# Taxation (Beneficiary Income of Minors, Services-related Payments and Remedial Matters) Bill

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

**19 February 2001**

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

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# PART I

# Taxing beneficiary income of minors at 33%

# TAXING BENEFICIARY INCOME OF MINORS AT 33%

## Introduction

The bill proposes a rule to ensure that distributions of beneficiary income from a trust to a child under the age of 16 years are taxed at a final tax rate of 33% (the minor beneficiary rule). In accordance with the generic tax policy process, the Government released a consultative issue paper outlining the proposed rule in June 2000 and officials consulted widely with a number of private sector organisations with particular knowledge in this area.

The proposed minor beneficiary rule is necessary to limit the ability of some families to gain a tax advantage by meeting expenses of the children through the use of a trust. Given the specific purpose of the rule, it will only apply when settlements have been made on the trust by a relative or guardian of the minor or by a person associated with a relative or guardian. The bill proposes a number of exceptions to the rule. For example, if the beneficiary income was distributed to a non-resident minor, or to a disabled minor for whom a child disability allowance is paid under the Social Security Act 1964.

The proposed rule will apply in respect of income derived from 1 April 2001 or for the equivalent income year.

## Overview of submissions

Eight submissions dealt with the taxation of minor beneficiaries. With one exception, submissions strongly opposed the proposed rule. In particular, it was submitted that the proposed rule breaches fundamental principles of trust law because it results in income being taxed to a different person and at a different tax rate than the person to whom the income legally belongs. The proposed rule was also opposed on the basis that its application is too broad and will apply inequitably to trusts operated for legitimate purposes not engaging in any tax motivated income splitting.

One of the most significant specific concerns raised was the appropriate treatment of mixed trusts. These are trusts where settlements by a relative, guardian or associate which were not within any of the exceptions (“tainted settlements”) are managed as one trust along with settlements which were not intended to be caught by the rule (“untainted settlements”).

Significant concerns were also expressed in submissions about the extent of the definition of “relative”, on the exceptions for testamentary trusts and the minimum threshold under which beneficiary income is exempted from the rule.

Officials provided details of the proposed amendments in respect of mixed trusts to the Institute of Chartered Accountants of New Zealand and the New Zealand Law Society and invited these organisations to provide comments.

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

- Clarify that all beneficiary income of a minor is subject to the minor beneficiary rule unless all settlements on that trust fit within any of the listed exceptions. However, the rule will not apply to beneficiary income of a minor from a mixed trust if all tainted settlements on the trust were dispositions of property and the total value of those tainted settlements at the date of settlement does not exceed $5,000. If any of the tainted settlements are not dispositions of property, for example, if they are settlements of financial assistance, or if a relative, guardian or their associate has provided services to the trust, then all minor beneficiary income from that mixed trust is subject to the rule.
- Extend the exception for settlements under a will or intestacy so that the exception will apply if the minor is alive within 12 months of the date of the settlor's death or a brother or sister of the minor is alive within 12 months of the date of the settlor's death.
- Increase from $200 to $1,000 the minimum threshold under which beneficiary income from trusts is exempt from the rule.
- Extend the definition of "relative" for the purposes of this rule to include settlements made on the trust by a de facto partner of the child's relation.

## SUPPORT FOR THE PROPOSED MINOR BENEFICIARY RULE

**Submission**
*(6 – National Council of Women of New Zealand)*

Overall, the National Council of Women of New Zealand supports the spirit of the proposed rule. If parents and guardians are placing income-earning assets in a trust, distributing income to children as beneficiary income taxed at a lower marginal rate and using the income to meet family expenses, then this is a clear example of tax avoidance and should be discouraged.

## OPPOSITION TO THE PROPOSED MINOR BENEFICIARY RULE

### Submissions

*(7 – ICANZ, 5 – PricewaterhouseCoopers, 3 – New Zealand Law Society, 3 – New Zealand Employers Federation, 4 – Federated Farmers of New Zealand, 1 – HB Thomas)*

The proposed minor beneficiary rule is strongly opposed. The current rules should be maintained in relation to the taxation of beneficiary income of minors.

The rule is opposed for the following reasons:

- *(ICANZ, PricewaterhouseCoopers)*

  It results in income being taxed to a different person and at a different tax rate than the person to whom the income legally belongs.

- *(1 – HB Thomas)*

  The proposals are contrary to the Government's pre-election commitment that there would be no rise in income tax for the 95% of taxpayers earning under $60,000.

- *(PricewaterhouseCoopers, Federated Farmers of New Zealand, New Zealand Employers' Federation)*

  The proposals are too broad in their application and will apply inequitably to trusts operated for legitimate purposes not engaging in any tax motivated income splitting.

  The primary purpose of trusts in a farming context, for example, is asset protection.

- *(New Zealand Employers' Federation, PricewaterhouseCoopers, Federated Farmers of New Zealand)*

  The proposed rule results in income being taxed differently depending on its source. Consequently, it is likely to lead to assets being owned directly by the child.

- *(PricewaterhouseCoopers, New Zealand Law Society)*

  The proposal creates a number of anomalies. Low-income spouses or other adult beneficiaries will continue to be taxable at their marginal tax rate. Consequently it will not achieve an equitable redistribution of the tax burden.

- *(PricewaterhouseCoopers)*

  Even if the minor's income could, in substance, be regarded as the income of the parents, this rationale does not justify taxing the minor at 33% if one (or both) of the parents has marginal tax rate less than 33%.

- *(New Zealand Employers' Federation)*

  The extent of income being distributed to minors in order to minimise income subject to the 39% tax rate does not appear to be sufficient to justify this measure.

