the five asset-recognition criteria in FRS 13 as a proxy for that boundary is designed to reduce that uncertainty, and assist taxpayers in determining how much of their R&D expenditure in any income year is deductible for tax purposes.

Paragraph 5.4 of FRS-13 limits the amount of development expenditure that can be treated as capital, to the amount of the likely future economic benefit flowing from the expenditure. Because applying paragraph 5.4 can affect the amount of current year expenditure that is treated as capital or revenue, it is logical that it be allowed to be taken into account.

Paragraphs 5.14 and 5.15 apply if new information comes to light in subsequent periods, and require expenditure previously treated as capital to be reversed out of the relevant asset value and treated as revenue. The Institute has not suggested that paragraph 5.16 be applied. That paragraph requires expenditure previously written down or written off under paragraph 5.14 or 5.15 to be reinstated if the circumstances that warranted the write-down or write-off change again. If paragraphs 5.14 and 5.15 were to be taken into account, which we do not recommend, paragraph 5.16 would have to be also.

Officials do not support allowing these adjustments to be made. Because these paragraphs deal with subsequent periods, they affect the period over which an asset is written down for accounting purposes. If this submission were accepted, it could affect the rate at which an asset created from R&D was depreciated for tax purposes. It was never the intention that the FRS 13 proposal affect depreciation rates on such assets. This goes well beyond the purpose of the FRS-13 proposal, which is to reduce uncertainty over the capital/revenue boundary.

In some cases these adjustments could relate to an income year before the depreciation rules become relevant. An example is where the five asset-recognition criteria are satisfied and the relevant expenditure is, therefore, treated as capital. If the asset is not used in the following income year, and information comes to light in that year showing that some or all of that expenditure should be treated as revenue, an adjustment could be made before tax depreciation provisions apply. However, even when tax depreciation rates would not be affected, officials do not support the submission. Reflecting for tax purposes adjustments made for accounting under paragraphs 5.14, 5.15 and 5.16 goes beyond the purpose of the proposal, and significantly increases the complexity of the provisions.

The Institute suggests that allowing these adjustments would reduce the "black hole" problem. The "black hole" problem arises where expenditure is on capital account and, therefore, cannot be deducted immediately, and does not give rise to an asset that can be depreciated for tax purposes. While it is possible that applying paragraphs 5.14 and 5.15 could increase the amount of expenditure that is immediately deductible, officials consider that the complexity created by such rules would not justify any limited reduction in the "black hole".

Recommendation

That the submission be declined.

R&D CARRIED OUT BY OR ON BEHALF OF A TAXPAYER

Clause 39

Submission
(8 – Institute of Chartered Accountants of New Zealand)

Proposed section DJ 9A(3), which limits the application of the new rules to R&D carried out by the taxpayer or by a person on the taxpayer's behalf, is unnecessary and should be removed.

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

MATERIALITY

Issue: Immaterial expenditure should be immediately deductible

Clause 39

Submission
(8 – Institute of Chartered Accountants of New Zealand, 10 PricewaterhouseCoopers, 11 – New Zealand Chambers of Commerce)

Taxpayers should not, for tax purposes, be required to subject R&D expenditure that has been expensed under FRS 13 because it is immaterial, to the five asset-recognition criteria in FRS 13. Immaterial R&D expenditure should be immediately deducted for tax purposes.

One of the stated purposes of the new rules was to reduce compliance costs through taxpayers being able to use their end of year accounts for tax purposes. By ignoring concepts of materiality, taxpayers will be required to review their accounting R&D figure and make adjustments for tax purposes. This will reduce greatly the intended compliance cost savings.

The incentive that exists to capitalise for accounting purposes (to maximise profits) will prevent the materiality concept being abused. If this natural tension does not prevent abuse in every case, Inland Revenue has reserved the power under section DJ 9B to prevent expenditure from being claimed as R&D.

Comment

Under paragraph 2.3 of FRS 13, the five asset-recognition criteria apply only if their application is of material consequence. This means that if an amount of R&D expenditure incurred by a firm is not material, it may all be expensed for accounting purposes. The proposed section DJ 9A(4) states that if a taxpayer wants to make use of the new R&D provisions, the five asset-recognition criteria must be applied to all R&D expenditure whether or not their application is of material consequence.

The purpose of the new R&D rules is not to "reduce compliance costs through taxpayers being able to use their end-of-year accounts for tax purposes". As noted earlier, the purpose of the new rules is to clarify the capital/revenue boundary as it applies to R&D expenditure (which will reduce compliance costs). To do this, it is not considered necessary to import every aspect of FRS 13, including materiality, into the tax law. The aspects of FRS 13 that are useful to clarifying the capital/revenue boundary are the five asset-recognition criteria in paragraph 5.3.

The paragraph 2.3 requirement to apply the asset recognition criteria to material items is designed to ensure that the users of the financial report are only presented with useful information. The paragraph is not concerned with determining whether immaterial items expensed are assets that give rise to future economic benefits.

Officials acknowledge that allowing taxpayers to expense immaterial items for tax purposes would further reduce compliance costs. However, such an approach gives rise to equity concerns. That is, what is immaterial to one entity may be material to another. If the submissioners' approach were adopted, it would result in situations where different tax treatments would apply to the same level of R&D expenditure, depending on the size of the entity that carries out the R&D. For example, if a large multi-national corporate carried out an R&D project involving $50,000 of R&D expenditure it is likely that the expenditure would be immaterial for accounting purposes. However, if a small firm carried out the same level of R&D expenditure, it is likely that the expenditure would be material. Under the approach that submissions suggest, the small entity would be required to apply the five asset-recognition criteria to the expenditure, whereas the large entity would not. This may result in the small taxpayer being required to capitalise a portion of the expenditure for tax purposes.

What some large entities consider as immaterial R&D can run into significant amounts. Providing an automatic deduction for such expenditure could result in revenue loss. That is, if (as the proposed provisions require) the five asset-recognition criteria were applied to this expenditure, there could be cases where at least a proportion of the expenditure would be required to be capitalised.

In addition, determining what is material for accounting purposes involves, to a large extent, the exercise of judgment. The automatic deduction that would apply to immaterial R&D if this proposal were adopted could provide an incentive to label items as immaterial purely to achieve an immediate deduction.

The Institute suggests that the incentive to label items as immaterial to gain favourable tax treatment will be controlled by an entity's desire to capitalise amounts for accounting. The degree to which this natural tension will operate in practice may have been overstated. Many entities may be more driven by the tax deduction than with presenting their stakeholders with a balance sheet that capitalises R&D.

The Institute also notes that allowing a deduction for immaterial costs would not be abused because Inland Revenue has reserved the power under section DJ 9B to prevent expenditure from being claimed as R&D. Section DJ 9B does not operate as a tool for use by Inland Revenue in specific avoidance cases. Rather, it gives legislative authority to Government through the Governor-General by Order in Council, to declare certain categories of expenditure not to be R&D for the purpose of the new rules. Any such order would apply to all taxpayers.

Recommendation

That the submission be declined.

Issue: Adjustments for tax purposes where financial reports reflect principles of materiality

Clause 39

Submission
(1 – New Zealand Law Society, 11 – New Zealand Chambers of Commerce, 5 – ASB Bank Ltd))

The Law Society considers that the provisions, as currently drafted, are unclear as to whether a taxpayer will be able to take advantage of the new rules at all if principles of materiality have been used for financial reporting purposes (even if the tax return is adjusted not to take into account materiality principles). Both the Society and the New Zealand Chambers of Commerce consider that the draft rules should be amended to make it clear that the new rules are only denied *to the extent that* the requisite adjustments are not made in the tax return.

ASB Bank proposes an amendment that would apply if taxpayers who use principles of materiality for financial reporting are unable to use the proposed R&D rules.

Comment

Officials agree with submissioners that, under the current wording, there is a strong argument that access to the provision is denied if a taxpayer has applied materiality principles for financial reporting purposes. This is inappropriate, and the new rules should be amended to allow access to the provision provided the necessary adjustments are made in the tax return to discount materiality principles. Access to the new rules should be denied only to the extent that the requisite adjustments are not made in the tax return.

Recommendation

Officials agree with the submissions. The provision should be amended to make it clear that taxpayers who have applied materiality principles to R&D for financial reporting purposes have access to the provision to the extent that the taxpayer makes the necessary adjustments in the tax return to discount materiality principles applicable for accounting.

If this recommendation is adopted, the ASB Bank proposal is no longer relevant.

SIMPLIFIED RULES FOR SMALL TAXPAYERS

Clause 39

Submission
(10 – PricewaterhouseCoopers, 11 – New Zealand Chambers of Commerce)

Small taxpayers, who do not necessarily prepare financial statements in accordance with financial reporting standards, should be allowed to deduct R&D immediately without being required to apply the relevant parts of FRS 13. Without such an exception, businesses that do not prepare financial statements would either not be able to access the new R&D rules or would need to seek expert accounting advice.

The trading stock tax rules provide a simplified method for valuing closing stock for small taxpayers (defined as taxpayers with a turnover not exceeding $3 million). This valuation method recognises that certain taxpayers do not prepare financial statements in accordance with financial reporting standards and relaxes the rules accordingly. The new R&D rules should also recognise this and remove the need for small taxpayers to apply FRS 13 to their R&D expenditure.

Comment

Tax concession

To exempt "small taxpayers", however defined, from the requirement to apply the asset-recognition criteria in paragraph 5.3 of FRS 13 and allow them to deduct all R&D immediately, amounts to a tax concession for small taxpayers. This is because small taxpayers would be able to deduct immediately development costs classified as capital for accounting purposes. Other taxpayers must either argue that such costs are immediately deductible under general provisions, or (where allowed) deduct the costs over time. The purpose of the new rules was not to create a tax concession for small taxpayers. Instead the rules were intended to clarify how the capital/revenue boundary operated in the area of R&D.

A favourable tax treatment for small taxpayers could, at the margin, provide a business with a tax incentive to structure itself so as to fall within the definition of 'small taxpayer'. This is economically inefficient.

Complexity

Different R&D tax rules depending on the size of a taxpayer would give rise to complexity. It would be necessary to define "small taxpayer". A definition based on turnover would not be sufficient as a business with a small turnover could undertake an R&D project involving substantial expenditure, and deduct the expenditure without applying the asset-recognition criteria in FRS 13. It would, therefore, be necessary to determine an arbitrary limit for the amount of R&D expenditure a 'small taxpayer' could undertake in a year before being required to apply the asset-recognition criteria.

Compliance costs

Officials recognise that taxpayers that prepare financial statements without applying FRS 13 in full (or at all) will be faced with some additional compliance costs if they want to take advantage of the new R&D rules. It is, however, important to note that these taxpayers will not be required to use the new rules to deduct their R&D expenditure – the FRS 13 rules are optional. Therefore if taxpayers do not want to incur the additional compliance costs associated with applying FRS 13 they can apply general deductibility rules to their R&D.

Many taxpayers that are not required to prepare their financial statements in accordance with financial reporting standards will still employ an accountant to prepare the financial statements. For these taxpayers, access to the new R&D rules does not require that they separately seek expert accounting advice.

Officials agree that the "small taxpayer" exception in the trading stock rules reduces compliance costs for taxpayers. The trading stock exception does not, however, exempt small taxpayers from the trading stock regime itself. Instead it removes some of the information requirements for small taxpayers by providing a simplified valuation option. The small taxpayer exemption proposed by the submissions would, if enacted, go further than this and exempt small taxpayers from the core R&D rule itself.

Recommendation

That the submission be declined.

INLAND REVENUE'S POLICY STATEMENT ON THE TAX TREATMENT OF SOFTWARE

Clause 39

Submission
(10 – PricewaterhouseCoopers)

The new R&D rules apply to software development. The tax treatment of software development is discussed in Inland Revenue's 1993 policy statement on the tax treatment of computer software. As the position expressed in the statement will be inconsistent with the proposed R&D rules, the policy statement should be withdrawn, and an updated statement issued.

Comment

In May 1993 Inland Revenue published a policy statement on the tax treatment of computer software (Income Tax Treatment of Computer Software, A Policy Statement from the Commissioner of Inland Revenue, 10 May 1993). Essentially, the statement suggested the following tax treatment:

Software developed in-house for use in the business – costs of developing the software should be carried forward until the project is completed, whereupon the asset is amortised over, generally, three years.

For software developed for sale or licence – the cost of an uncompleted software project is taken into account as trading stock with the deduction for the cost of the goods effectively arising when the first sale or licence occurs.

Broadly, the new R&D rules allow an immediate deduction for the cost of developing software that constitutes R&D where such costs are expensed for accounting.

Officials agree that a review of the policy statement should be considered and have therefore referred the submission to the Rulings Unit in Inland Revenue.

Recommendation

Officials see merit in the submission and have referred it to the Rulings Unit of Inland Revenue which issues interpretation statements.

Unit trusts:
transfer of expenses proposal

UNIT TRUSTS – OVERVIEW

The bill introduces provisions addressing a number of issues that have arisen for unit trusts under the company tax rules. The amendments concern the transfer of deductible expenses from one unit trust to another unit trust, the continuity of ownership requirement for unit trusts and imputation credit streaming by unit trusts before 1996.

Transfer of expenses proposal

A qualifying unit trust will be able to elect to transfer deductible expenses it has incurred to another qualifying unit trust if it invests in whole or in part in that second unit trust. The second unit trust will be able to deduct the expenditure so transferred.

Continuity proposal

Unit holders (shareholders) of a qualifying unit trust can be treated as a "notional single person" for the purpose of the shareholder continuity rules. Provided a unit trust continues to satisfy the new definition of "qualifying unit trust", it will be able to carry forward losses and imputation tax credits without the need to incur the compliance costs associated with tracking unit-holding changes to ensure continuity has not been breached.

The definition of "qualifying unit trust" is relevant to both these proposals.

Imputation credit streaming

An exposure to an imputation tax credit streaming anti-avoidance rule for unit trusts during the period 1 April 1988 to 31 March 1996 is being removed. The situation arose whereby unit trusts did not attach imputation tax credits on unit repurchases by unit trust managers. Such a repurchase would have given rise to tax-exempt dividends for the managers during the relevant period.

The submissions received on the unit trust provisions were, on the whole, positive and welcomed the proposed changes but identified a number of technical issues with the application of these proposed rules. Given that these proposals are concessionary in nature, officials propose that the use of the provisions be closely monitored so that they are not abused. If there is evidence of the provisions not being used as they are intended the legislation will need to be reviewed.

BROADENING THE SCOPE OF THE LEGISLATION

Clause 31

Issue: Transfers to a 100% owned wholesale unit trust

Submission
(3 – Rudd Watts & Stone, 4 – New Zealand Law Society)

The proposal should be amended to allow expenditure incurred in deriving exempt dividend income to be transferred to the second unit trust where the first unit trust holds 100% of the units in the second unit trust.

Comment

The present proposal is intended to address the situation where a first unit trust incurs deductible expenditure in relation to investment in a second unit trust but receives gross income in the form of fully imputed dividends from the second unit trust. Hence, there is a problem that the first unit trust has insufficient gross income to deduct the expenditure and therefore fully utilise the imputation credits.

Officials consider that different policy considerations apply in the case where the first unit trust receives exempt dividend income from the second unit trust. Expenditure incurred in deriving exempt dividends is not deductible to the first unit trust. The scope of this proposal's intention does not extend to providing for non-deductible expenditure to be transferred to another entity to deduct.

Recommendation

That the submissions be declined.

Issue: Application to other entities

Clause 31

Submission
(1 – Investment Savings and Insurance Association of NZ Inc, 8 – Institute of Chartered Accountants of New Zealand, 6 – New Zealand Funds Management Ltd, 10 – PricewaterhouseCoopers)

The proposal should be broadened to enable transfers of expenditure from a qualifying unit trust, category A group investment fund, superannuation fund or life fund to another such entity in which it invests.