- *(PricewaterhouseCoopers)*

  Anti-avoidance rules are already in place to deal with situations where beneficiary income derived by minors is not being used directly to benefit the minor, or is being used to provide the basic necessities of life for the minor. Rules therefore exist currently to counter family expenses being funded by distributions to minors. These existing measures should be enhanced if not achieving their objective.

## Comment

The purpose of the proposed minor beneficiary rule is to limit the ability of some families to gain a tax advantage by meeting expenses of the children through the use of a trust. Parents generally meet the expenses of their children from their after-tax income. However, by settling income-earning assets on a trust and distributing the income to the children, these expenses can be met from income taxed at the marginal tax rates of the children. Thus, where the parents' marginal tax rate is 33% or 39% and that of the children is 19.5%, income that would otherwise be taxable to the parents at the higher rate becomes taxable to the children at the lower rate. Whilst this income is legally that of the child, it is unlikely in these cases that the children are actually determining how the funds are spent. In fact, the income distribution is likely to take the form of payment of school fees or expenses, rather than a cash distribution. The limitation of the rule to minors under 16 years recognises that above that age it is increasingly likely that beneficiary income is not, in fact, used to meet family expenses.

For example, Inland Revenue records show that in the 1999 income year, about 3000 children under the age of six received beneficiary income exceeding $21 million in total. This is an average of $7,000 income for each child under the age of six and excludes interest and dividend income distributed by trusts.

The Income Tax Act 1994 does include general anti-avoidance provisions to deal with situations where beneficiary income derived by a minor is not being used directly to benefit the minor, or is being used to provide the basic necessities of life. However, in the situation described above, provided that the expenses met are over and above normal parental obligations and that the distributions are genuinely used to benefit the child, these anti-avoidance rules will not apply. Yet, these families are clearly able to obtain a tax advantage not available to families without a trust.

Because this tax advantage is only being obtained in a specific situation, it is appropriate that a specific rule be provided to deal with this situation, rather than amending the general anti-avoidance rules.

Officials recognise that trusts are used by a wide variety of people for a wide range of reasons. Consequently, the minor beneficiary rule does not apply in all situations in which a minor derives beneficiary income. Rather, its application is limited to those trusts on which a settlement has been made by a relative or guardian of the minor, or a person associated with a relative or guardian. The specific exceptions from the rule and the minimum threshold exemption are aimed at ensuring that the rule does not apply in situations where a tax advantage clearly would not be obtained.

Because this rule applies only to income distributed to a minor, the important role of trusts in asset protection will not be affected by this proposal.

The point was made in submissions that the rule could result in the minor being taxed at 33%, when the tax rate of the settlor may in fact be lower. Given the purpose of the rule, a case could be made for taxing minor beneficiary income at the settlor's tax rate (who may or may not be a parent of the beneficiary) rather than at the trustee rate of 33%. It is likely that in many cases the settlor's marginal tax rate will be 33% or 39% but it could be 19.5% in some cases. However, to use the settlor's tax rate would involve considerable administrative and compliance costs. For example, trustees would be required to find out the tax rate of the settlor. This information may not be readily available. The applicable tax rate could be either the settlor's tax rate at the date the settlement was made or the settlor's current tax rate.

It is for these reasons that trustee income is taxed at 33% and not at the settlor's rate, and the same pragmatism leads to the conclusion that the 33% trustee rate is appropriate for minor beneficiary income. During its hearing of evidence on the bill, the Committee asked officials for information as to whether Inland Revenue had considered taxing children's beneficiary income at the marginal tax rate of their parents. Officials provided this information in a letter to the Committee of 20 December 2000.

The rule will be limited to beneficiary income of minors. It is recognised that, subject to anti-avoidance provisions, income can be allocated to low-income spouses to produce tax benefits. A spouse's income is more likely to be, in substance, income of that spouse. In addition, given changes currently being made to matrimonial property legislation in relation to de facto relationships and the consideration which is currently being given to the appropriate treatment of same-sex relationships throughout the law, it would be inappropriate to deal with tax avoidance involving low-income spouses at this time.

The proposal does not apply to income derived directly by a minor. While it is recognised that an asset can be transferred directly to a child, it is less likely that a parent would transfer substantial income-earning assets directly to a child in order to gain the benefits of a lower tax rate. The advantage of settling the asset on a trust is that the child receives only the income from the asset, and not the asset itself, since the child may not handle the asset itself wisely.

**Recommendation**

That the submissions be declined.

## Issue: Definition of 'trusts' subject to the rule

**Submission**
*(5 – PricewaterhouseCoopers)*

Clarification is required as to precisely which trust relationships will be caught by the minor beneficiary rule. The legislation should expressly state the intention expressed in the issues paper released in June 2000, that the rules will only apply to those trusts for which current law now requires a tax return. In particular, the legislation should clarify that bare trustees and assets in the name of children will not be subject to the proposals. Clarification will also be required on which trusts are required to file a tax return under current law.

**Comment**

A trust is a relationship by which an equitable obligation is imposed on a trustee to hold and administer property transferred to them by a settlor for the benefit of nominated beneficiaries. A trust is not a separate legal entity. Consequently, whether a trust tax return is required is dependent on whether such a relationship exists.

The common law of trusts contains a number of well-established essential elements which must be met for a trust to exist including the division of legal and beneficial ownership of the trust property between the trustee and the beneficiary.

A trust is a relationship which can exist in an infinite variety of situations as the functions performed by trusts constantly evolve in response to changing social and legal requirements. Consequently, it is neither practical nor appropriate for tax legislation to define a trust.