Comment

Officials are concerned about extending these rules generally because of their concessional nature, since that would allow one entity to transfer expenditure to another.

Following discussions with the Investment Savings and Insurance Association of NZ, we understand it is particularly concerned about investments by superannuation funds and category A group investment funds into qualifying unit trusts. In these cases expenditure incurred by the superannuation fund or group investment fund should be able to be transferred to the qualifying trust it invests in. The policy reason for allowing this is the same as for allowing transfers between two superannuation funds and two qualifying unit trusts. We understand that these are the most common investment scenarios.

Furthermore, other submissions argue in principle that there is no reason not to extend this proposal to cover the following scenarios:

- a qualifying unit trust investing into a category A group investment fund;
- a category A group investment fund investing into another category A group investment fund; and
- a superannuation fund investing into a category A group investment fund.

The request appears valid and we would be happy to recommend extending the rules to all the scenarios above. We are not resolved at this stage whether to recommend extending the treatment to life companies.

Recommendation

That the submission be accepted to cover the scenarios outlined above and the proposed rules modified to reflect the broadening of the scope of the rules.

Issue: Imputation credits

Clause 31

Submission
(8 – Institute of Chartered Accountants of NZ, 1 – Investment Savings and Insurance Association of NZ Inc, 6 – New Zealand Funds Management Ltd)

The proposal should be amended to provide that where a first qualifying unit trust transfers expenses to a second qualifying unit trust, a credit arises to the imputation credit account of the second unit trust to prevent a shortfall causing an inability to fully impute dividends.

Comment

At present, the proposal does not take account that the second unit trust, in reducing the tax it pays by using a deduction transferred to it, reduces the amount of credit to its imputation credit account. This would cause an inability to fully impute the actual income it has to distribute. The amendment proposed by the submission would prevent this shortfall occurring.

The issue arises because the first unit trust has surplus imputation credits attached to the dividend it receives from the second unit trust. The solution is to "balance" the credits by taking some from the first unit trust and giving them to the second unit trust.

The simplest way to implement this modified proposal is to deem a credit to arise in the second unit trust's imputation credit account equal to 33% of the amount of the expenditure transferred, and to deem a corresponding debit, equal in amount, to the first unit trust's account. The credit and debit will arise at the time the expenditure is transferred.

This deemed debit may result in the imputation credit account of the first unit trust being in debit at the end of the imputation year. Officials consider that if the deemed debit does result in an imputation debit balance, there be no requirement to pay additional tax.

Recommendation

That the submission be accepted, but a debit should also arise to the imputation credit of the first unit trust.

Issue: Change of investment

Clause 31

Submission
(8 – Institute of Chartered Accountants of NZ)

Proposed section DI 3C(8) should be amended so that the first unit trust is not required to continue investing in the second unit trust but need only have an investment in some other qualifying unit trust at all times from incurring the expenditure until the second unit trust deducts it.

Alternatively, if the submission is not accepted, the remaining balance of unused deductions (carried forward under proposed section DI 3C) should be refunded when the first unit trust disposes of its investment in the second unit trust.

Comment

The submissioner is concerned that the requirement that the first unit trust must have an investment in the second unit trust throughout the period between incurring the expenditure and the second unit trust deducting it is onerous. Investments are often fluid.

It is worth noting that there is no requirement that the expenditure which the first unit trust transfers to the second unit trust must be incurred in deriving income from that particular unit trust. There is no requirement that the expenditure be related in any way to the second unit trust. The submissioner views this as supporting the case for no requirement to continue investing in the particular second unit trust.

However, we consider there should be a relationship between the first and second unit trust when the second unit trust deducts the expenditure that is transferred from the first unit trust.

Regarding the alternative submission, the submissioner views the unused deductions as representing the amount of excess imputation credits that the proposal is designed to address. Hence, the submissioner views the unused deductions as representing overpayment of tax. However, it is not current tax policy to refund excess imputation tax credits or cash out excess expenditure (losses).

Recommendation

That the submissions be declined.

LEGISLATIVE CERTAINTY

Issue: Timing of dividend exemption

Clause 10

Submission
(8 – Institute of Chartered Accountants of NZ, 6 – New Zealand Funds Management Ltd)

The proposal should be amended by removing the words "in that income year" from proposed new section CF 3(1)(l), in order to ensure the whole amount of the consideration for the transferred expense is excluded from being a dividend.

Comment

The proposal includes a new section CF 3(1)(k), which is intended to exclude any consideration paid to the first unit trust for the transfer of expenditure from being a dividend. Officials now recommend that this new section be removed from the proposal as unnecessary. (See officials' submission below.)

However, if our recommendation to remove section CF 3(1)(l) is not accepted, our comment on the present submission is as follows. As currently worded, the exclusion appears restricted to the proportion of consideration paid for the transferred expenditure that is deducted in the income year in which the consideration is paid. It was not the intention of the proposal to place such a restriction. The restriction could be eliminated by deleting the words "in that income year" from the new section.

Recommendation

That the submission be accepted if our submission to remove section CF 3(1)(l) is not accepted. If officials' submission is accepted this submission will not be relevant.

Issue: Removal of the dividend exemption

Submission
(Matter raised by officials)

Clause 10, inserting new section CF 3(1)(l), should be removed from the bill.

Comment

The proposed new section CF 3(1)(l) would specifically provide that consideration paid to the first unit trust for transferring expenditure is not a dividend to the first unit trust.

However, the proposal proceeds on the basis that the second unit trust pays only the value of the tax benefit it derives from deducting the transferred expenditure. This will be an amount determined between the two parties at arm's length. In this case, there is a value for value transaction. The value that the first unit trust receives is a payment equal to the value that it gives. There is thus no gain to the first unit trust that will be dividend under ordinary tax rules.

In discussions with the Institute on this matter, it considered that this provision should remain to provide certainty. In discussions with other submissioners, they were more relaxed in that its inclusion could add to confusion.

Recommendation

That the submission be accepted.

Issue: Gross income of the first unit trust

Clause 31

Submission
(3 – Rudd Watts & Stone, 4 – New Zealand Law Society, 6 – New Zealand Funds Management Ltd)

There should be specific provision to exclude the amount paid to a first qualifying unit trust for transferring deductible expenditure from gross income of the first unit trust.

Comment

There is no specific provision in the proposal to exclude the amount paid to the first unit trust for transferring expenditure from being gross income. The bill does include a provision which treats the payment as not being a dividend regarding this issue.

However, the proposal proceeds on the basis that the second unit trust pays only for the value of the tax benefit it derives, which will be an amount determined by the parties at arm's length. In this case, there is a value for value transaction. The value that the first unit trust receives is a payment equal to the value that it gives. There is thus no profit to the first unit trust that will be gross income.

Furthermore, the value the first unit trust receives is derived from the "sale" of a tax benefit. This should not be regarded as part of the business or a profit-making scheme of the first unit trust. Hence, sections CD 3 and CD 4 do not apply.

In discussion with submissioners on this issue, they have argued that legislative certainty be provided. Officials propose to state clearly in the *Tax Information Bulletin* that will follow enactment that the benefit received is not gross income or a dividend for tax purposes.

The similar rules for transfer of expenditure for superannuation funds do not specifically exclude the consideration for the transfers from gross income. Making a special case for the transfer rules for unit trusts might raise interpretative difficulties with respect to these other transfer rules, for which no specific exclusion was provided.

Recommendation

That the submission be declined.

Issue: Deductible expenditure of second unit trust

Clause 31

Submission
(6 – New Zealand Funds Management Ltd)

The proposal should specifically preclude the consideration the second unit trust pays for the transferred expenditure being deductible expenditure.

Comment

The transfer of expenditure does not result in the second unit trust deriving any gross income. The consideration that the second unit trust pays for the transfer is not expenditure incurred in deriving gross income.

Furthermore, we believe that the expenditure concerned would be on capital account and therefore not deductible. Officials propose to state clearly in the *Tax Information Bulletin* that will follow enactment that the consideration paid for the expenditure transferred is not deductible.

Recommendation

That the submission be declined.

Issue: Cost price and available subscribed capital

Clause 31

Submission
(1 – Investment Savings and Insurance Association of New Zealand, 10 – PricewaterhouseCoopers)

The proposal should include provision to confirm a cost price (and hence available subscribed capital) for units issued by the second qualifying unit trust as consideration to the first qualifying unit trust for transferring expenditure under the proposal.

This cost price should be the tax benefit (that is the consideration paid) of the expenses transferred.

Comment

It is possible that the consideration provided for the expenditure transferred will be an issue to the first unit trust of additional units in the second unit trust. The submissions are concerned that unless there is specific provision confirming a cost price for such an issue, there will not be appropriate available subscribed capital for the units when they are redeemed. Similarly, the first unit trust will not be able to establish a cost price if it on-sells the units.

However, if the value of the transferred expenditure is the tax benefit of the expenditure transferred, then this is the value of the consideration the second unit trust receives for issuing the extra units. Consequently, the available subscribed capital of that class of units increases by that amount. Similarly, the value of the transferred expenditure, is the cost price to the first unit trust for the issue of the extra units, should the first unit trust on-sell the units. Hence, there is no need for a specific provision to establish a cost price and available subscribed capital.

Furthermore, to establish in legislation a cost price and available subscribed capital would give rise to uncertainty under current legislation in respect of similar situations. For example, a similar issue may arise with a group of companies where consideration is provided in the form of shares for a loss offset between the companies for tax purposes. There would also be precedential issues with such legislation.

Recommendation

That the submission be declined.

Issue: Exclusion from gift duty

Clause 31

Submission
(6 – New Zealand Funds Management Ltd)

- There should be specific provision to exclude from the application of gift duty the amount paid to a first qualifying unit trust for transferring deductible expenditure.
- There be similar provision to exclude the transfer of expenditure to the second unit trust from the application of gift duty.

Comment

There is no specific provision to exclude a payment in the form of cash or additional units by the second unit trust to the first unit trust for the amount of the expenditure transferred from the application of the Estate and Gift Duties Act 1968.

Under the Estate and Gift Duties Act, a gift arises only to the extent that the consideration for the disposition is inadequate. The consideration the first unit trust gives is the tax benefit it derives from the transferred expenditure. The proposal has proceeded on the basis that the second unit trust will pay an amount to the first unit trust for the transferred expenditure equal to this tax benefit. This is the value-for-value transaction, and consequently these amounts will not be gifts under the ordinary rules of the Estate and Gift Duties Act. In some cases the consideration paid for the transferred expenditure may be less than 33 percent of the expenditure transferred. This will not result in a gift if there is an arm's length agreement between the two parties.

Recommendation

That the submission be declined.

TRANSFERABLE EXPENDITURE

Issue: Nature of transferable expenditure

Clause 31

Submission
(8 – Institute of Chartered Accountants of NZ, 1 – Investment Savings and Insurance Association of NZ Inc, 10 – PricewaterhouseCoopers)

The restrictions in proposed section DI 3B(1)(b) on what kind of expenditure may be transferred, which are additional to the restrictions in section BD 2, should be removed. (*Institute of Chartered Accountants of NZ*)

Alternatively, expenditure should be transferable if either the restrictions in paragraphs (a) or the restrictions in paragraph (b) of proposed section DI 3B(1) are met, but it should not be necessary for the restrictions in both to be met. *(Investment Savings and Insurance Association of NZ Inc, PricewaterhouseCoopers)*

Expenditure that relates to the deriving of exempt income should be able to be transferred and deductible to the second unit trust. *(Investment Savings and Insurance Association of NZ Inc)*

Comment

We consider that the expenditure that should be allowed to be transferred to the second unit trust should be restricted to expenditure that is deductible to the first unit trust under section BD 2. The further restrictions in paragraph (b) of proposed section DI 3B(1) on what kind of expenditure may be transferred are intended to mirror the specific rules applying to transfer of expenditure for superannuation funds. However, as these specific rules apply to superannuation funds, they are permissive. They allow specified types of expenditure to be transferred to the second superannuation fund notwithstanding that section BD 2 might not allow it to be deducted by the first superannuation fund.

It may be that, in the present proposal, requiring these specific rules to be met as well as the restrictions in section BD 2 will be more restrictive than section BD 2 by itself. With some exceptions, there seems no reason to impose further restrictions on the kind of expenditure the first unit trust may transfer than that the expenditure must be deductible to it under section BD 2.

The first exception is that the first unit trust should not be able to transfer expenditure it incurs in purchasing revenue account property (particularly shares). If the first unit trust ultimately makes a loss on such revenue account property this would allow the first unit trust, in effect to transfer the loss to the second unit trust when it may not be able to do so under ordinary loss transfer rules. The second exception is that there should not be a transfer of expenditure incurred in relation to financial arrangements. An exception is warranted to cover the costs of the direct funding of the investment in

second unit trust – for example, if the first unit trust has taken out a loan to invest in the second unit trust, the interest expense could be transferred.

The proposal is intended to allow transfer of, for example, management and marketing-type expenses incurred by the first unit trust in relation to its investment in the second unit trust, rather than expenditure and losses incurred by the first unit trust relating to its own trading activities.

The Investment Savings and Insurance Association of NZ has submitted that expenditure that relates to the earning of exempt income should be able to be transferred and deducted. Section BD 2(2)(b) currently prevents the deductibility of such expenditure. Officials recommend that the expenditure relating to the deriving of exempt income should not be made deductible under this proposal.

Recommendation

That the submission be accepted, except that expenditure on revenue account property and financial arrangements (when the financial arrangement is not part of the direct funding of the investment in the second unit trust) should not be transferable. However, expenditure incurred in deriving exempt income should not.

Issue: Information required to transfer expenditure

Clause 31

Submissions
(3 – Rudd Watts & Stone, 4 – New Zealand Law Society)

The first unit trust should not be able to require information from the second unit trust in respect of the second unit trust's gross income. This information should only be available when the two unit trusts are associated.

Comment

We are recommending that the restrictions in the proposed section DI 3B(1)(b) be removed (see submission above). If our recommendation is accepted, these submissions will not be relevant.

If our recommendation is not accepted we suggest that the first unit trust be able to rely on disclosure from the second unit trust as to whether it has sufficient gross income to deduct the transferred expenditure (see submission below). This would mean that the second unit trust would not agree to receiving expense if it did not have sufficient gross income.

Recommendation

That the submissions be declined on the basis that they are not relevant if officials' recommendations are accepted.

Issue: Scope to reject transfer of expenditure

Clause 31

Submission
(1 – Investment Savings and Insurance Association of NZ Inc)

The proposal should include provision that the second unit trust may reject the transfer of expenditure.

Comment

The proposal assumes that the first unit trust and the second unit trust will communicate and agree with one another over a contemplated transfer of expenditure. It is true that, as currently drafted, the proposal appears to enable the first unit trust to elect unilaterally to make a transfer, but there is no requirement for the second unit trust to give any consideration for the transfer. The matter is left to the agreement of the parties.

Furthermore, if a first unit trust elects to transfer expenditure without the agreement of the second unit trust, there is no requirement that the second unit trust must deduct the transferred expenditure. (If it does not, the expenditure remains deductible to first unit trust under ordinary rules, and the first unit trust is able to transfer it to another "second unit trust".)

We recommend that the legislation reflect the requirement that there be an agreement between the first unit trust and second unit trust to transfer the expenditure.

Recommendation

That the submission be accepted by requiring an agreement between the two unit trusts.

TIMING OF EXPENSE TRANSFER

Issue: Expenditure incurred in same year

Clause 31

Submissions
(8 – Institute of Chartered Accountants of NZ, 2 – Ernst & Young)

Proposed new section DI 3B(4) should be amended so that the transferred expenditure is treated as incurred by the second unit trust in the income year in which it is incurred by the first unit trust, rather than "on the date" it is incurred by the first unit trust.