The minor beneficiary rule will apply to all trust relationships in which the settlor of the trust is a relative or guardian of the minor or a person associated with a relative or guardian, unless the settlement is specifically provided for in an exception.

Officials understand that there is some uncertainty amongst taxpayers as to whether a child's bank account operated by his or her parents might be considered to be a trust and therefore come within this rule. Whether a bank account will constitute a trust is dependent on the particular nature of the relationship. Consequently, officials consider that it is not appropriate to expressly exclude bank accounts from the application of the minor beneficiary rule. However, in the majority of situations involving a bank account, it is unlikely that there will be any division of legal and beneficial ownership of the trust property – the essential element of a trust relationship. Rather, the income will be earned directly by the child, in which case the minor beneficiary rule will not apply.

Given that in the majority of cases the income from a child's bank account is unlikely to exceed $1,000, a minimum level of $1,000 effectively eliminates any uncertainty as to whether the rule applies to such income.

Officials also consider that it is appropriate to deal with any uncertainty relating to bank accounts by clarifying when a bank account will constitute a trust relationship in the *Tax Information Bulletin* explaining these new rules when they are enacted.

**Recommendation**

That the submission be declined.

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## Issue: Trusts containing both tainted and untainted settlements

**Submission**
*(5 – PricewaterhouseCoopers, 7 – ICANZ)*

Under the proposals as introduced, it will be very difficult for trustees to determine whether, or the extent to which, income distributed is derived from property settled by a relative or a guardian of a minor or a person associated with a relative or guardian ("tainted settlements"). Consequently, trustees will incur significant compliance costs.

*(5 – PricewaterhouseCoopers)*
These heavy compliance difficulties are a further reason for not proceeding with the proposed rules. However, if it is decided to proceed with the legislation, it should be amended to provide for simple tracing rules, rather than adopting a broad approach where all distributions to minors are taxed at 33%, where any property of the trust includes a 'tainted' settlement.

*(7 – ICANZ)*
The concept of "property settled" on the trust should be defined and its scope should be clarified.

**Comment**

As previously noted, the minor beneficiary rule is not aimed at all situations in which a minor receives beneficiary income, but only those situations where families can gain a tax advantage. Consequently, in order to ensure that the application of the rule was limited in this way, the rule as introduced applies only to income derived from a settlement of property on the trust by a relative or guardian of the minor or an associate of that relative or guardian, unless that settlement of property fits within certain specified exceptions.

However, as submissions have highlighted, the legislation as introduced raises a number of issues:

- Focussing on income derived from property settled by certain people on the trust creates difficulties in allocating income of the trust to particular settlements of property. These difficulties arise from the fact that:

  (a) property settled on the trust may have been sold and replaced with different property;

(b) there may be property subject to the rule and property which is not accounted for as one trust; and

(c) thirdly, these two settlements may have become intermingled.

- While section OB 1 defines “settlor” and “settlement”, neither “settled” nor “property settled” are defined in the Act.
- The rule as introduced is limited to beneficiary income derived from property and, inappropriately, does not apply to settlements of services by a relative, guardian or their associates. This oversight should be corrected. It is intended that the minor beneficiary rule will apply to all types of settlements on a trust (as defined in section OB 1).

In equity each settlement constitutes a new trust. However, in practice two or more settlements under the same trust deed with the same trustees may be managed as one trust with one tax return filed. It is likely that there are some trusts that have been established for many years that contain both settlements intended to be subject to the rule and settlements that are not, and the income from those settlements may have become intermingled in new assets. In such a case it may be very difficult, if not impossible, to determine the extent to which beneficiary income is subject to the rule. The legislation as introduced does not clearly provide how the rule should apply to beneficiary income from such a trust.

It is recognised that the current legislation will result in considerable compliance costs for trustees to determine whether or the extent to which, income distributed to a minor should be subject to tax at 33%.

Officials have considered a number of options for dealing with mixed trusts, where settlements by a relative, guardian or associate which are not within any of the exceptions (“tainted settlements”) are managed as one trust along with settlements which were not intended to be caught by the rule (“untainted settlements”).

The objective is to ensure that an equitable result is reached for beneficiaries of mixed trusts, whilst minimising compliance costs for trustees.

Officials have considered whether a simple tracing rule could be introduced to provide guidance on tracing the source of income of distributions. However, given the wide variety of trusts to which such a rule would potentially apply, any tracing rules would necessarily be highly arbitrary and would involve significant ongoing compliance costs.

Consequently, officials consider that the legislation should be amended to provide that all beneficiary income of a minor from a trust will be subject to the minor beneficiary rule, unless all settlements on the trust fit within any of (a)-(d):

(a) made by a person who is neither a relative nor guardian of the minor, nor a person associated with a relative or guardian; or

(b) made under the terms of a will, codicil, intestacy or a court variation of a will, codicil or intestacy if the minor was alive within 12 months of the date of the settlor’s death, or a brother or sister of the minor was alive within 12 months of the date of the settlor’s death; or

(c) made by a person as agent of the minor, if the settlor received the property from someone other than a relative, guardian or associated person; or

(d) damages or compensation which the settlor was required by a court order to pay to the child."

The legislation should also specifically provide for the current practice that if more than one settlement has been made under the same trust deed and with the same trustees, this may be treated as one trust for the purposes of taxation.

Focussing on settlements on the trust, rather than income derived from property settled on the trust this option:

- removes the uncertainty created by use of the words "settled" and "property settled";
- deals with the situation where property settled on the trust – for example – shares, has been sold, and replaced with different property, as the focus is on who made each settlement;
- includes settlements of services (with the exception of incidental services).