Similar amendments should be made with respect to the transfer of expenditure rules for superannuation funds (present section DI 3(2)) and group investment funds (present section DI 3A(2)). *(Ernst & Young)*

Comment

The proposal, as currently worded, treats transferred expenditure as incurred by the second unit trust "on the date" on which it is incurred by the first unit trust. When the first unit trust and second unit trust have different balance dates, the first unit trust, in order to comply strictly with the proposed section, will need to identify the dates on which the expenditure is incurred, and to allocate the expenditure to different income years, depending on whether it was incurred before or after the balance date of the second unit trust. A simple apportionment of annual expenditure will not satisfy the requirements of the section. This will impose unnecessary compliance costs.

The solution would be to treat the expenditure as incurred by the second unit trust in the same income year that it is incurred by the first unit trust. This seems practical and does not appear to offer any avoidance opportunities, but this will be monitored in the future. If it is being abused, officials will report to the Government on possible solutions.

Similar amendments should be made to the expenditure transfer rules for superannuation funds and group investment funds.

Recommendation

That the submission be accepted.

Issue: Time when second unit trust deducts

Clause 31

Submission
(6 – New Zealand Funds Management Ltd)

It is not clear, in proposed section DI 3C(8), what date is referred to by the words "the date on which the expenditure is deducted from the second qualifying unit trust's gross income". Hence, this wording should be replaced by "the last day of the income year in which the expenditure is deducted from the second qualifying unit trust's gross income".

Comment

We agree with this submission that the wording is unclear in this respect. The proposed amendment will allow expenditure to be transferred to the second unit trust up until the end of the income year, even though the investment relationship ceased part way through the year.

Recommendation

That the submission be accepted.

ELECTIONS

Issue: Notice of election

Clause 31

Submissions
(1 – Investment Savings and Insurance Association of NZ Inc, 8 – Institute of Chartered Accountants of NZ, 10 – PricewaterhouseCoopers)

The proposal should not require the election to be made by notice in writing to the Commissioner. Instead the election should be deemed to be made when the expenditure is actually transferred (that is, deducted by the second unit trust).

Alternatively, if the submission is not accepted, the proposal should merely require the written notification to be provided to, and retained by, the manager of the second unit trust.

Comment

The proposed legislation requires qualifying unit trusts to provide an election in writing to the Commissioner. The present rules concerning transfer of expenditure for superannuation funds, upon which the present proposal is modelled, also require the relevant election to be made by notice in writing to the Commissioner.

We agree that it would be in line with a simpler tax system not to require such a notice. Officials consider that a notice is not necessary. The unit trust manager should keep records of any transfers that can be provided to Inland Revenue in the future if required. Also, it is proposed (see page 45) that there be an agreement between the unit trusts for the transfer of expenditure. This agreement will be a record of the transfer.

Recommendation

That the submission be accepted.

Issue: Time limit on election

Clause 31

Submission
(1 – Investment Savings and Insurance Association of New Zealand, 10 – PricewaterhouseCoopers)

Proposed section DI 3B(3) should be amended to provide that the election must be made by the due date for filing the first unit trust's tax return, *or within such further time as the Commissioner allows*.

Comment

Proposed section DI 3B(3), as currently worded, requires the election to be made within the time that the first unit trust must furnish a return for the income year. The rules allowing transfer of expenditure for superannuation funds, on which the present proposal is modelled, require the election to be within the time within which that fund is required to furnish a return, *or within such further time as the Commissioner may allow*.

Officials consider that there should be no requirement to file an election with Inland Revenue, to be consistent with self-assessment and simplification. The unit trust manager will, however, need to keep records of expense transfers that may be required by Inland Revenue in future audits. Also, it is proposed (see page 45) that there be an agreement between the unit trusts for the transfer of expenditure. This agreement will be a record of the transfer.

The Commissioner may need to be given some discretion in respect of expense transfers made after returns are filed.

Recommendation

That the submission be declined if officials' recommendation not to require the filing of elections is accepted.

DEDUCTION BALANCE FORMULA

Issue: Non-resident withholding income

Clause 31

Submission
(8 – Institute of Chartered Accountants of New Zealand)

The reference to non-resident withholding income in the "deduction balance" formula in proposed section DI 3C(1) is not appropriate in the context of unit trusts and should be replaced with a simple rule that refers to the taxable income of the unit trust.

Comment

In practice, qualifying unit trusts may not derive non-resident withholding income. However, we would prefer to leave the legislation wide enough to cover this possibility. There appears to be no disadvantage to leaving the provision as it is.

Recommendation

That the submission be declined

Issue: Excess imputation credits refunded

Clause 31

Submission
(8 – Institute of Chartered Accountants of NZ)

Excess imputation credits carried forward as a loss be refunded when the second unit trust is unable to benefit from the transfer of expenditure (or after a qualifying period, for example – four years)

Comment

The submission views the unused deductions as representing the amount of excess imputation credits that the proposal is designed to address; hence, the unused deductions represent overpayment of tax. It is not current tax policy to refund excess imputation tax credits or cash out excess expenditure (losses).

Recommendation

That the submission be declined.

Issue: Denial of unused expenditure

Clause 31

Submission
(8 – Institute of Chartered Accountants of NZ, 6 – New Zealand Funds Management Ltd)

If the first unit trust ceases to invest in the second unit trust, the potential tax benefit of the transferred expenditure being carried forward under proposed section DI 3C should revert to the first unit trust.

Comment

As currently drafted, the proposal does not provide for expenditure carried forward under proposed section DI 3C to revert back to the first unit trust. If the first unit trust ceases to invest in the second unit trust (in which case the unutilised expenditure may no longer be transferred to the second unit trust), or the second unit trust has no ability to utilise the transferred expenditure, the potential tax benefit of the expenditure does not become available to the first unit trust. If the first unit trust carries forward expenditure under proposed DI 3C, it does not deduct the expenditure in the year it was incurred, and the expenditure is not converted into net loss. There is no provision in the proposal to allow the first unit trust to deduct the carried forward expenditure in a later income year.

The proposal is not intended to deny the first unit trust the potential tax benefit of deductible expenditure that the second unit trust is unable to utilise. We consider it necessary to include provision that the first unit trust may treat the unutilised expenditure carried forward under section DI 3C as available net loss in the income year in which it ceases to invest in the second unit trust.

Recommendation

That the submission be accepted.

Issue: Allowing for adjustment

Clause 31

Submission
(8 – Institute of Chartered Accountants of NZ)

The first unit trust should be entitled to transfer additional expenditure if the taxable income (and hence deduction balance) of the second unit trust is increased.

Comment

As currently drafted, the proposal would not allow the first unit trust to make a further election after the time it is required to furnish a return for the relevant income year. This means that if a taxation audit increases the taxable income (and hence the deduction balance) of the second unit trust after that time, the first unit trust would be unable to transfer further expenditure with respect to that increase.

We recommend that the Commissioner has some discretion in these sorts of cases to amend a return to allow for an expense transfer after a return is filed.

Recommendation

That the submission be accepted.

Issue: Whether the first unit trust should be able to deduct the unutilised transferred expenditure under ordinary rules

Clause 31

Submission
(6 – New Zealand Funds Management Ltd)

The transferred expenditure not deducted by the second unit trust should continue to be treated as incurred by the first unit trust until it is carried forward under new section DI 3C.

Comment

Under the proposal at present, only the portion of transferred expenditure the second unit trust deducts is treated as not incurred by the first unit trust. The unutilised portion reverts to the first unit trust, which may, but is not obliged to, carry it forward to the next income year as expenditure. As currently worded, the proposal does not prevent the first unit trust, in the original income year, deducting the unutilised expenditure itself, or perhaps transferring it to a different wholesale unit trust in which it invests. This should not cause any problem since, presumably, the second unit trust pays for only the amount of the transferred expenditure it is able to deduct. Hence, in respect of the original income year, there is no need to expressly protect the first unit trust's entitlement.

However, if the first unit trust carries forward the unutilised expenditure to a later income year, it is only able to utilise the carried forward expenditure by passing it back up to the second unit trust under new section DI 3C. The first unit trust will not be able to deduct the carried forward expenditure itself since it is not able to allocate the expenditure to that later year. There is no need to expressly provide that the expenditure carried forward is treated as not incurred by the first unit trust.

We recommend that the new section be clarified so that the first unit trust may "carry forward" unutilised expenditure to later income years but not deduct it in later income years. Officials recommend (see page 51) that the unutilised expenditure be treated as a tax loss of the first unit trust.

Recommendation

That the submission be accepted.

TECHNICAL AMENDMENTS

Clause 31

A number of technical amendments, not raising any policy issues, have been suggested in the submissions. These are presented here in summary form.

Submission
(8 – Institute of Chartered accountants of NZ)

The proposed section DI 3C(3) contains a typographical error. The word "being" should be "been".

Recommendation

That the submission be accepted.

Submission
(6 – New Zealand Funds Management Ltd)

For clarity of interpretation, the expenditure able to be transferred in terms of section DI 3B should be defined as "transferable expenditure", and this term should then be used where applicable.

Comment

The proposed provisions are not unclear as they stand, in this respect.

Recommendation

That the submission be declined.

Submission
(6 – New Zealand Funds Management Ltd)

In proposed section DI 3B(2), the words "any amount of" should be inserted after the words "elect that".

Comment

As currently worded, the proposal is clear that the first unit trust may elect to transfer only a portion of its deductible expenditure to the second unit trust.

Recommendation

That the submission be declined.

Submission
(6 – New Zealand Funds Management Ltd)

For clarity of expression, in proposed section DI 3B(3), the words "under subsection (2)" should be inserted after the word "election".

Recommendation

That the submission be accepted.

Submission
(6 – New Zealand Funds Management Ltd)

For clarity of interpretation, in section DI 3B(4), the first instance of the word "incurred" should be replaced by the words "deemed to be incurred by the second qualifying unit trust under subsection (2)".

Comment

The suggested rewording would aid clarity. We suggest a briefer wording by replacing the first instance of "incurred" with "subject to an election under subsection (2)".

Recommendation

That the submission be accepted in substance.

Submission
(6 – New Zealand Funds Management Ltd)

For clarity of interpretation, in proposed section DI 3C(1), the words "in an income year" should be inserted after the words "unit trust".

Comment

The suggested rewording would aid clarity.

Recommendation

That the submission be accepted.

Submission
(6 – New Zealand Funds Management Ltd)

For clarity of interpretation, the proposed section DI 3C(2) should be reworded.

Comment

Officials agree that the provision could be reworded to aid clarity.

Recommendation

That the submission be accepted in substance.

Unit trusts: unit-holder continuity rule and definition of qualifying unit trust

DEFINITION OF "QUALIFYING UNIT TRUST"

Clause 178(25)

Issue: Temporary holders of greater than 10% in unit trusts with over 100 unit-holders

Submission
(1 – Investment Savings and Insurance Association of NZ Inc, 10 – PricewaterhouseCoopers)

The definition of "qualifying unit trust" should be amended to allow for temporary holders of greater than 10% in unit trusts with over 100 unit-holders.

Comment

Sub paragraphs (a)(iii)(B) and (b)(iv) of the definition currently provide that if a unit trust has more than 100 unit holders but one or more of those unit-holders *temporarily* has a greater than 10% interest, that unit trust cannot be a qualifying unit trust.

This is not the case when the unit trust has fewer than 100 unit-holders, so is inconsistent. The legislation should allow for the percentage of temporary changes to be consistent for unit trusts that have more than 100 unit-holders and those that have fewer.

If officials' recommendation to increase the threshold from 10% to 25% is accepted, we recommend that temporary holdings of greater than 25% be allowed for unit trusts with fewer than and more than 100 unit holders. (See page 61.)

Recommendation

That the submission be accepted and the temporary change percentage be consistent between unit trusts of fewer than or more than 100 unit holders.

Issue: More than one type of investor

Clause 178(25)

Submission
(1 – Investment Savings and Insurance Association of NZ Inc, 8 – Institute of Chartered Accountants of NZ, 6 – New Zealand Funds Management Ltd)

The definition of "qualifying unit trust" should be amended to allow for a variety of investors in the unit trust concerned.

Comment

Under sub paragraph (c) (iii) it is unclear whether a unit trust that has a number of different entities in which it invests can qualify as a qualifying unit trust. The legislation should be clarified so that it makes no difference as to whether the unit trust is invested in by one or more of the types of entities listed in this sub paragraph.

Recommendation

That the submission be accepted.

Issue: Associated person test

Clause 178(25)

Submission
(8 – Institute of Chartered Accountants of NZ, 6 – New Zealand Funds Management Ltd)

The definition of "qualifying unit trust" should exclude the associated person rule. In the alternative, the Institute has suggested that trustees should be able to obtain and rely on disclosure provided from the unit-holders of any associated holdings.

Comment

The submissioners argue that the need for the trustees to know whether or not the unit-holders are associated will be difficult, if not impossible to administer.

The associated person rule should remain in the legislation. Officials, however, consider that the alternative submission should be accepted so that disclosure of associated holdings should be made by the unit-holders to the trustee. The trustee should be able to rely on such disclosures. This will reduce compliance costs associated with the trustee determining whether unit-holders are associated. The New Zealand Funds Management Ltd on the disclosure proposal has indicated that it will be difficult to obtain such disclosures and will increase the compliance costs of trustees in obtaining such disclosures from existing and new unit-holders. Officials consider that the recommendation to increase the investment threshold from 10 percent to 25 percent (see submission below) should mean that a trustee will need to obtain such a disclosure only in situations where a unit-holder's interest is significant in relation to the threshold.

Maintaining the associated person rule will ensure that the proposed definition of "qualifying unit trust" applies to widely held unit trusts.

Recommendation

That the submission to remove the associated persons test from the definition be declined. The alternative solution should be accepted.

Issue: Non-qualifying unit trusts or high net worth individual members of qualifying unit trusts

Clause 178(25)

Submission
(8 – Institute of Chartered Accountants of NZ, 6 – New Zealand Funds Management Ltd)

The definition needs to be widened to cater for "qualifying unit trusts" that may have non-qualifying unit trusts or high net worth individuals as members.

Comment

The industry advises that raising the investment threshold from 10% to 25% will widen the application of the legislation for non-qualifying unit trusts and high net worth individuals. That is, these investors can hold up to 25% in the unit trust, and that unit trust will consequentially meet the definition of "qualifying unit trust".

Recommendation

That the submission be accepted and the investment threshold be raised from 10% to 25%.

Issue: Clarification changes

Clause 178(25)

Submission

1. *(8 – Institute of Chartered Accountants of NZ, 6 – New Zealand Funds Management Ltd)*

   Sub-paragraph (c)(ii) of the definition of qualifying unit trust should be amended by the addition of the word "otherwise" between "being" and "a qualifying unit trust".

2. *(6 – New Zealand Funds Management Ltd)*

   The words "in the unit trust" should be inserted for clarity in paragraphs (a)(iii)B and (b)(vi) after the word "less".

Comment

The suggested changes clarify the legislation.

Recommendation

That the submission be accepted.

Issue: Clearing houses that dispose and acquire on behalf of unit trust investors

Clause 178(25)

Submission
(6 – New Zealand Funds Management Limited)

The definition should provide for the situation where it is an entity other than the unit trust manager who operates as the clearing house in acquiring or disposing of units for investors.

Comment

We understand it is normal practice for trust deeds to provide that the party to acquire or dispose of units from investors can be the manager, trustee on a party nominated by either the manager or trustee. The legislation should allow for this practice.

Recommendation

That the submission be accepted.