The advantage of this option is that it sets out a clear rule for the future. Untainted settlements can be settled in a separate trust from property that is subject to the rule to ensure that the 33% rate will not apply to all beneficiary income.

***$5,000 exemption provision***

There is, however, a transitional issue concerning existing mixed trusts which contain both tainted settlements and untainted settlements, as all income distributed from such a trust to a minor will be subject to the rule.

Consequently, it is proposed that an exemption provision be provided to ensure that the minor beneficiary rule will not apply to income from a mixed trust if the total value of the tainted settlements does not exceed $5,000. This is aimed at preventing a trust being tainted where it contains both untainted settlements and tainted settlements and the tainted settlement is of only a minor value.

An example of such a situation would be one in which $100 has been settled by a parent (tainted) and $10,000 settled as compensation for the child (not tainted).

***Valuation of settlements***

Placing a $5,000 value on tainted settlements before all income of the trust is subject to the rule requires a value to be placed on settlements. The value of the settlement should be its value at the date of settlement; otherwise difficulties would arise if a tainted settled asset had later become mingled with an untainted asset, or if the value of the asset fluctuated from year to year.

Settlements on a trust which come within paragraph (i) of the definition of "settlor" in section OB1 will generally be able to be valued reasonably easily. Paragraph (i) provides that there will be a settlement when a person has made "any disposition of property to or for the benefit of the trust or on the terms of the trust for less than market value." It is likely that the majority of settlements on a trust, particularly family trusts, will fit within paragraph (i).

Other settlements, however, such as the provision of financial assistance (paragraph ii) and the provision of services to the trust (paragraph iii), will in some cases be very difficult to value. For example, placing a value on a guarantee is not necessarily easy.

Consequently, to minimise compliance costs involved in placing a value on such settlements, it is proposed that the $5,000 exemption provision for mixed trusts will apply only if all tainted settlements are dispositions of property within paragraph (i) of the definition of "settlor". If any of the tainted settlements are not within paragraph (i) – for example, if they are settlements of services, or financial assistance – then all income from that mixed trust is tainted.

Consideration was given to a variety of options for taking settlements other than dispositions of property into account in determining whether the $5,000 limit on tainted settlements was exceeded. These options included:

- using the fringe benefit tax rate for valuing low interest loans;
- using the value underlying the settlement – for example, the value of a loan in the case of a low interest loan, or the amount guaranteed, in the case of a guarantee.

It was concluded, however, that the compliance costs which trustees would incur in determining whether the value of such settlements exceeded $5,000 might outweigh the tax benefits of being outside the minor beneficiary rule.

### *Trading trusts*

The exemption provision for mixed trusts where the value of the tainted settlements does not exceed $5,000 will not apply in respect of trading trusts, where a relative provides services (other than incidental services) to the trust, whether or not for less than market value.

Income distributed to a minor from a trading trust was always intended to be within the scope of the minor beneficiary rule. However, an unintended consequence of the $5,000 threshold for tainted settlements would be that some trading trusts would no longer be subject to the rule.

Take for example, the situation of a professional who sets up a trust with an initial settlement of $100 (a tainted settlement). He/she then provides services to the trust and is paid a market value salary. Because it is for market value it is not a settlement. Because the only settlement on the trust is the $100 "tainted" settlement it is not a mixed trust. Therefore the threshold exemption provision would not apply, and all income distributed to a minor from the trust would be subject to the rule.

However, if there was also an "untainted" settlement on the trust – for example, a settlement by a non-relative – it would be a mixed trust. Because the only tainted settlement is the $100, the threshold exemption provision will apply and any income distributed from this trust to the children will not be subject to the rule.

This result is unintentional. To prevent it, the mixed trust exemption does not apply to trading trusts.

**Recommendation**

That the proposed rule be amended to provide to provide that all beneficiary income of a minor from a trust will be subject to the minor beneficiary rule, unless all settlements on the trust were either:

(a) made by a person who is neither a relative nor guardian of the minor, nor a person associated with a relative or guardian; or

(b) made under the terms of a will, codicil, intestacy or a court variation of a will, codicil or intestacy if the minor was alive within 12 months of the date of the settlor's death, or if a brother or sister of the minor was alive within 12 months of the date of the settlor's death; or

(c) made by a person as agent of the minor, if the settlor received the property from someone other than a relative, guardian or associated person; or

(d) damages or compensation which the settlor was required by a court order to pay to the child."

However, when a trust contains both settlements which fit within any of the exceptions (a)-(d) and settlements which are tainted, if all tainted settlements fit within paragraph (i) of the definition of "settlor" in OB1, and if the total value at the date of settlement of all tainted settlements is $5,000 or less, the minor beneficiary rule will not apply to income from that trust.

This $5,000 exemption provision for mixed trusts will not apply if a relative or guardian or their associate provides services (other than incidental services) to the trust, whether or not this is for less than market value.

The legislation should also specifically provide for the current practice that if more than one settlement has been made under the same trust deed and with the same trustees, this may be treated as one trust for the purposes of taxation.

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## Issue: Structure of sections HH 3A and HH 3B

**Submission**
*(9 – New Zealand Law Society)*

Sections HH 3A and HH 3B are not very well integrated and the structure is very confusing. The provisions should be drafted in a clearer way.

**Comment**

On the 13 December, during the hearing of evidence, the Finance and Expenditure Committee requested a comment from officials in relation to the concerns of the New Zealand Law Society. In addition, the Chair of the Committee, Mr Mark Peck, asked officials to liase with the New Zealand Law Society on the drafting of these provisions.