SPECIAL CORPORATE ENTITY STATUS

Clause 179

Submission
(8 – Institute of Chartered Accountants of NZ)

The issue of continuity of "shareholding" for unit trusts should be resolved by amending the definition of "special corporate entity" to include qualifying unit trusts.

Comment

The new unit holder continuity rule uses the definition of "notional single person" in the Income Tax Act. This submission suggests that the continuity issue for unit trusts is better resolved with reference to the existing "special corporate entity" definition, which would reduce the complexity of the rule.

We do not agree. The concept of special corporate entity is used primarily in relation to entities that do not define their ownership with reference to shares or units held. Examples include statutory bodies and life insurance funds that have not issued shares. The unit trust entity does not fit well with these entities.

The use of notional single person is not more complex. In particular, it would appear to operate better for unit trusts that alternate between the ordinary continuity rules and the new special unit-holder continuity rules, as will occur from time to time. The "special corporate entity" definition does not contemplate entities that fall in and out of the definition from time to time.

Recommendation

That the submission be declined.

LOOK-THROUGH RULES

Clause 179

Submission
(8 – Institute of Chartered Accountants of NZ)

If the proposed new section OD 5(4A) proceeds as drafted, it is necessary to ensure that the rules in sections OD 3(3)(d) and OD 4(3)(d) do not apply.

Comment

Sections OD 3(3)(d) and OD 4(3)(d) are "look-through" rules that require the tracing of a company's shareholding back to its ultimate natural person shareholders. This rule should not apply so that it is necessary to look behind the deemed notional single person.

We do not consider that under current legislation the look-through rules will apply to look behind the notional single person. This is because the provision, which deems there to be a notional single person, also stipulates that the notional single person is not a company. Since sections OD 3(3)(d) and OD 4(3)(d) apply only to look-through a company they cannot apply to the notional single person.

Recommendation

That the submission be declined.

SECTION OD 5(4A) APPLICATION CRITERIA

Clause 179

Submission
(8 – Institute of Chartered Accountants of NZ)

The bracketed modifiers in section OD 5 (4A),

> "other than a company, and separate and distinct from those persons who are unit-holders in their capacities other than as unit-holders in the qualifying unit trusts"

should be removed and replaced with:

> "not being a company".

Comment

The modifier is intended to make it clear that the notional single person is unique to the particular qualifying unit trust. The legislation needs to be clarified to achieve this objective. In clarifying we need to look to the ordinary continuity rules and, in particular, other scenarios under these rules where the concept of notional single person has been used.

Recommendation

That the submission to remove the current modifier be accepted but the legislation should reflect the unique notional single person concept.

DROP-IN/DROP-OUT PROVISION

Clause 179

Submission
(1 – Investment Savings and Insurance Association of NZ,
10 – PricewaterhouseCoopers, 8 – Institute of Chartered Accountants of NZ)

The rules need to specify that a qualifying unit trust will not breach the shareholder continuity rules whenever it changes to the new rule or ceases to use it.

Comment

We believe there is an issue that needs to be addressed in respect of a unit trust choosing to use the new continuity rules once they are introduced. If this is not addressed, imputation credits and losses arising before the 2001-2002 income year may be lost. The legislation needs to ensure that the balance of imputation credits and losses will remain and be available when the qualifying unit trust becomes a notional single person from the application date of the new rules (the 2001-2002 income year).

The legislation could also be made clearer in respect of a unit trust that goes in and out of the new rule. It is intended that the new rules will operate as a layer of the existing rules, so that if the unit trust ceases to use the new rule it will go to the next "layer" to use the existing continuity rules. We recommend that the legislation be made clearer to reflect this. This will mean that there will be no need to put in any other special transitional rules to cover the ongoing situation of unit trusts going into the new rule and coming out of it.

Recommendation

That the submission be accepted in part with respect to the application date of the new rule. However, for the ongoing operation of the new rule the current legislation should be clarified.

SECTION OD 5(4A) CONCESSIONAL TREATMENT

Clause 179

Submission
(1 – Investment Savings and Insurance Association of New Zealand
10 – PricewaterhouseCoopers)

The proposed wording of new section OD 5(4A) should be amended to clarify that the notional single person is a concessionary rule for qualifying unit trusts.

Comment

Section OD 5(4A) implies that if the definition of a qualifying unit trust is met, all unit holders in that qualifying trust *must* be treated as a notional single person.

The legislation should make it clear that even if the criteria to apply the new unit-holder continuity test are met, the unit trust may still choose to use it or not. It should be clear in all cases when the concept of notional single person is used that the rule is optional and not mandatory.

Recommendation

That the submission be accepted.

REFERENCE TO UNITS

Clause 179

Submission
(6 – New Zealand Funds Management Ltd)

The proposed section OD 5(4A) should refer to "units" in a qualifying unit trust rather than "shares".

Comment

Section HE 1, which deals with unit trusts, deems the interest of a unit holder to be shares in a company for the purposes of the Income Tax Act.

Recommendation

That the submission be declined.

PROHIBITION OF GROUP LOSS OFFSETS

Clause 97

Submission
(2 – Ernst and Young, 10 – PricewaterhouseCoopers, 1 – Investment Savings and Insurance Association of NZ Inc, 6 – New Zealand Funds Management Ltd)

The proposed new section GC 4A should be removed and the proposed section OD 5(4A) reworded to allow for qualifying unit trusts to make loss offsets with other companies/unit trusts, where the ordinary group loss offset rules are met.

New Zealand Fund Management Ltd, however, supported the proposal, as it ensures that the loss offset provisions are not used for improper purposes.

Comment

The legislation, as drafted, does not allow qualifying unit trusts to group their losses for tax purposes with other unit trusts or companies that own more than 66% of the units in the qualifying unit trust.

Qualifying unit trusts should not be placed in a position that makes them worse off than they would be under the ordinary grouping rules. The legislation should be amended to allow for group loss offset by qualifying unit trusts where the ordinary grouping rules are satisfied. In this regard, the notional single person concession is not relevant. Section GC 4A should be removed. As a result of the ordinary grouping rules applying, the loss offset provisions will not be used for improper purposes.

Recommendation

That the submission be accepted.

SECTION GC 22A – A NEW IMPUTATION ANTI-STREAMING RULE

Clause 100

Submission
(1 – Investment Savings and Insurance Association of NZ Inc, 8 – Institute of Chartered Accountants of NZ, 6 – New Zealand Funds Management Ltd, 10 – PricewaterhouseCoopers)

The proposed section GC 22A should not proceed as it is superfluous, and is more narrowly worded than the already comprehensive anti-streaming rules in section GC 22.

The Institute of Chartered Accountants also submits in the alternative that if GC 22A proceeds, the meaning of "higher credit value" is clarified.

Comment

There are already comprehensive imputation anti-streaming provisions in section GC 22. In particular, section GC 22(1)(b) covers the same ground as proposed section GC 22A. There is no reason to duplicate the operation of the rules in GC 22, which will apply to qualifying unit trusts in the present form.

Recommendation

That the submission be accepted.

Unit trusts: imputation credit streaming

UNIT TRUSTS: IMPUTATION CREDIT STREAMING

Clauses 105 and 235

Submission
(8 – Institute of Chartered Accountants of NZ)

A provision should be included in section MZ and the Income Tax Act 1976 equivalent that provides that allocation debit rules in section ME 8(4) not apply when the failure to file a ratio change declaration arises in connection with the dividends paid that are subject to section GZ 2 or section 394ZGA.

Comment

The issue concerns ratio change declarations. In the scenarios covered by the legislation, some dividends were imputed at zero cents in the dollar and others at 33c in the dollar. In this case the unit trust manager should have advised of a change in the ratio. In many cases this did not occur.

There should be no adverse allocation debit consequences in circumstances where section GZ 2 or section 394ZGA applies. If this were the case the proposed solution would not be sufficient in many of the cases where the solution is needed.

Recommendation

That the submission be accepted.

Transfers of overpaid tax

TRANSFERS OF OVERPAID TAX

OVERVIEW

Proposed amendment

The bill introduces new sections MZ 5 and MZ 6 into the Income Tax Act 1994. Corresponding amendments are made to the Income Tax Act 1976.

The amendments require the Commissioner, at the request of a taxpayer, to transfer overpaid tax that is refundable to the taxpayer to a period in which there is no outstanding liability for tax. The amendments apply retrospectively and will enable certain taxpayers who have requested a transfer of excess tax to a nil period to receive use-of-money interest on the excess tax.

The amendment is a pragmatic solution to a difficult issue. Before 1997-98, use-of-money interest was payable only until the terminal tax date of the year in which the excess tax was paid. The Commissioner would often, at the taxpayer's request, roll forward excess tax to future periods, regardless of whether there was a liability, so that taxpayers could, in effect, obtain use-of-money interest on excess tax retained by the Commissioner beyond that date. In late 1999, Crown Law advised the Commissioner that he has no power to roll-forward excess tax to future periods in which there is no outstanding liability for tax.

The inability to transfer excess tax to a nil period has given rise to a different issue in relation to the 1997-98 and following years. The Commissioner cannot transfer excess tax to satisfy an underpayment of provisional tax in certain circumstances. This means that a taxpayer can be paid use-of-money interest at 5.74% on the excess, and simultaneously be charged use-of-money interest at 12.62% on the deficiency. This is clearly inequitable.

In relation to tax paid in past income years, the amendment will apply only where

- before 21 April 2001, a taxpayer either requested the Commissioner in writing to transfer the excess to a future period, or received written notification from the Commissioner that evidences an oral request to transfer, or
- the excess arises on an assessment or reassessment on or after 21 February 2001.

The amendment is restricted in this way so that taxpayers who overpaid tax in previous years and had the excess refunded, cannot now request a transfer and receive use-of-money interest for the period up to the date of refund.

A cut-off date of 21 April applies because this was the date on which the proposed amendment was first discussed with the Institute of Chartered Accountants. The 21 February date was selected because, if this had also been 21 April, taxpayers who were assessed immediately before that date (on, say, 20 April) would have had insufficient time to request a transfer in writing and would therefore have been unable to bring themselves within either category.

In relation to excess tax arising in the current year, the amendment provides that taxpayers need simply request the Commissioner to transfer the excess.

Submissions

Three submissions have been made on the amendments, all of which support the proposed changes. The Institute of Chartered Accountants notes that the amendments represent a pragmatic and sensible solution to a problem of legislative uncertainty. Two of the submissions have made recommendations on the detail of the proposed provisions.

LINK WITH USE-OF-MONEY INTEREST RULES

Clauses 161, 169A, 235A and 235B

Issue: Additional provision linking amendments with use-of-money interest rules

Submission
(KPMG)

There should be an express provision stating that the tax rolled forward is overpaid tax for the purposes of the use-of-money interest rules.

Comment

KPMG argues that, for the avoidance of doubt, there should be an express provision ensuring that the tax overpaid and rolled forward to a subsequent income year qualifies as "overpaid tax" for the purposes of the use-of-money interest rules. Officials agree.

Recommendation

That the submission be accepted and the provisions in the bill be amended to provide that the tax rolled forward is overpaid tax for the purposes of the use-of-money interest rules.

Issue: Publication of effect of amendments in *Tax Information Bulletin*

Submission
(Institute of Chartered Accountants of NZ)

The proposed amendments take a reasonably minimalist approach in that the full intended consequences for use-of-money interest of the amendments are not specified in the legislation. The effect of the amendments and their intended application, therefore, need to be clearly specified for taxpayers and Inland Revenue staff in a *Tax Information Bulletin.*

Comment

Officials have recommended above that the provisions in the bill be amended to provide an express link with the use-of-money interest rules. This should reduce the concerns of the Institute about minimalist legislation.

However, as is usual, Inland Revenue will issue a detailed discussion of the amendments in a *Tax Information Bulletin* published after enactment of the legislation.

Recommendation

That the submission be accepted.

REQUESTS FOR TRANSFER

Clauses 169A and 235B

Issue 1: Taxpayer who satisfies criteria to contact Inland Revenue following enactment

Officials' submission

Section MZ 5(1) and 409A(1) should apply only where a taxpayer who satisfies the criteria in subsections (1)(a) to (c) contacts Inland Revenue following enactment of the legislation.

Comment

The amendment is intended to apply only when taxpayers initiate contact with Inland Revenue and identify themselves to the Commissioner as coming within the scope of the amendment.

Arguably, sections MZ 5(1) and 409A(1) require the Commissioner to search through all files to identify taxpayers who satisfy the criteria in paragraphs (a) to (c). This is not intended and is wasteful of Inland Revenue's resources. The provisions should be amended so that they apply only when taxpayers who satisfy the criteria contact Inland Revenue following enactment of the bill.

Recommendation

That sections MZ 5(1) and 409A(1) be amended so that they apply only when taxpayers who satisfy the criteria in paragraphs (a) to (c) contact Inland Revenue following enactment of the bill.

Issue 2: Additional circumstance in which provision should apply

Submission
(Institute of Chartered Accountants of NZ)

In relation to excess tax paid in past years, the Commissioner is required to transfer the excess tax to a nil period where the taxpayer has requested the transfer in writing, or where the taxpayer has received notification in writing from the Commissioner evidencing a transfer request. The amendment should also apply where "the Commissioner's records show that a taxpayer has requested a transfer".

Comment

The proposal reflected in the amendments was developed with the aim of providing some relief to taxpayers who had requested transfers of excess tax, without significantly increasing administration costs. The amendments are intended to apply only when taxpayers can identify themselves to the Commissioner as coming within the scope of the amendments and they hold evidence in writing to or from the Commissioner that a request has been made. This prevents the Commissioner having to search through all taxpayer files to determine whether certain taxpayers come within the specified criteria, or to field queries from taxpayers who do not know whether they satisfy the criteria.

The Institute proposes that the amendment be extended to include the circumstance where the Commissioner has noted on a taxpayer's file that the taxpayer has requested a transfer. This is so that taxpayers who have made oral requests which have been declined orally can obtain use-of-money interest when Inland Revenue has recorded the request on the taxpayer's file.

The Institute considers that taxpayers would only contact the Commissioner when they had made an oral request previously, and when there was a significant amount of money involved. Their view is that few requests will be made, and that this will not create significant additional work for Inland Revenue.

Clearly, only those who have made oral requests previously will call Inland Revenue. However, they may do so when there is less than a significant amount at stake. Officials have no reason to consider that there will be few requests. Fielding calls from taxpayers and tax practitioners ringing to check whether Inland Revenue has made a record of a taxpayer request could impose significant administrative costs on Inland Revenue, diverting resources away from other business.

Inland Revenue may or may not have recorded a request in a particular case. This is therefore a completely arbitrary basis upon which to allow use-of-money interest to be paid.

Recommendation

That the submission be declined.

Issue 3: Provision should apply where no request because of earlier refusal

Submission
(KPMG)

The legislation should apply in relation to excess tax that a taxpayer did not request to be transferred because of Inland Revenue's refusal to transfer an earlier overpayment of that taxpayer

Comment

KPMG argues that taxpayers who have had their request for roll forward of overpaid tax denied by Inland Revenue in respect of an earlier year are unlikely to have sought to roll forward overpaid tax that arose in a subsequent year. Therefore where the taxpayer met the criteria in relation to one overpayment, they should be entitled to roll forward subsequent overpayments even though they have not requested a transfer of the subsequent overpayment.

Officials do not support the proposed extension of the legislation. The amendment applies only where a taxpayer or their agent requests a transfer of overpaid tax. A request may not have been made for several reasons – for example, because an earlier request by a taxpayer was denied, or because the tax agent representing the taxpayer had made a request in relation to another taxpayer which was denied. It is no fairer, and probably is more arbitrary, to distinguish between taxpayers on the basis of the reason for their not requesting a transfer than to distinguish between taxpayers on the basis of whether or not they requested a transfer in relation to the excess tax at issue.

Recommendation

Officials recommend that the submission be declined.

ROLL- FORWARD OF TAX THROUGH SUBSEQUENT YEARS

Clauses 169A and 235B

Submission
(KPMG)

It should be clear that overpaid tax is to be rolled forward to all subsequent years where the excess tax exceeds the tax liability in those years.

Comment

KPMG argues that it should be clear that overpayment of tax is to be rolled forward to all subsequent years where there is a net overpayment so that taxpayers receive use-of-money interest for the intervening periods until refund, rather than just one year's worth of interest. This is the intent of the legislation.

Recommendation

That the submission be accepted and the provisions be amended to clarify that the excess tax is to be rolled forward through all subsequent years in which the excess tax exceeds the tax liability until the tax is refunded (or credited against a tax liability).

Submission
(KPMG)

Interest should be payable to taxpayers who requested a transfer and were refused and who subsequently applied the overpayment of tax to satisfy a tax liability in a later tax year.

Comment

KPMG is concerned about the effect of the opening words of section MZ 5(1) and (2), which state that "To the extent that tax paid in excess by or on behalf of a taxpayer is refundable **and has not been applied to satisfy a tax liability or other amount due …".**

They argue that the words in bold may result in a taxpayer losing any entitlement to interest where the taxpayer requested but was denied a roll-forward of the overpaid tax (still satisfying the criteria in subsection (1)) and applied the excess in satisfaction of a liability at some future date. For example, if the Commissioner determined in May 1998 that tax was overpaid for the 1995 year, and the Commissioner would not roll that excess through the intervening years, the taxpayer therefore used the excess to satisfy a provisional tax liability on 7 July. KPMG asks for the legislation to be clarified to ensure that there is interest payable in the period up until the time the overpayment is used to offset another tax liability.

This is the intent of the legislation.

Recommendation

That the submission be accepted and the legislation be clarified to ensure that there is use of money interest payable on the excess tax in the period up until the time it is used to offset another tax liability.

Other changes to Income Tax Act 1994

ATTRIBUTION RULE

Issue: The attribution rule and double tax

Clause 162

Submission
(Institute of Chartered Accounts of New Zealand, New Zealand Law Society, Rudd Watts & Stone)

Amounts attributed by a company should be made exempt from tax, as opposed to being made fully imputed dividends. Rudd Watts and Stone suggest, as an alternative, that the imputation credit could be increased to 64% (being the rate necessary to fully pay the tax at a marginal rate of 39%) or could be deemed to be available subscribed capital (i.e. generally tax-free when returned to the shareholder).

Comment

The submissioners point out that the attribution rule could still cause tax to be paid in excess of a marginal rate of 39% when an amount attributed from a company intermediary is then subsequently distributed as a dividend to a shareholder whose marginal tax rate is 39%.

This is correct. It is a result of ensuring that the attribution rule would not have any accounting impact. The attribution rule, as currently presented, applies for income tax purposes only with the amount attributed being left in the intermediary to be dealt with for accounting purposes in the ordinary course of events.

When the intermediary is a company, the amount attributed can be paid out as a dividend, with imputation credits. If the dividend is then paid to the high-income individual (over $60,000 of income) who provided the services, or to any other shareholder whose marginal tax rate is 39%, the effective tax rate is 48%. Clearly this is undesirable. However, this problem only arises if the shareholder has a marginal rate of 39%, if the shareholders' marginal rate is 33% or less there is no problem.

The submissioners recommend that the amount attributed be made exempt from income tax. We believe this approach would be difficult to implement as dividend streaming rules would be necessary so as to identify the dividend. The dividend would, in some cases, also flow through intermediate companies and special rules may be needed to cater for its exempt status. In addition, by the time this bill is enacted, a significant number of 2000-01 tax returns will have been filed. It does not seem practicable to significantly change the mechanism retrospectively.

However, most companies involved are likely to be qualifying companies and rules already exist for qualifying companies in that their dividends are ordinarily exempt to the extent they cannot be fully imputed. Therefore, qualifying companies can be excluded from the deemed imputation credit rule. This is likely to considerably reduce the problem raised by the submitters. There is still an issue if the 2001 tax

return has been filed, but this is of a considerably smaller magnitude, and the qualifying company exempt dividend delivery mechanism is clearly understood.

Furthermore, in other cases:

- the attribution rule seems likely to apply infrequently anyway, as when it could apply, the income is often being taken as salary;
- when it does apply, it is likely that any company intermediary will not pay a dividend to the high income earner – why voluntarily pay out income that will be subject to 39%?
- when it does apply, it is likely that any company intermediary will not pay a dividend to the high income earner – because a number, probably most, of these companies will be owned by a trust.

This leaves a probably very small set of high-income earners potentially subject to a tax rate of higher than 39%. In practice it seems that this will only happen by mistake and, even then, the circumstances have to be exactly right.

Recommendation

That the submission be declined, but the issue be substantially addressed by not providing the notional imputation credit to companies that are qualifying companies.

Issue: Technical issue where the intermediary (person B) is a trust

Clause: N/A as not in the bill

Submission
(Matter raised by officials)

When an intermediary (referred to in the legislation as person B) is a trust and some of its income is paid to the service provider (person C) as beneficiary income, the rule in section GC 14D(7) which reduces beneficiary income should not reduce any beneficiary income provided to the service provider (person C).

Comment

This change to correct a mistake is necessary because any reduction in the beneficiary income of the service provider has the effect of reducing the amount to be attributed. The reduction should instead be applied to any other trust beneficiaries only. In this way, the full amount to be attributed is taxable income of the service provider.

Given that some 2001 tax returns will have been filed it seems inappropriate to require them to be refiled. Therefore we suggest the amendment should apply to tax returns for the 2001-02 and subsequent income years.

Recommendation

That the submission be accepted.

DEFINITION OF "ASSOCIATED PERSONS"

Clause 178

Submission
(9 – New Zealand Law Society)

The submissioner considers that the new definition of "associated persons", inserted by clause 178 of the bill, is too vague as the shorthand form adopted lacks precision. The proposed wording states that:

> "Associated persons, and other expressions about the association of persons with each other, have the meanings set out in sections OD 7 and OD 8."

Comment

Clause 178 replaces the existing definition of "associated person" in section OB 1 of the Income Tax Act 1994 with a new definition of "associated persons" that contains a general cross-reference to the substantive associated persons definitions in sections OD 7 and OD 8.

The existing definition of "associated person" in section OB 1 contains a number of errors. In particular, the lists of operative provisions in paragraphs (b), (c) and (d) of the definition, to which the specific associated persons definitions in section OD 8 apply, are either incorrect or incomplete in various respects. (The substantive definitions in section OD 8 do correctly list the operative provisions to which they apply.)

These existing deficiencies are addressed in the amendment by simplifying the section OB 1 definition to provide that "associated persons", and other "expressions concerning the association of persons with each other", have the meanings given in sections OD 7 and OD 8.

The amendment will make future maintenance of the section OB 1 definition of "associated persons" unnecessary, while still achieving the cross-referencing function (it has no other function) of the existing definition. (Most users of the Act would currently refer directly to the substantive associated persons definitions in section OD 7 and OD 8.)

The language that the submission is concerned about – "and other expressions about the association of persons with each other" – is the same wording used in the existing definition of "associated person". The wording is meant to include slightly different ways of referring to associated persons such as "persons associated with each other" or "associated person". Therefore, as the proposed wording of the new definition of "associated persons" has not been changed from the existing definition of "associated person", officials do not agree with the submission.

Recommendation

That the submission be declined.

MINOR REMEDIAL AMENDMENTS TO INCOME TAX ACT 1994

Submission
(Matter raised by officials)

An amendment is required to renumber new section EO 6 (enacted by section 13 of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001) as section EO 7.

Comment

A new section EO 6 was introduced in the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Bill, with a view to it being renumbered as section EO 7 once the Taxation (GST and Miscellaneous Provisions) Bill was enacted. The Taxation (GST and Miscellaneous Provisions) Bill proposed a section EO 6 for the attribution rule. Unfortunately, the renumbering was overlooked. Officials recommend that section EO 6, as enacted by the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001, be renumbered.

Recommendation

That the submission be accepted.

Taxpayer assessment

TAXPAYER ASSESSMENT – OVERVIEW OF SUBMISSIONS

Introduction

The bill proposes changes to recognise that the tax system is administered on the basis that taxpayers make the initial assessment of their tax liabilities. It is now less appropriate to write legislation on the basis that the Commissioner of Inland Revenue performs all the functions of assessment. Assessments are in practice made by taxpayers, with Inland Revenue automatically processing their returns in the first instance.

Reform of the tax administration rules over recent years has proceeded on the basis that tax is essentially self-assessed and that the system should encourage voluntary compliance.

Although not involving significant policy change, the introduction of self-assessment will add to and enhance other improvements being made to simplify tax administration. As well as aligning the law with practice, the changes in this bill will facilitate the continuing development of policy and legislation in areas such as the review of compliance and penalties legislation, the review of the tax disputes procedures and the rewrite of the Income Tax Act.

The bill proposes to replace the Commissioner's general power of assessment in section 92 of the Tax Administration Act 1994 (TAA) with a specific requirement that taxpayers assess their tax liability each year. Taxpayers will also, under an amended section 33 of the TAA, be required to furnish a notice of self-assessment with their return. The Commissioner will retain specific powers of assessment to amend a taxpayer's assessment or make an assessment if a taxpayer fails to self-assess.

A large part of the bill is devoted to making consequential amendments to ensure taxpayers can make assessments by:

- modifying language that presupposes that assessments are made only by the Commissioner; and
- replacing various discretions of the Commissioner with objective rules in areas affecting the calculation of a taxpayer's tax liability for an income year.

These changes will allow taxpayers to make the initial assessment of their tax liability each year. The Commissioner’s functions that operate once the initial assessment is made are retained, thereby retaining the administrative flexibility already provided for in the legislation.

Other features of the bill are that:

- It removes references to the Commissioner making determinations of various amounts such as of losses and foreign tax credits. These amounts will be implicitly determined as part of making an assessment (either by the taxpayer at first instance or by the Commissioner).

- The two-month period for taxpayers to issue proposed adjustments to their returns will now apply from the date of taxpayer assessment (the filing of the return) rather than from the date of Commissioner assessment.
- Section EC 1, relating to adjustments for incorrect accounting practices, will be replaced with a specific rule to ensure that amounts of income and expenditure are recognised once, rather than leaving open the possibility that such amounts might not ever be taxed or deducted properly.

Overview of submissions

Five submissions on the taxpayer assessment amendments have been made. Two submissions expressly support the principle of legislating for taxpayer assessment. None of the submissions are opposed to legislating for taxpayer assessment. Submissions are generally focused on suggesting possible technical improvements to the bill.

In particular, the submission from the Institute of Chartered Accountants of New Zealand agrees in principle with the main changes for:

- replacing the Commissioner's general power to make assessments with a requirement for taxpayers to make the initial assessment of their tax liabilities;
- removing various determination processes; and
- removing "Commissioner discretions" and references to the Commissioner, as necessary for self-assessment.

The New Zealand Law Society notes that "while the principles behind such amendments are reasonable, and that the amendments themselves are not likely to adversely affect taxpayers, the sheer number of amendments … is of concern." The Society suggests that many of the changes could be dealt with as part of the rewrite of the Income Tax Act 1994.

The main recommendations by officials to the Committee following submissions are that amendments should be made to the bill to:

- retain the terminology of "adequate rent" in the context of leases;
- extend the definition of "notice of proposed adjustment" to include a notice of assessment issued by a taxpayer;
- remove from the bill the changes proposed to section EG 17, relating to transfers of depreciable property between associated persons; and
- improve the clarity of the extent of a taxpayer's obligations in respect of making the first assessment of their tax liability and their filing obligations.

TRANSFER OF DEPRECIABLE PROPERTY BETWEEN ASSOCIATED PERSONS

Clause 58

Submission
(10 – PricewaterhouseCoopers, 67W – Deloitte Touche Tohmatsu)

The Commissioner should give guidance to taxpayers by way of an item in the *Tax Information Bulletin* on the application of the new criteria in section EG 17(2), which allows transfers of depreciable property between associated persons to be based on the transferee's cost price if certain criteria are satisfied.

The reference to "sales" in the phrase "arm's length sales" is too restrictive.

Although both "normal commercial practice" and "arm's length" have commonly understood meanings, the meaning and scope of these terms is sufficiently uncertain not to provide the objectivity required for self-assessment. Referring to the bona fides of a transaction is more certain and should be used instead.

The proposed section EG 17(2)(b) provides that one of the criteria for transferring property at the cost to the purchaser is that the cost of the property to the taxpayer is the market value of the property on the date of acquisition. Although it is implicit in the proposed amendment, this provision should be clarified by adding that the transferor must receive market value.

Comment

Submissions highlight a number of technical complexities in relation to the rules proposed to replace the Commissioner's discretion in section EG 17(2). Officials note that section EG 17(2) in effect provides an anti-avoidance rule and that other Commissioner discretions in anti-avoidance rules have been retained.

Given the technical difficulties that have been raised and the need for consistency with the approach elsewhere in the bill, we recommend that the changes proposed to section EG 17 be removed from the bill.

Recommendation

That officials' submission be accepted.

MARKET VALUE

Issue: The meaning of market value

Clauses: various including 47, 49, 58, 60, 61, 64, 66, 67, 75, 78, 82, 88, 101, 102

Submission
(8 – Institute of Chartered Accountants of New Zealand, 10 – PricewaterhouseCoopers)

The term "market value" implies a requirement that independent valuations be sought. "Market price" does not and should be used as an alternative.

Comment

The bill replaces various references to "value" as determined by the Commissioner with the more objective term "market value". References to "market value" are also inserted in other appropriate instances to better reflect the concept of self-assessment.

In general terms "market value" includes a market price, and alternatively, in the absence of a market price, an arm's length price. Thus, in most circumstances, having the market price for something is sufficient to determine the market value without requiring the use of other independent valuation services.

"Market value" is a flexible concept and has not been legislatively defined so it bears its natural meaning. It is a term already extensively used in the tax legislation with its meaning determined according to the surrounding (commercial) circumstances. For example, in contrast to using "market price", "market value" more naturally allows for the inclusion of a discount given for trading in certain quantities or under pricing structures that recognise market segmentation (such as retail, trade and wholesale).

The term "market value" is used widely in (tax and non-tax) legislation and has also been considered by the courts, particularly in respect of the general principles in *Hatrick v Commissioner of Inland Revenue* [1963] NZLR 641.

Recommendation

That the submissions be declined.

Issue: Leases for inadequate rent

Clause 103

Submission
(10 – PricewaterhouseCoopers)

The proposal to replace "adequate rent" with "market rent" should not proceed. Amendments can be made to section GD 10 to remove the Commissioner's discretion and make it capable of being self-assessed without removing the reference to "adequate rent".

The submission notes that while the focus of the provision seems to be on transactions between relatives involving income splitting, the actual drafting of section GD 10 has given it a potentially much wider application. In particular, the provision can apply to any lease of property by a company to any other person (whether or not associated). Section GD 10 can, therefore, apply in wholly arm's length situations where there is no attempt to split income and have it taxed at a lower rate.

The current terminology of "adequate rent" provides flexibility, thereby ensuring that the application of section GD 10 to a lease by a company does not give an inappropriate result in arm's length cases where there is no tax benefit.

The proposed change to "market rent" could provide less flexibility because factors such as other transactions between the parties, the commercial purpose and effect of the transaction, and the relationship between the parties will not be able to be considered. However, these other factors could be relevant in determining an "adequate rent".