Following the submission process, officials are recommending that a number of changes be made to the substance of the legislation, which will result in consequent changes to the structure of the legislation. Officials are liasing with the New Zealand Law Society on the structure of this amended legislation, to ensure that the Society's concerns are met.

**Recommendation**

That officials continue to liaise with the New Zealand Law Society in relation to the redrafted legislation to ensure that the Society's concerns are met.

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## Issue: Definition of a relative

**Submission**
*(7 – ICANZ, 5 – PricewaterhouseCoopers)*

Given the stated policy of the proposal of preventing trusts being used to meet expenses of the family, the scope of the rule should be narrowed.

*(7 – ICANZ)*
The rule should only apply to settlements by a relative within two degrees of relationship.

*(5 – PricewaterhouseCoopers)*
The rule should apply only where parents or guardians make settlements. Arrangements where the minor's parents or guardians indirectly fund the property through another person such as a relative or associated person should be dealt with through specifically targeted anti-avoidance provisions.

*(9 – New Zealand Law Society)*
The rule should apply only where settlements are made on the trust by a parent of the minor.

**Comment**

The purpose of the minor beneficiary rule is to limit the ability of families to gain a tax advantage by meeting the expenses of their family by using a trust.

Consequently, the minor beneficiary rule will not apply to all situations in which a minor receives beneficiary income. Rather, it will apply only to beneficiary income of a minor from a trust when a settlement has been made on that trust by a relative or guardian of the minor or an associated person of that relative or minor.

The rule adopts the existing definition of "relative" in section OB 1 of the Income Tax Act 1994. Under this section individuals are regarded as relatives when they are connected by:

- blood relationship (this includes persons within the fourth degree of relationship);
- marriage (this includes not only persons married to each other but also those with a blood relationship to their spouse);
- adoption.

Officials agree that within the fourth degree of relationship is a wide definition of "relative", encompassing an individual's great great grandparent. In the majority of situations where a tax advantage may be gained through use of a trust, the settlor is likely to be a parent or guardian of the child. However, it is necessary to go beyond the immediate family, as a grandparent (two degrees of relationship) or an aunt or uncle of a child (three degrees of relationship) may also meet expenses of the child. This would normally be done out of their after-tax income. By distributing this income to children as beneficiary income, these expenses can be met out of income taxed at the child's tax rate. Also, a parent might request that the grandparents settle assets on a trust of which the children are beneficiaries, instead of giving these assets directly to the parents.

Officials consider that the number of settlements made by relatives who are removed by four degrees will be relatively small. However, if the definition of relative were narrowed for the purposes of this rule, it would be possible for some families, to avoid the minor beneficiary rule and gain a tax advantage, by establishing ongoing family trusts, subject only to the rule against perpetuities. Instead of income going to one generation and taxed at their marginal tax rate, it could be distributed to their children, and used to meet family expenses.

Officials consider that whilst a relative could be defined in terms of three degrees of relationship without significantly undermining the rule, given that the Income Tax Act already contains two definitions of "relative", introducing a further definition would result in unnecessary complication. The Income Tax Act defines a relative as within four degrees of relationship for all purposes but the international tax rules. In the international tax rules, a relative is defined as two degrees of relationship. The Goods and Services Tax Act 1985 also defines a relative as within two degrees of relationship.

It is necessary to include settlements made by associates of relatives or guardians within the scope of the rule. This ensures that settlements made via a family company, for example, are still subject to the rule.

Officials consider that it is not necessary to adopt specific anti-avoidance rules, as a relative who has arranged for someone else to settle the property on his/her behalf will still be a settlor of the trust in terms of the existing definition of a settlor in the Income Tax Act.

### Recommendation

That the submission be declined.

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## Issue: Definition of a "relative"

### Submission

*(Matter raised by officials)*

An amendment should be made to the definition of "relative" in section OB 1 for the purposes of the minor beneficiary rule to ensure that the rule applies to the beneficiary income of a minor when a settlement has been made on the trust by a de facto partner of the child's relative.

### Comment

The minor beneficiary rule is aimed at restricting the ability of families to gain a tax advantage by meeting the expenses of their family by using a trust. Consequently, the rule will only apply to beneficiary income of a minor from a trust when a settlement has been made on that trust by a relative or guardian of the minor or an associated person of that relative or minor.

The rule adopts the existing definition of "relative" in section OB 1 of the Income Tax Act 1994.

However, because the connection by marriage does not include de facto couples or same sex couples, the result of adopting this definition is that the minor beneficiary rule will not apply when a settlement has been made on a trust by a de facto or same sex partner of the child's relative.

Consequently, some families will still be able to gain a tax advantage in meeting the expenses of the family from beneficiary income, but other families will not be able to, depending on the structure of that family. Thus currently, the rule would apply if a person settled property on a trust for their spouse's child, but would not apply if a person settled property on a trust for their de facto partner's child, or for the child of their partner of the same sex. This result is inequitable and is inconsistent with the policy intent.

Officials consider that the definition of "relative" should be extended for the purposes of the minor beneficiary rule to encompass settlements made by the de facto partner of the minor's relative. A recent amendment to the Goods and Services Tax Act 1985 provides a precedent for including de facto relationships within the definition of a relative.

However, consideration is currently being given to the appropriate treatment of same-sex relationships throughout the law, including tax law. Consequently, officials consider that given that none of the revenue acts currently take account of same-sex relationships, settlements made by a partner in a same-sex relationship should not be included at this stage. Rather, these should be dealt with as part of the wider issue of same sex couples, in order to ensure consistency.

**Recommendation**

That the submission be accepted.