The submission refers to the example of a mining company that has caused damage to a farmer's land. As part of the settlement between the parties, the company buys the land from the farmer and leases it back to him for 30 years for a low yearly rental. There is no tax benefit in this situation. To the extent that there is a reduction in gross income to the mining company, there is also a lesser tax deduction to the farmer. Therefore there is no reduction in net tax collected. Under the existing GD 10 it is possible that, in the light of the relationship between the parties and the surrounding circumstances, the rent is "adequate". However, the rent could not be described as a "market rent".

Comment

Section GD 10 increases the amount of rent received for a property by a lessor for tax purposes when the actual rent is less than an "adequate rent". The section applies when property owned by any person, persons, or partnership is leased:

- to a relative of any of those persons or of any member of the partnership; or
- to a related company; or
- by a company to a person.

Section GD 10 has a tax avoidance focus. It is directed against income splitting, especially in a family situation, whereby income from leasing property is shifted to persons on lower tax rates than the owner of the leased property.

Officials agree with the submissioner that it is not appropriate to apply a market rent in situations such as that in the submissioner's example, where there is no possible tax benefit because the lessor and lessee are on the same tax rate.

Officials agree that the existing term "adequate rent" provides more flexibility than "market rent" and allows other factors such as other transactions and the surrounding circumstances to be taken into account. Such factors could probably not be taken into account in determining a market rent.

In situations where there is a difference in tax rates between the lessor and lessee – for example, between earning adults and minors, and therefore an opportunity to derive a tax benefit, officials consider that an adequate rent would be equivalent to the market rent for the purpose of section GD 10. However, in situations where the lessor and lessee are on the same tax rate, and therefore have no opportunity to derive a tax benefit, officials consider that an adequate rent will not necessarily be the same as the market rent.

Officials are, therefore, in favour of retaining the terminology of "adequate rent" in section GD 10 in order to prevent the section applying in situations where it would not be appropriate – where there is no opportunity to derive a tax benefit between the lessor and lessee. The provision itself can still be placed on a self-assessment footing by removing the Commissioner references while retaining the term "adequate rent".

Recommendation

That the submission be accepted.

AMENDING EXCEPTIONS TO TIME BAR

Clause 206

Submission
(10 – PricewaterhouseCoopers)

The submissioner acknowledges that the proposed amendments to the Commissioner's time bar for amending income tax assessments in section 108 of the Tax Administration Act 1994, made by clause 206 of the bill, accommodate self-assessment. However, the submissioner raises a new issue concerning one of the exceptions to the income tax assessment time bar. This exception is contained in section 108(2)(b) and provides that the time bar may not apply if a return for an income year does not mention gross income which is of a particular nature or was derived from a particular source, and in respect of which a tax return is required to be provided.

The submissioner wants the words in section 108(2)(b) "in respect of which a tax return is required to be provided" to be replaced by "which is required to be disclosed in the return required by the Commissioner under section 33".

Comment

Section 108(1) of the Tax Administration Act 1994 provides that the Commissioner may not increase an income tax assessment more than four years after it was made. This time bar on amending assessments is subject to two main exceptions. Under section 108(2), the Commissioner may increase an assessment if the Commissioner is of the opinion that a tax return provided by a taxpayer:

- is fraudulent or wilfully misleading; or
- does not mention gross income which is of a particular nature or was derived from a particular source, and in respect of which a tax return is required to be provided.

The second exception was recently considered by the Privy Council in *O'Neal v Commissioner of Inland Revenue* (2001) 20 NZTC 17,051, which concerned a J G Russell tax avoidance template. The Privy Council upheld the Commissioner's application of this exception to allow assessments of participants in this tax avoidance scheme, which were made outside of the time bar, to be increased by the Commissioner.

The amendment suggested by the submissioner to the second exception to the time bar should not be considered as part of this bill because it is outside the scope of self-assessment. Clause 206 of the bill is only amending section 108 in order to make it consistent with self-assessment.

The issue raised by the submissioner would more properly be considered as part of the post-implementation disputes procedures review. As part of this review, a discussion document will be published which will give an opportunity for submissions to be made under the normal generic tax policy process.

The submissioner considers that the Commissioner will no longer require information about particular sources of income to make an assessment, and the return will only be a source of general statistical information. However, officials note that returns will continue to have a very important role in the post-assessment phase of the Commissioner's activities, namely, as a source of information for audit purposes.

Recommendation

That the submission be declined.

WHETHER ADJUSTMENTS FOR INCORRECT ACCOUNTING PRACTICE SHOULD BE TREATED DIFFERENTLY FROM OTHER ADJUSTMENTS

Clause 53

Issue: The extent adjustments for incorrect accounting practices should be allowed – section EC 1

Submission
(8 – Institute of Chartered Accountants of New Zealand, 10 – PricewaterhouseCoopers)

The circumstances in which taxpayers can make adjustments for incorrect accounting practices should not be narrowed so as to preclude making adjustments which, although valid, would not come within the proposed section EC 1.

In particular, taxpayers will not be able to make adjustments in the current income year for incorrect accounting practices in previous income years or spread income arising from such adjustments over four income years.

Comment

The proposed changes to section EC 1 are designed to better target the provision and clarify how amounts of income and expenditure should be recognised, so they are recognised once, rather than leaving open the possibility that such amounts may not ever be taxed or deducted properly.

As canvassed in the 1998 discussion document *Legislating for self-assessment of tax liability*, the Court of Appeal's decision in *Hutchinson Bros Ltd v CIR* (1997) 18 NZTC 13,374 restricted the scope of the rule in section EC 1. The decision limited the application of the rule to circumstances already covered by the Commissioner's general power to make amending assessments in section EC 1 before the four-year time bar. In the light of the Court of Appeal decision, despite the rule in section EC 1 originally being intended to permit the Commissioner to make particular assessments beyond the four-year time bar, the bill proposal confirms the four-year time bar limit as appropriate for a system including taxpayer assessment.

The bill takes the decision in *Hutchinson* into account, providing clear rules for the treatment of amounts of income and expenditure, when a taxpayer changes from a cash accounting method to an accrual method or vice versa. These rules are designed to assist taxpayers to determine the correct treatment of such amounts when they change their accounting practices and make assessments accordingly.

Officials note that the discussion document *Legislating for self-assessment of tax liability* invited submissions on the situations to which the section should apply. Submissions received in response referred to hire purchase reserves and warranty provision reserves, neither of which represent changes in accounting practice but rather recognise costs under ordinary accounting principles – this does not alter the

ordinary requirement to account for costs correctly when making a taxpayer assessment.

Officials consider it would not be appropriate to continue to provide for current period adjustments to be made in relation to incorrect accounting practices in either previous incomes years or be spread over a period of up to four years. To do so would be inconsistent with many of the changes made to the tax system, including tax rates and the rules for making adjustments. For example, officials consider the purpose of providing a spreading rule was to give practical relief from the more progressive and higher tax rates that existed in 1971, when the predecessor to section EC 1 was introduced.

Also, officials note that there have been many significant changes to the tax administration rules, including the dispute procedures, which provide a general process for making adjustments. In this regard and in the context of the above, officials consider it would not be appropriate to provide an exception in relation to changes in accounting practices, particularly as making agreed adjustments is specifically provided for in the Tax Administration Act 1994.

Recommendation

That the submission be declined.

Issue: Proposed definition of "cash accounting method" – section EC 1

Submission
(8 – Institute of Chartered Accountants of New Zealand)

The proposed new section EC 1(3) should be amended by changing the words "cash receipts or outgoings" to "cash receipts and outgoings".

Comment

Officials agree that making this change would clarify the relationship between "accrual accounting method" and "cash accounting method" as defined in section EC 1.

Recommendation

That the submission be accepted.

RESIDUAL DISCRETIONS MAINTAINED BY COMMISSIONER

Clauses: various

Issue: Allowing taxpayers to self-assess remaining Commissioner discretions

Submission
(10 – PricewaterhouseCoopers)

Although a large number of Commissioner discretions are being removed by substituting objective tests, a number of residual Commissioner discretions remain. The submissioner considers that retaining the Commissioner's powers on certain matters still leaves a "gap" in the logic of the self-assessment process. This is because taxpayers will not have the power to determine all matters essential to assessing their liability under the Income Tax Act 1994.

The submission notes that this "gap" in the self-assessment process leaves taxpayers in the position of either being pragmatic and "second guessing" what the Commissioner might think ("the current practice") or being technically correct and formally asking the Commissioner to determine these issues annually (thereby burdening the Commissioner with an unwanted obligation).

Accordingly, the submissioner recommends an amendment along the following lines:

> "Where any matter affecting the assessment of the taxpayer's liability is subject to the opinion of the Commissioner on a particular matter, the taxpayer is entitled to determine the matter for the purposes of issuing an assessment under section 33 of the Tax Administration Act 1994 but not so as to exclude the Commissioner's powers to make an assessment or issue a notice of proposed adjustment."

Comment

The bill removes a very large number of Commissioner discretions from provisions to place them on an objective basis. The provisions which have been amended to remove Commissioner discretions are mainly those which affect the calculation of a taxpayer's tax liability for an income year and would otherwise, at least in a technical sense, be obstacles to taxpayers self-assessing. Thus the removal of these discretions are a necessary consequential amendment for self-assessment. Other discretions have been retained either because this is administratively necessary (as explained in the following paragraph) or because their removal is not seen as strictly necessary for placing the legislation on a self-assessment basis. Some discretions in this latter category are likely in the future to be removed as part of other tax policy projects, particularly the rewrite of the Income Tax Act.

Examples of discretions that should be retained are those that relate to procedural matters such as the requirement to obtain the Commissioner's approval to a balance date change, or to maintaining the revenue base such as a number of anti-avoidance provisions.

If taxpayers were able to change their balance dates at will significant tax deferral advantages could be obtained.

The 1998 discussion document *Legislating for self-assessment for tax liability* stated that it was necessary to retain the Commissioner discretions in anti-avoidance provisions to reconstruct transactions. Avoidance arrangements often involve multiple transactions between a number of taxpayers. It is, therefore, appropriate to retain the Commissioner's discretion to recharacterise an avoidance arrangement.

The suggested amendment would allow taxpayers to exercise such Commissioner discretions themselves subject to the Commissioner's powers to amend assessments. Officials do not agree with the suggested amendment because it would undermine the administrative necessity of many of the remaining discretions and pose a risk to the revenue base.

Recommendation

That the submission be declined.

Issue: Retention of Commissioner discretion in section LB 2(5)

Clause 147

Submission
(8 – Institute of Chartered Accountants of New Zealand)

Clause 147(2) and (3) of the bill amends section LB 2(5) of the Income Tax Act 1994. Section LB 2(5) is an anti-avoidance provision which disallows an imputation credit if the Commissioner is satisfied that insufficient tax has been paid by the company that issued the imputation credit.

The submissioner queries the retention of the Commissioner discretions in section LB 2(5). It also considers that a further change may be needed given that the process of the Commissioner disallowing the credit has been altered – the submissioner suggests that this amendment would involve omitting the words "by the Commissioner" from section LB 2(5)(b).

Comment

As indicated above, certain Commissioner discretions have been retained in anti-avoidance provisions such as section LB 2(5) because they are necessary to protect the revenue base and are not a legislative obstacle to taxpayer assessment.

The only change that is being made to section LB 2(5) is to recognise that it is the Income Tax Act itself which disallows the imputation credit rather than the Commissioner. The Act disallows the credit if the Commissioner is satisfied that it would be inappropriate for a taxpayer to be allowed a credit because the company issuing the imputation credit has not paid sufficient income tax.

The submissioner's recommendation for a further amendment to remove the reference to "by the Commissioner" from section LB 2(5)(b) is unnecessary because those words are already being removed by the schedule in clause 183 of the bill containing various common self-assessment amendments.

Recommendation

That the submission be declined.

REMOVING COMMISSIONER DISCRETIONS

Clauses: various

Issue: Drafting of amendment to section DF 2

Submission
(10 – PricewaterhouseCoopers)

The replacement wording for section DF 2 contained in clause 22 is not easy to read and interpret, and gives alternative wording.

Comment

Section DF 2 deals with the deductibility of employers' contributions to employees' benefit funds. Clause 22 of the bill replaces the existing wording in order to place it on a self-assessment footing.

Officials do not consider that the replacement wording suggested by the submissioner would make the provision easier to read and interpret.

Recommendation

That the submission be declined.

Issue: Section DL 1(11) – cost of timber determinations

Clause 43

Submission
(8 – Institute of Chartered Accountants of New Zealand)

In the proposed amendment to section DL 1(11) contained in clause 43 of the bill, the use of the word "determine" may need to be reconsidered since it has the connotations of "determinations", which have been altered significantly with the formalisation of the self-assessment. Consideration to using a similar word, such as "ascertain", should be investigated.

Comment

The use of "determine" is based on the existing wording, and officials consider that it remains the best word to use in section DL 1(11), which relates to cost of timber determinations. The self-assessment legislative exercise will result in a number of existing determinations, such as loss and foreign tax credit determinations, being dispensed with. However, this should not mean that the word "determine" cannot continue to be used elsewhere in the Act where appropriate.

Recommendation

That the submission be declined.

Issue: Drafting of section DN 1(8)(c) amendment

Clause 47

Submission
(8 – Institute of Chartered Accountants of New Zealand)

In clause 47(6)(a) of the bill, a further portion of section DN 1(8)(c) needs to be omitted for the provision to read sensibly. In particular, the words "so as to preclude" should be removed.

Comment

Officials do not agree that the words "so as to preclude" should be removed from section DN 1(8)(c), as amended by clause 47(6)(a), because such omission would mean that the provision would no longer read properly.

The wording the submission suggests be removed is set out in italics below in the relevant portion of section DN 1(8)(c), as amended by the bill:

> "Subsection (7) shall not apply *so as to preclude*, so long as that asset continues to be used for that purpose, such deductions by way of depreciation in respect of that asset…"

Recommendation

That the submission be declined.

Issue: Drafting of section HF 1(4)

Clause 110

Submission
(8 – Institute of Chartered Accountants of New Zealand)

In clause 110 of the bill, the replacement words in section HF 1(4) should begin with a capital letter, as they are the start of the subsection.

Comment

Officials agree that the replacement wording for section HF 1(4), contained in clause 110(2)(a), should begin with a capital letter.

Recommendation

That the submission be accepted.

Issue: Section KC 1 – low income rebate

Clause 136

Submission
(8 – Institute of Chartered Accountants of New Zealand)

Clause 136 of the bill applies to the version of section KC 1(1) that applies from the 1999-2000 income year rather than the version that applies only for the 1998-99 income year.

Comment

Clause 136 of the bill applies only to the current version of section KC 1. This is made clear by the application date of clause 136, which is the 2002-03 and subsequent income years. As such, there is only one version of section KC 1, which will apply in relation to self-assessment.

Recommendation

That the submission be noted.

Issue: Location of new section KD A1

Clause 141

Submission
(8 – Institute of Chartered Accountants of New Zealand)

Clause 141 of the bill, by introducing a new section KD A1 of the Income Tax Act, does not follow the standard alphanumeric style. The provision would be better labelled section KD 1AA, which would still appear before the current section KD 1A, the intended location for this new provision.

Comment

Clause 141 inserts a new provision which provides that despite self-assessment, family support and family plus tax credits are calculated by the Commissioner. Officials note that the intended location for this new provision is at the very beginning of subpart KD – before section KD 1, rather than before, as the submission suggests, section KD 1A.

Therefore the proposed numbering of the provision to be inserted by clause 141 – section KD A1 – is the correct numbering as it ensures that this provision will be the first provision in subpart KD.

Recommendation

That the submission be declined.