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## Issue: Definition of "associated person"

**Submission**
*(Matter raised by officials)*

An amendment should be made to the definition of "associated person" in section OD 7 to remove paragraph (c) from the definition for the purposes of the minor beneficiary rule.

**Comment**

The minor beneficiary rule applies to beneficiary income of a minor from a trust when a settlement has been made on that trust by a relative or guardian of the minor or an associated person of that relative or minor. Associated persons were included primarily to ensure that settlements made by a family company are within the scope of the rule. The definition of an associated person in section OD 7 applies.

However, section OD 7(1)(c) includes as associated persons, two persons who are relatives. Given that a relative includes persons within four degrees of relationship, the effect of paragraph (c) is that the minor beneficiary rule will apply when the settlor is removed from the beneficiary by eight degrees of relationship. This was not intended. Relatives who are removed from the beneficiary by more than four degrees of relationship should not be covered by the rule. Consequently, for the purposes of this rule, paragraph (c) of the definition of "associated persons" should be removed.

**Recommendation**

That the submission be accepted.

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## Issue: Definition of "guardian"

### Submission

*(7 – ICANZ)*

To ensure certainty, a definition of "guardian" should be inserted into the provisions relating to the taxation of minor beneficiaries, either by cross-reference to other legislation or preferably by specific definition in the tax law.

### Comment

The minor beneficiary rule applies when a guardian of the minor makes a settlement. The legislation as introduced does not define a guardian.

The terms "guardianship" and "guardian" are comprehensively defined in section 3 of the Guardianship Act 1968. It is intended that this meaning will also apply for the purposes of this rule.

Officials agree that this intention should be clarified. This should be done by cross-reference to the definition of guardian in section 3 of the Guardianship Act. This is consistent with the approach taken in other legislation, for example the Children, Young Persons and Their Families Act 1989.

Under a number of pieces of legislation, however, the chief executive of a government department or the court itself, for example, may be appointed guardian of the child. It is not intended that such a guardian should come within the scope of the minor beneficiary rule.

Consequently, such guardians should be specifically excluded from the application of the rule when:

- a chief executive has been appointed guardian of the child under section 7(4) of the Adoption Act 1955;
- the court (which has declared a child to be in need of care and protection) has appointed the chief executive, an iwi social service, a cultural social service, or the director of a child and family support service to be a guardian of that child under section 110(1)(a)-(d) of the Children Young Persons and their Families Act 1989;
- the court has been appointed guardian of the child under section 10B of the Guardianship Act 1968; and
- the Public Trustee has been appointed guardian of an infant by an order of the court under Section 53 of the Public Trust Office Act 1957.

### Recommendation

That the submission be accepted. The legislation should be amended to provide that for the purposes of the minor beneficiary rule the definition of "guardian" in section 3 of the Guardianship Act 1968 applies.

The legislation should also be amended to provide that a person will not be a guardian for the purposes of the minor beneficiary rule if they have been appointed as guardian under section 7(4) of the Adoption Act 1955, section 110(1)(a)-(d) of the Children Young Persons and Their Families Act 1989, section 10B of the Guardianship Act 1968, or by order of the court under section 53 of the Public Trust Office Act 1957.

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## Issue: Definition of "settlor"

**Submission**
*(Matter raised by officials)*

An amendment is necessary to ensure that a person will not be a settlor if the only settlement they made on the trust consisted of incidental services to the operation of the trust.

**Comment**

It is intended that a relative, guardian or associated person will not be a settlor for the purposes of the minor beneficiary rule if the only settlement they made on the trust was the provision of incidental services to the operation of the trust. An example would be if damages for the benefit of the child are settled on a trust and the parent of the child provides free accounting services to the trust.

As introduced, the legislation provides that a person will not be a settlor if they provide any services to the trust. This was an oversight. Rather, it should provide that a person will not be a settlor for the purposes of the minor beneficiary rule if the only settlement they made to the trust was of incidental services to the operation of the trust.

**Recommendation**

That the submission be accepted.

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## Issue: Definition of a "minor"

**Submission**
(*4 – Federated Farmers of New Zealand*)

For the purposes of this rule a minor should be defined as a person under the age of 15 years. At 15 years, farm children obtain drivers licenses and tend to adopt a mature role in a farming operation. They are likely to commence earning income in their own right.

*(1 – H B Thomas)*
The proposed rule is age discriminatory and unfair.

**Comment**

The proposed section HH 3A(3) defines a "minor" as a person under the age of 16 years.

Officials consider that it is appropriate that the rule should apply to those children under the age of 16 years. From the age of 16 years, individuals are increasingly less dependent on their parents to provide for their needs. Consequently, there is less likelihood that beneficiary income will be used to meet expenses that would otherwise have been met by parents out of their after-tax income. It is from the age of 16 that a person may be in full-time employment, at polytechnic or may be married. While any age has an arbitrary aspect, 16 seems the most appropriate age at which a person can be said to be determining how his or her income is spent.

**Recommendation**

That the submission be declined.

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## Issue: Definition of a "minor"

**Submission**
*(Matter raised by officials)*

An amendment should be made to the proposed definition of a "minor" in section HH 3A(3) to insert the word "natural" in front of person.

**Comment**

It was intended that the rule would only apply to natural persons under the age of 16 years, and not to a company, for example. In order to give effect to this intention, the word "natural" should be added to the definition of a minor in the proposed section HH 3A.

**Recommendation**

That the submission be accepted.