Issue: Use of "reflected" terminology

Clauses 149 and 150

Submission
(8 – Institute of Chartered Accountants of New Zealand)

In clauses 149(1) and 150(4) of the bill, use of the word "reflected" may not be entirely clear. It would be more appropriate to use text such as "included" or "applied".

Comment

Clauses 149 and 150 amend sections LC 3 and LC 4 respectively of the Income Tax Act 1994, which relate to foreign tax credits and controlled foreign company foreign tax credits. The amendments are consequential to the decision to remove the separate determinations for these credits. Accordingly, the existing references to the date of the notice determining the credit are replaced by references to "the date of the notice of assessment in which the credit for foreign tax is reflected".

Officials consider that it is more appropriate to use the term "reflected" in this context than "included" or "applied", as suggested by the submission. This is because the notice of taxpayer assessment will include the following information: taxable income, income tax liability and, if applicable, net loss, terminal tax or refund due. Although credits are taken into account in ascertaining the amount of terminal tax or refund due, they are not directly included in the notice of assessment. Therefore the use of the word "reflected" in clauses 149 and 150 is more accurate and indicates that credits are taken into account in ascertaining the amounts of terminal tax or refund due for the purpose of a notice of assessment.

Recommendation

That the submission be declined.

Issue: Identifying definition to which amendment is made

Clause 183

Submission
(8 – Institute of Chartered Accountants of New Zealand)

In clause 183(1) of the bill, the particular definition being amended in section EP 1(11), namely "annual income tax balance date", should be identified.

Comment

Officials agree that it would be consistent with the rest of clause 183, which contains a schedule of consequential amendments related to self-assessment, for the particular definition in section EP 1(11), namely "annual income tax balance date", to be identified.

Recommendation

That the submission be accepted.

Issue: Certain rights of challenge not conferred

Clause 216

Submission
(8 – Institute of Chartered Accountants of New Zealand)

In clause 216(1) of the bill, a reference to section 183B is included in section 138E(1)(e)(iv) of the Tax Administration Act, yet by clause 216(2) the section 183B reference is omitted. The reference to section 183B in clause 216(1) should be omitted, given that clause 216(1) applied from the 2002-03 income year and clause 216(2) from 1 April 2002.

Comment

The application dates for subclauses (1) and (2) of clause 216 are different in the case of a taxpayer with a non-standard balance date. The earliest balance date for the 2002-03 income year would be 1 October 2002, while the latest balance date for that income year would be 30 September 2003. Therefore the application dates for subclauses (1) and (2) of clause 216 are not necessarily the same. The retention of

separate references to clause 183B in clause 216(1) and (2) is, therefore, appropriate. The 1 April 2002 application date for the repeal of the section 183B reference in section 138E(1)(e)(iv) is also consistent with the application date for the repeal of section 183B itself, and the separate reference to it in clause 216(2) allows readers to more easily track this amendment.

Recommendation

That the submission be declined.

Issue: Replacing alteration references

Clause 226

Submission
(8 – Institute of Chartered Accountants of New Zealand)

In clause 226(2), the change to section 176(1) of the Tax Administration Act 1994 is not to replace "altered" by "amended", but rather replace "alterations" by "amendments".

Comment

The proposed amendment to section 176(1) of the Tax Administration Act 1994 by clause 226(2) of the bill, which involves replacing "altered" by "amended", is correct. A separate amendment to section 176(1) is made by clause 224, which involves replacing "alterations in" with "amendments to".

Recommendation

That the submission be declined.

SCOPE OF THE BILL

Issue: Taxpayer assessment as part of the Rewrite of the Income Tax Act

Clauses: various

Submission
(4 – New Zealand Law Society)

Changes to the Commissioner's discretions would be better able to be considered as part of the rewrite of the Income Tax Act.

Comment

In respect of the changes contained in the bill, the Law Society agrees with legislating for self-assessment, noting in its submission that "the principles behind such amendments are reasonable" and "that the amendments themselves are not likely to affect taxpayers". The objection expressed is only to the number of amendments in the bill, which in the Society's view should be added to the rewrite of the Income Tax Act.

Legislating for self-assessment requires the removal of the outdated language of Commissioner assessment, placing the legislation on a footing that reflects modern administrative practices based on self-assessment. The nature of the changes necessary to achieve this are fundamental and wide-ranging in scope and as such are an important aspect of progressing wider reform, including the rewrite of the Income Tax Act. Legislating for self-assessment in this bill will allow the rewrite to be progressed to best effect.

The purpose and scope of the rewrite of the Income Tax Act is quite distinct from that of self-assessment. This is reflected in the main changes for self-assessment being made in the Tax Administration Act, which in turn give rise to the need to make consequential amendments to other related legislation. Although the Income Tax Act is the largest piece of legislation requiring consequential amendment as a result of the central self-assessment changes in the Tax Administration Act, other Acts, such as the Child Support Act, also require consequential amendment for the same reason. The reason for the large number of consequential changes is the widespread use of wording that if not amended would, at least in a technical sense, impede taxpayers in making their own assessments. These changes proposed by this bill are integral to legislating for taxpayer assessment.

Tax legislation can be written either on the basis of recognising taxpayer assessment together with the Commissioner's assessment function as proposed in the bill, or on the basis of Commissioner-only assessment as in the current legislation. As such, there is limited middle ground which would allow self-assessment to be addressed as part of the rewrite of the Income Tax Act as submitted by the Law Society. In addition, officials consider that combining the legislation for self-assessment with the rewrite of the Income Tax Act would unduly complicate what are each in their own right highly complex legislative projects.

In addition to the consultative process stemming from the 1998 discussion document, early draft legislation on self-assessment was sent to the Law Society for comment. Officials note that this is the first suggestion from the Society that changes to the Commissioner's discretions to cater for self-assessment should be incorporated into the project for the rewrite of the Income Tax Act.

Recommendation

That the submission be declined.

Issue: GST and self-assessment

Clause: n/a

Submission
(8 – Institute of Chartered Accountants of New Zealand)

Section 27 of the GST Act should be put on an explicit self-assessment basis.

Comment

Legislating more explicitly for self-assessment of GST would involve a number of complex policy issues that are currently being considered as part of the forthcoming post-implementation review of the disputes procedures. Officials consider that given the significance of some of the policy issues involved with GST, full consultation in accordance with the generic tax policy process is desirable.

In addition, the GST legislation already closely approximates self-assessment. In most cases, taxpayers' self-assessed GST returns are treated both as a matter of law and in practice as being conclusive and correct, unless the Commissioner makes an assessment or a challenge is initiated by either party.

Recommendation

That the submission be declined.

MINOR AMENDMENTS

Issue: Definition of "notice of proposed adjustment"

Clause 185

Submission
(3 – Rudd Watts & Stone)

The definition of "notice of proposed adjustment" in section 3 of the Tax Administration Act 1994 needs to include a notice issued by a taxpayer under proposed section 89DA.

Comment

New section 89DA, inserted by clause 198 of the bill, will allow a taxpayer to issue a notice of proposed adjustment to the Commissioner in respect of an income tax assessment made by the taxpayer. Officials agree with the submissioner that the definition of "notice of proposed adjustment" in section 3 of the Tax Administration Act should include a notice issued by a taxpayer in respect of their own assessment under the new section 89DA.

Recommendation

That the submission be accepted.

Issue: Default assessments

Clause: n/a

Submission
(10 – PricewaterhouseCoopers)

Section 106 of the Tax Administration Act 1994 allows the Commissioner to make a default assessment if a taxpayer fails to furnish a return or the Commissioner is "not satisfied with the return made by any person". The submissioner considers that because it is arguable that the return and the notice of assessment referred to in section 33 are separate documents, section 106 should possibly refer to the Commissioner not being satisfied with either document.

Comment

Officials do not consider that this amendment is necessary. This is because new section 33, inserted by clause 187 of the bill, ensures that the notice of the taxpayer assessment is part of the return. In particular, new section 33(2) will read: "A return must contain a notice of the assessment required to be made under section 92".

Recommendation

That the submission be declined.

Issue: A purpose provision in relation to taxpayer assessment

Clause: n/a

Submission
(8 – Institute of Chartered Accountants of New Zealand)

A purpose or interpretation provision should be added to the Tax Administration Act.

Comment

The bill already includes an amendment to a general provision in the Tax Administration Act (section 15B) that provides a summary of the main obligations of taxpayers.

This amendment proposed by the bill makes it clear that if required to do so, taxpayers must make an assessment of their taxes.

Elsewhere in the legislation the respective obligations of the taxpayer and the Commissioner are provided for in context and in more detail.

Recommendation

That the submission be declined.

Issue: A return as a "notice of self-assessment"

Clauses 187 and 202

Submission
(8 – Institute of Chartered Accountants of New Zealand)

- For the purpose of the provision requiring taxpayers to make an assessment, a return should be referred to as a "notice of self-assessment".
- The provision requiring tax returns to be made should refer to "notice of self-assessment" instead of "notice of assessment".

Comment

"Assessment" is defined in the bill as either Commissioner or taxpayer assessment. There is no separate term "self-assessment". The fact that the notice of assessment will be part of the taxpayer's return will remove any scope for confusion. It will be clear in the design of the return form that the notice is of the taxpayer's self-assessment.

Recommendation

That the submission be declined.

Issue: Section 80H

Clause 194

Submission
(Matter raised by officials)

Amendments to sections 80G(2) and 80H (dealing with personal tax summaries/income statements) are required to better reflect that a return of income must contain a notice of assessment under the new section 33 proposed by the bill.

Comment

Changes are required to improve the way assessments and notices of assessments are provided for in relation to personal tax summaries/income statements. The suggested changes would make the current bill proposals clearer, in particular, by referring to the notice of assessment explicitly in relation to the treatment of personal tax summaries/income statements that taxpayers accept as being correct in which case no further action is required.

Section 80G(2) should be amended along the following lines (new text italicised):

> "… an income statement issued to a person … is deemed to be a return of income furnished by the person under section 33 and to *contain a notice of assessment* signed by the person."

Similarly, the changes proposed by the bill in relation to section 80H, regarding assessments deemed to have been made in respect of these personal tax summaries/income statements, could be provided for more clearly along the lines of:

> "An assessment required to be made under section 92 is treated as having been made by the person in respect of an income statement deemed to be a return of income under section 80G(2)."

Recommendation

That the submission be accepted.

Issue: Definition of "assessment" in relation to the Tax Administration Act

Clause: n/a

Submission
(8 – Institute of Chartered Accountants of New Zealand)

Specific reference to the definition of "assessment" should be included in section 3(1) of the Tax Administration Act 1994 (TAA) to emphasise the importance of self-assessment.

Comment

The proposed Income Tax Act definition of "assessment" applies in the TAA by virtue of section 3(2) of the latter. It is clear, therefore, that the same definition applies for both Acts.

Furthermore, the importance of taxpayers making their own assessment is emphasised by other changes introduced in the bill such as adding a reference to taxpayers having to make assessments to provisions that already set out taxpayers' main obligations (for example, section 15B of the TAA).

Recommendation

That the submission be declined.

Issue: How time limits apply to an assessment that includes losses

Clauses: various

Submission
(8 – Institute of Chartered Accountants of New Zealand)

The legislation should take into account time limits in circumstances where losses have been incurred.

Comment

The time limits in the legislation apply to an assessment that includes losses in the same way as they apply to an assessment that does not include losses. As the submission notes from the *Commentary on the Bill*, losses will be available to taxpayers to include in their annual assessments. The time limits that apply in respect of taxpayer losses will continue to apply under self-assessment, as they do now.

Recommendation

That the submission be declined.

Issue: The two-month period for taxpayers to propose adjustments to their self-assessments

Clause: n/a

Submission
(8 – Institute of Chartered Accountants of New Zealand, 10 – PricewaterhouseCoopers)

More time should be provided for taxpayers to propose adjustments to their own self-assessment than the existing two months. PricewaterhouseCoopers submits that this two-month period should be extended to 12 months.

Comment

Officials note that the bill recognises the current two-month period is important for taxpayers, particularly as it allows a self-assessment to be adjusted in a way that limits exposure to penalties. Taxpayers already have this general ability available to them, but the period applies from the date they receive a (generally) computer generated notice of assessment from the Commissioner that corresponds to their return, rather than from the date of filing the return, as at present.

There are a number of wider issues related to the two-month period that link to the general design and operation of the disputes procedures, which are being considered as part of the post-implementation disputes procedures review. As part of this review, a discussion document will be published which will give an opportunity for submissions to be made according to the generic tax policy process.

Recommendation

That the submission be declined.

Issue: Whether taxpayers should be able to fix a date of self-assessment

Clause: n/a

Submission
(10 – PricewaterhouseCoopers)

Taxpayers should have the ability to fix a specific date of assessment on their notice of assessment if that date is not later than the date on which the notice of assessment must be furnished to the Commissioner.

The submissioner notes that the definition of "response period" turns on the date of issue of a notice of assessment. Allowing taxpayers to fix a date on their notice of assessment would avoid unnecessary uncertainty about the date of issue.

Comment

The submissioner notes that the date an assessment is issued is central to the definition of the two-month response period in the disputes procedures. Officials consider the submission has merit because the date from which this two-month period begins should be certain. However, we consider that a timeframe should be provided for determining the earliest date that can appear on a taxpayer's notice of assessment. (The precise timeframe can be determined by the Commissioner administratively, in consultation with interested parties.) We note that making this change would entail minor drafting consequential amendments.

Recommendation

That the submission be accepted.

Issue: Section 89C

Clause 196

Submission
(Matter raised by officials)

The bill amendments incorrectly change "…the Commissioner may issue a taxpayer with an assessment of tax…" to refer to a notice of assessment. Instead the bill should change section 89C to refer to the Commissioner making an assessment.

Comment

Section 89C provides the circumstances in which the Commissioner can make an assessment without first issuing a notice of proposed adjustment. Instead of referring to the notice of assessment, the changes being made to section 89C should refer to the ability to make an assessment.

The opening words of section 89C should be amended along the following lines:

> "The Commissioner must issue a notice of proposed adjustment before the Commissioner *makes an assessment*, unless…".

In respect of the other related changes proposed for section 89C, the amendments should refer to an assessment being made rather than, as proposed by the bill, the notice of assessment being issued.

Recommendation

That the submission be accepted.

Issue: New section 89D(2)

Clause 197

Submission
(Matter raised by officials)

The proposed new section 89D should be amended to ensure that new section 33(2) does not apply.

Comment

New section 89D(2) provides that a taxpayer that has not furnished a return of income may dispute an assessment made by the Commissioner only by furnishing the return of income.

Taxpayers are obliged to furnish annual returns of income under section 33. New section 33(2) will provide that a return must contain a notice of the taxpayer assessment required to be made under new section 92. New section 33(2) caters adequately for the normal self-assessment situation. However, for the purpose of new section 89D(2) it is necessary to "switch off" section 33(2).

When the Commissioner makes the first assessment, instead of the taxpayer, the notice of assessment required under section 33(2) to be included in a return of income is not needed. This should be clarified in the context of new section 89D for taxpayers proposing adjustments to assessments made by the Commissioner. The Commissioner may, for example, make the first assessment when the Commissioner makes an assessment after completing some calculations for some taxpayers, such as those who receive rebates of income tax under Part KD of the Income Tax Act.

Recommendation

That the submission be accepted.

Issue: New section 89DA

Clause: 198

Submission
(Matter raised by officials)

The words used in the proposed section 89DA should reflect the terminology already used in section 89D(1).

Comment

New section 89DA allows taxpayers to file notices of proposed adjustment in respect of their own assessments. Officials consider that wording along the following lines should be added to the end of subsection (1):

> "… if the Commissioner has not previously issued a notice of proposed adjustment to the taxpayer in respect of the assessment, whether or not in breach of section 89C."