## Issue: Exception for settlements under a will or intestacy

**Submission**
*(5 – PricewaterhouseCoopers, 7 – ICANZ, 9 – New Zealand Law Society)*

The proposed section HH 3B(2)(c) provides an exception from the minor beneficiary rule when property has been settled on a trust under the terms of a will, codicil, intestacy or a court variation thereof, if the minor is alive within 12 months of the date of the settlor's death.

The restriction on the exception to minors who are alive within 12 months of the date of the settlor's death should be removed. It is inappropriate that two minor beneficiaries of a trust created under a will are subject to different tax rates simply because one was alive within 12 months of the death of the settlor, while one was not.

*(6 – National Council of Women of New Zealand (NCWNZ))*

NCWNZ agrees that the proposed rule should not apply where the income is derived from inherited property under the terms of a will, codicil or intestacy.

**Comment**

When a person who is meeting the costs of a child dies and settles property under the terms of their will on their child, it is appropriate that the minor beneficiary rule should not apply to this income. It is likely that such a person will be the parent of the child, but in some instances it may be a grandparent or an aunt or uncle of the child who meets expenses of the child. If the settlor is dead, the beneficiary income received by the minor from the trust property is not income the settlor would otherwise have earned him/herself and used to meet the needs of the child, so no tax advantage is gained in meeting the costs of a child by use of a trust.

However, in other situations where property is settled on a trust for the benefit of a child under the terms of a will, it is appropriate that the minor beneficiary rule does apply. An unlimited exception for testamentary trusts would enable some families to redirect assets into a trust thereby ensuring that the rule does not apply. This occurs whereby grandparents are requested by parents to place assets (which would otherwise have been left to the parents) in a trust on their death and distribute the income to the children rather than to the parent.

An unlimited exception for testamentary trusts would also enable some families to gain a tax advantage by establishing a continuing family trust. The settlor would leave property under the terms of his /her will to a discretionary family trust, with his/her children, grandchildren, great grandchildren and so on as beneficiaries. Instead of income going to one generation and taxed at their marginal tax rate, it could be distributed to their children and used to meet family expenses.

Officials consider that the current exception ensures, as accurately as possible, that only the appropriate testamentary trusts are subject to the minor beneficiary rule. The exception for testamentary trusts, by including children alive or conceived at the time of the settlor's death, ensures that settlements made by a person responsible for meeting the costs of the child are not subject to the rule. It also effectively limits the risk of ongoing family trusts.

However, officials recognise the concern raised in submissions that it seems unfair and illogical that one child in a family will not be subject to the rule because they were alive at the time of the settlor's death, but their younger sibling will be subject to the rule.

Consequently, officials consider that the exception should be extended so that it applies if either the minor is alive within 12 months of the date of the settlor's death, or a brother or sister of the minor is alive within 12 months of the date of the settlor's death. For the purposes of this rule, brother or sister should include a half-brother or half-sister.

### Recommendation

That the restriction not be removed, but be reduced so that it also applies if a brother or sister, or a half-brother or half-sister of the minor was alive within 12 months of the settlor's death.

### Submission

*(5 – PricewaterhouseCoopers)*

The exception should be extended to situations where a person receives property from a will, codicil or intestacy and subsequently settles this on an inter-vivos trust on behalf of a minor.

### Comment

The minor beneficiary rule will only apply when it is a relative, guardian or their associate who receives property under the terms of a will and settles it on an inter vivos trust for the benefit of a minor. Officials consider that it is appropriate that the rule should apply to beneficiary income in this situation. The source of an asset subsequently settled by a relative, guardian or associate on a trust is irrelevant in determining whether the rule should apply. A parent, for example, who receives property under the terms of a will, can earn income on this asset which will be taxed at his/her marginal tax rate, and which can be used, just like any other income, to meet expenses of the family. By settling this asset on a trust of which the child is a beneficiary, the parent is then able to meet expenses of the family from beneficiary income, and thereby gain a tax advantage.

### Recommendation

That the submission be declined.

**Submission**
(*5 – PricewaterhouseCoopers*)

The exception should be extended to situations where property is settled on an inter vivos trust by a settlor in contemplation of his/her death and beneficiary income is distributed to minors from that trust after the settlor has died.

**Comment**

The same rationale for excluding some testamentary trusts can also be applied to property settled on an inter vivos trust in contemplation of death where the beneficiary income is distributed after death. However, officials consider that it is not possible to effectively define when a settlement is made in contemplation of death. Extending the exception in this way would add extra complexity to the exception and create difficulty for a trustee in determining whether the exception applies consistently and accurately.

**Recommendation**

That the submission be declined.

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## Issue: Education trusts

**Submission**
*(5 – PricewaterhouseCoopers, 4 – Federated Farmers of New Zealand (Inc))*

Beneficiary income used to fund a minor’s education should be specifically excluded from the minor beneficiary rule.

*(4 – Federated Farmers)*

Many farming families use education trusts in order to meet the expenses of a boarding school education for their children. Taxing distributions of beneficiary income to minors at the trustee rate where the trust is for an educational purpose will increase education costs.

**Comment**

Officials consider that an exception should not be provided for beneficiary income used to fund a child’s education. Normally, parents meet the costs of their children’s education out of their own after-tax income. Allowing an exception for education trusts provides a tax advantage for parents who meet these costs out of beneficiary income distributed to the child.

Furthermore, it would be difficult to define the boundaries of such an exception, as a wide range of costs associated with children could be described as educational, including, for example, many extra-curricular activities.

### Recommendation

That the submission be declined.

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## Issue: Minors with special needs

### Submission

*(9 – New Zealand Law Society)*

The Society cannot see any rationale for the exception for a child for whom a child disability allowance is paid.