The new wording above mirrors that contained in the corresponding provision in section 89D(1). These words prevent competing disputes procedures being invoked in respect of the same assessment.

Recommendation

That the submission be accepted.

Issue: New section 92

Clause 202

Submission
(Matter raised by officials)

Amendments should be made to clarify that when the Commissioner, instead of the taxpayer, makes the first assessment, the taxpayer does not make an assessment.

Comment

The requirement for taxpayers to make an assessment is being established only in relation to making the first assessment. In circumstances where taxpayers do not or are not required to make an assessment, the Commissioner may make an assessment in place of the taxpayer. A tie-breaker provision is necessary to prevent the possibility of there being competing initial assessments for the same period.

The assessment rules in section 92 should more clearly provide that when the Commissioner makes an assessment for an income year in respect of a taxpayer before the taxpayer does so, then section 92 ceases to apply to the taxpayer for that income year. Examples of when the Commissioner may make an assessment include when taxpayers default (section 106, TAA), a special assessment (section 44, TAA), or when the Commissioner calculates certain rebates of income tax for taxpayers (Part KD, ITA).

The wording of the tie-breaker provision in section 92 could be along the following lines:

> "This section does not apply to a taxpayer for an income year if the Commissioner has made an assessment in respect of the taxpayer for the income year."

Thus, if the Commissioner has made the initial assessment in respect of a taxpayer for an income year there can be no taxpayer assessment for that income year, and if the taxpayer does not agree with the Commissioner assessment the taxpayer may dispute that assessment. The taxpayer will continue to have an obligation to file all relevant returns.

Recommendation

That the submission be accepted.

Issue: What happens when the Commissioner calculates rebates of income tax

Clauses 187, 141, 196 and 202

Submission
(Matter raised by officials)

The bill should more clearly provide that taxpayers' obligations in respect of making assessments are limited by the extent calculations are made by the Commissioner in relation to rebates of income tax under Part KD (family tax credits) of the Income Tax Act 1994.

Comment

In the circumstances where the Commissioner calculates the amount of a rebate of income tax under Part KD of the Income Tax Act 1994, taxpayers will not be able to assess their tax liability. The Commissioner will make the initial assessment for the taxpayers involved. These taxpayers cannot complete the notice of assessment required under the new section 33 to be contained on the return. This should be clarified further in the bill, consistent with the approach already taken in new section KD A1 proposed by the bill. Officials note that further consequential amendments are necessary to reflect that the Commissioner will make assessments that include a rebate of income tax to be calculated by the Commissioner under Part KD.

Recommendation

That the submission be accepted.

Issue: Minor amendment to new section 33(1)

Clause 187

Submission
(Matter raised by officials)

It is sufficient to refer to a " return of income" rather than to "return or returns of income" in the context of taxpayers furnishing their self-assessed returns to the Commissioner.

Comment

The wording of the new section 33(1) proposed by the bill uses terms carried over from the current section 33. However, officials consider that referring to "a return of income or returns of income" in the new section 33(1) would not fit comfortably with new section 33(2), which assumes a single annual return of income. Referring to more than one return in this context is also unnecessary given sections 79 and 80 of

the TAA, which provide for the furnishing of any other returns required by the Commissioner. Accordingly, the words "or returns of income" should be omitted from new section 33(1).

Recommendation

That the submission be accepted.

Issue: Minor amendment to section 177(4)

Clause: n/a

Submission
(Matter raised by officials)

In existing section 177(4), the words "issue an amended assessment" should be replaced by "amend an assessment" for consistency with the terminology used elsewhere in the bill.

Comment

The amendments in the bill distinguish between making an assessment and providing a notice of that assessment. Officials consider language that refers to the "issuing of an assessment" should be amended so that the legislation refers to either making an assessment or providing a notice of that assessment. As the Commissioner's general power to assess is being removed, it is important that the legislation is clear where it confirms the Commissioner may make an assessment. In this case it is appropriate to provide that the Commissioner may make an amending assessment to give effect to providing hardship relief under section 177.

Recommendation

That the submission be accepted.

MINOR ASSOCIATED AMENDMENTS TO THE CHILD SUPPORT ACT

Issue: Amendment to the definition of "taxable income"

Clause 240

Submission
(Matter raised by officials)

The definition of "taxable income" in section 29(1) of the Child Support Act should be amended to ensure the application of the definition does not change.

Comment

Instead of the current amendment proposed in clause 240(1)(a), officials consider the words proposed to replace "the Commissioner has not assessed a liable parent's taxable income for an income year and no income statement has been issued" should be "a liable parent's taxable income for an income year has not been assessed". These words provide a better translation into a self-assessment environment. In particular, these words allow the provision to operate, as it does now, in relation to taxpayers who are required to file a return but who do not.

With this proposed change the definition of "taxable income" in section 29(1) of the Child Support Act 1991 would read (with changes italicised):

> "**Taxable income** has the same meaning provided in section OB 1 of the Income Tax Act 1994 and—
> (a) If *a liable parent's taxable income for an income year has not been assessed,* the taxable income for the income year may be determined on the income and any other particulars known to the Commissioner; and
> …"

Recommendation

That the submission be accepted.

Issue: Application of assessment

Clause 242

Submission
(Matter raised by officials)

The changes proposed to section 38(6) of the Child Support Act 1991 should be amended to include reference to the Income Tax Act 1976.

Comment

Assessments made before the 1995-1996 income years may still be relevant in some cases for child support purposes. Officials consider that clause 242(3) should include a reference to "the Income Tax Act 1976 or" before the words "the Tax Administration Act 1994".

With this proposed change, section 38(6) of the Child Support Act 1991 would read (with changes italicised):

> "Where—
>
> (a) Notice of an assessment (including an amended assessment) of a person taxable income *has been given under the Income Tax Act 1976 or the Tax Administration Act 1994*; and
>
> (b) The notice was dated,—
>
> the assessment is to be taken, for the purposes of this section, to have been made on the date of the notice.

Recommendation

That the submission be accepted.

Changes to GST Act

(except for changes included after introduction of the bill)

GST ON TOKENS, STAMPS AND VOUCHERS

Issue: Amendment to section 5(11G) of the GST Act

Submission
(Matter raised by officials)

A minor drafting change should be made to section 5(11G) to clarify that paragraphs (a) and (b) operate disjunctively and not conjunctively. The change should apply from 10 October 2000.

Comment

Section 5(11G) was redrafted in the Taxation (Beneficial Income of Minors, Services-Related Payment and Remedial Matters) Act 2001 to ensure that the words "not practical" did not unreasonably prevent taxpayers from accounting for GST at the time of redemption when a voucher was used to acquire goods and services.

The amendment clarified that if the issuer of a voucher and the person supplying the goods and services in exchange for the voucher are not the same person, the issuer may elect to recognise GST at the time of redemption rather than at the time the voucher was issued (which is the standard rule). The intended application of the section requires there to be an agreement between the issuer and the supplier to this effect or that the issuer is party to such an agreement. However, no such agreement is required if the issuer of the voucher and the supplier of the goods and services are the same person.

Further clarification is desirable to ensure that section 5(11G) paragraph (a) (the not practical test), and paragraph (b) (the requirement to have an agreement if a third party is involved) are disjunctive and not conjunctive.

The clarification can be easily achieved if the last opening word to the paragraph "if" were deleted and an "if" placed at the beginning of both paragraphs (a) and (b) and therefore are effective where no third party is involved.

The change should apply from 10 October 2000, the date when the original amendments concerning the accounting for GST for vouchers (as contained in the Taxation (GST and Miscellaneous Provisions) Act 2000) and subsequent amendments (as contained in the Taxation (Beneficial Income of Minors, Services-Related Payment and Remedial Matters) Act 2001) came into effect. Officials recommend this retrospective date as the proposed amendment clarifies the interpretation of the legislation.

Recommendation

That the submission be accepted.

GST ON SUPPLIES TO VISITING FOREIGN-BASED PLEASURE CRAFT

Issue: Definition of 'consumable stores'
Clause 228

Submission
(10 – PricewaterhouseCoopers, 8 – Institute of Chartered Accountants of New Zealand)

The submissioners agree with the proposed change to the GST Act, allowing final provisioning of consumable stores supplied to a departing foreign-based pleasure craft to be zero-rated. However, they consider that the proposed definition of consumable stores should not exclude spare parts and that the exclusion of spare parts from the definition is based on unfounded concerns.

Comment

The current legislation uses the term "stores for consumption" in relation to commercial ships. "Stores for consumption" (or consumable stores) is not specifically defined in this context but is an internationally recognised term reflected in the International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto convention) carried over into the Protocol of Amendment 1999, by which New Zealand is bound. Consumable stores are those goods intended for consumption by passengers and crew (such as food) and goods necessary for the operation of a vessel, including fuel and lubricants but excluding spare parts and equipment.

The definition proposed in the bill is consistent with the term used in the context of commercial ships, which excludes spare parts and equipment.

Officials consider that it is not appropriate that spare parts are zero-rated as there is a greater risk (than in relation to final provisions) that the goods will be on-sold to residents and/or consumed in New Zealand.

However, in response to a submission made by the Boating Industry Association officials are recommending that specific maritime goods that may be required by foreign-based pleasure boats such as tenders, spare sails and life jackets, should be zero-rated.

Officials note that other goods such as those required by boats that are not stores for consumption can be entered for export and exported by the supplier at a zero-rate upon departure of the vessel. This requires the purchaser to satisfy the supplier that the goods are to be taken outside New Zealand (exported). The supplier must keep sufficient evidence, which proves the goods have left New Zealand. The supplier must deliver the goods entered for export to the boat on the day of departure from New Zealand.

Recommendation

That the submissions be declined.

Issue: Zero-rating of particular detachable maritime goods to foreign-based pleasure craft

Submission
(39 – Boating Industries Association of New Zealand)

The Boating Industry Association supports the proposed change in the bill to zero-rate consumable stores to foreign-based pleasure craft. It considers that it is important that fuel and food supplied just prior to departure is zero-rated for GST to facilitate the continued visits of large foreign-based pleasure craft to New Zealand.

There is, however, an issue surrounding the application of the zero-rating provisions to goods supplied to boats such as spare sails, tenders, life jackets and spare anchors. The submissioner argues that a change to the legislation allowing this is needed to assist the growth of the number of foreign-based pleasure craft visiting New Zealand.

Comment

Currently, the GST legislation allows goods that become part of a temporary import to be zero-rated on the basis that the goods will be taken out of New Zealand, and are much like exports. Goods that are loose or detachable are not zero-rated because of the risk that they may be consumed in New Zealand and/or that they may be onsold to a resident.

Sails, tenders, life jackets, and spare anchors are considered to be loose or detachable and are currently not zero-rated. This is creating difficulties for the boating industry and is resulting in anomalies – for example, a furling mainsail is zero-rated but a standard main or staysail is sold standard rated.

In the case of the goods in question being built or provided specifically for the particular yacht, the risk of the goods being consumed in New Zealand or being on-sold to a resident is relatively low. It is therefore appropriate to zero-rate these supplies.

Recommendation

That the submission be accepted.

Issue: Removal of definition of 'consumable stores'

Submission
(Raised by officials)

That the proposed definition of 'consumable stores' which defines goods supplied for consumption by the passengers and crew to include food, fuel and lubricants but exclude spare parts, be removed from the bill.

Comment

"Stores for consumption" (consumable stores) is currently used in the context of zero-rating supplies to commercial vessels and is an internationally recognised term, which does not include spare parts.

In light of the submission made by the boating industry, it is proposed to zero-rate specific spare parts required by foreign-based boats, which will alleviate the boating industry's concerns.

Officials therefore consider that including a separate definition is unnecessary.

Recommendation

That the submission be accepted.

Issue: Time limit required for departure

Submission
(10 – PricewaterhouseCoopers)

The submissioner considers that there is a risk that a pleasure craft will be supplied with zero-rated goods and stay for, say, 18 months after the supply. The submissioner suggests that there should be a time limit imposed outside which zero-rating is not possible.

Comment

Officials agree that the intention is to ensure that zero-rated goods are consumed outside New Zealand. The proposed clause and existing rules meet those concerns.

A supplier (provedore) must be satisfied that the boat is departing before zero-rating can be applied to the consumable stores required for the duration of the voyage. Provedores are specialist suppliers equipped to handle the needs of departing boats. Provedores are generally licensed as customs controlled areas under customs legislation. The stores must be bought for use outside New Zealand and the boat must be going to a destination outside New Zealand.

Customs may allow entry of foreign-based pleasure craft under what is termed a "temporary import entry" (TIE). This is issued for a period of no longer than 12 months. Zero-rating will only be available to those pleasure craft that are in New Zealand with a TIE. The TIE will be used as a way of limiting the number of boats entitled to the stores on departure in that it excludes New Zealand based yachts. The fact that the TIE is issued for a limited time combined with the requirements in the bill that the boat must be going to a destination outside New Zealand and the stores must be bought for consumption outside New Zealand adequately addresses the concern expressed by the submissioner. These requirements minimise the risk that the stores will be consumed in New Zealand.

Recommendation

That the submission be declined.

Changes to other Acts

AMENDMENTS TO STAMP AND CHEQUE DUTIES ACT 1971

Issue: Drafting issue

New clause

Submission
(Matter raised by officials)

An amendment to section 86I(b) of the Stamp and Cheque Duties Act 1971 is required to clarify a change made to this section in the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001. The change was to include AIL within the compliance and penalty rules and was intended to apply to payments of interest on and after the date of royal assent (27 March 2001).

Comment

While the intent of the original amendment was that it should apply to payments of interest made on and after the date of Royal assent, this did not in fact occur. The original amendment was, in fact, passed with application on but not after the date of Royal assent.

The original amendment also did not state that it specifically applied to the payments of interest from that date. It is important also that this is clarified as in both cases taxpayers have been applying the law as it should be rather than as it currently is.

Recommendation

That an amendment be made to section 86I(b) of the Stamp and Cheque Duties Act 1971 to clarify that the inclusion of AIL within the compliance and penalty rules applies to payments of interest made on and after the 27 March 2001.

MINOR REMEDIAL AMENDMENTS TO TAXATION (BENEFICIARY INCOME OF MINORS, SERVICES-RELATED PAYMENTS AND REMEDIAL MATTERS) ACT 2001

Issue: Correction

Submission
(Matter raised by officials)

Section 66(1)(c) of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001 should be amended to correctly refer to paragraph (b).

Comment

Section 66(1)(c) of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001 amends section 21B(3) of the Goods and Services Tax Act 1985. Officials recommend that section 66(1)(c) be amended to correctly refer to paragraph (b) instead of paragraph (c).

Recommendation

That the submission be accepted.

Issue: Correction

Submission
(Matter raised by officials)

The first reference to subsection (1) in section 64 of the Taxation (Beneficiary Income of Minors, Services-Related Payments and Remedial Matters) Act 2001 should be a reference to subsection (2).

Comment

Section 64 of that Act enacts part of the tax simplification initiative to move the return of GST on fringe benefits from GST returns to FBT returns. The subsection reference should be to subsection (2) and is an inadvertent error.

Recommendation

That the submission be accepted.

MINOR REMEDIAL AMENDMENT TO CHILD SUPPORT ACT 1991

Submission
(Matter raised by officials)

That the reference to the fourth proviso to section NC 6(1) of the Income Tax Act 1994 in section 30(5) of the Child Support Act 1991 be corrected.

Comment

Three definitions in section 30(5) of the Child Support Act 1991 incorrectly refer to the fourth proviso to section NC 6(1) of the Income Tax Act 1994. The correct reference is section NC 6(1D) of the Income Tax Act 1994. Officials recommend that these references be corrected from 1 April 1999, the date from which the new section NC 6(1D) came into force.

Recommendation

That the submission be accepted.