### Comment

From the initial announcement of this policy, it has been the Government’s stated intention that trusts set up for children with severe disabilities should not be within the scope of this measure. A basis for determining whether a child has a severe disability is eligibility for the child disability allowance under the Social Security Act 1964. This payment is available to caregivers of children who have a physical or mental disability, are in need of constant care and attention because of that disability and are likely to need care for at least 12 months. Consequently, an exception to the rule applies for children in receipt of the child disability allowance.

### Recommendation

That the submission be declined.

### Submission

*(5 – PricewaterhouseCoopers)*

The legislation provides an exemption from the minor beneficiary rule for minors for whom a child disability allowance is paid under the Social Security Act 1964. The Government should consider extending this exemption to include minors who are eligible for an allowance, but who, for whatever reason, have not applied for the allowance.

The exception should be extended to ensure that the minor beneficiary rule does not apply to any minor who has special needs owing to a physical, mental or emotional condition, and receives beneficiary income from a trust to meet those needs. The Government should conduct a wide review to ensure that the rule will not apply to minors who require additional assistance but who are not eligible for the specific child disability allowance.

**Comment**

Officials recognise that some families who would otherwise be entitled to the Child Disability Allowance do not apply for it. However, limiting the exception to children for whom the child disability allowance is paid provides an objective standard against which the exception is based. This is necessary to ensure that the trustees are able to determine whether an exception applies consistently and with minimum compliance costs. Recipients of the allowance are able to provide the trustee with a copy of a letter of entitlement from the Department of Work and Income.

Parents of many children face extra costs as a result of the special needs of their child. To provide an exception for all children with some special need would effectively undermine the minor beneficiary rule. The result would be that all families with a trust would be subsidised in meeting whatever extra costs were associated with their children, whereas all other parents would have to meet the additional costs of their child out of their own after-tax income.

**Recommendation**

That the submission be declined.

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## Issue: Exception for distributions of beneficiary income from the Maori trustee or a Maori authority

**Submission**
*(9 – New Zealand Law Society)*

The Society cannot see any rationale for the exception for distributions from the Maori trustee.

**Comment**

The Maori Trustee is taxed as a Maori authority except in its capacity as a collection and distribution agent for rents, royalties or interest, in which case the Maori Trustee is taxed as if it were beneficially entitled to the income.

The taxation of Maori authorities, including the Maori Trustee, is currently under review. It is appropriate that the taxation of beneficiary income distributed to a minor from the Maori trustee or a Maori authority should be specifically excluded from the minor beneficiary rule pending completion of this review.

**Recommendation**

That the submission be declined.

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## Issue: Exception for services rendered by a minor

**Submission**
*(5 – PricewaterhouseCoopers)*

Beneficiary income of a minor should be excluded from the rule when the trust owns income-producing assets such as a farm or a business and that beneficiary income is in compensation for work or effort performed by those minors on the farm or business.

**Comment**

If the beneficiary income received by a child is, in fact, employment income of the child, it should be paid as salary or wages, rather than as a distribution of beneficiary income. It may then appropriately be subject to PAYE and taxed at the marginal tax rate of the minor. A schoolchild who earns a weekly wage of $20 is not required to complete a tax code declaration form, and consequently the employer is not required to deduct PAYE from the child's wage.

**Recommendation**

That the submission be declined.

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## Issue: Exception for trusts established in situations of family breakdown

**Submission**
*(5 – PricewaterhouseCoopers)*

The Government should consider providing an exception for distributions of beneficiary income from a trust used to hold property for the benefit of minors arising from a family breakdown.

**Comment**

During the development of the minor beneficiary rule, consideration was given to providing an exception for trusts established in situations of family breakdown.

However, an exception has not been provided for two key reasons:

(i) such an exception raises the risk of the court process being exploited in order to gain a tax advantage; and

(ii) providing an exception is inconsistent with the policy of the minor beneficiary rule.

### *Risk of an increase in court orders and subsequently that the rule would be undermined*

Such an exception would need to be based on objective criteria in order to prevent the rule being undermined and to enable trustees to apply the exception on a consistent basis. The most appropriate criterion is that of a court order that property be settled on a trust.

Under the Matrimonial Property Act 1976 the court has wide powers to make such orders as it considers just in determining shares and in dividing property. The court must, in all proceedings under the matrimonial property legislation, consider the interests of any minor or dependent children of the marriage. These powers include ordering property to be settled on a trust of which the parents and children are beneficiaries.

However, if an exception is provided where a trust has been ordered by the court under the Matrimonial Property Act, there is a significant risk that families would be motivated to go through the court process in order to gain the tax advantage.

This is a real risk because under the Matrimonial Property Act the court may make orders by consent, provided the discretion is exercised in accordance with the principles of the matrimonial property legislation. Thus either or both spouses may apply to the court for an order that property be settled on a family trust.

In addition, the court’s powers are not limited to situations of family breakdown. Orders can also be made by consent in relation to specific property where the parties are living happily together without any contemplation of a separation

During the 1980s and early 1990s the courts were considering a significant number of applications for orders placing assets in a family trust, one of the key motivations being an exemption from gift duty. Before 1993, section 75A of the Estate and Gift Duties Act provided an exemption from gift duty for any disposition of property made by any order of the Court under section 25 of the Matrimonial Property Act 1976.

The risk of the rule being undermined is increased by the fact that the courts have taken a fairly liberal approach to consent orders vesting matrimonial property in family trusts. In the High Court in *Re Roberts* [1993] NZFLR 731, Gallen J stated that in considering settlements involving children of the marriage, where made by consent orders, the court must be satisfied that the settlement is within the parameters of the Matrimonial Property Act. The fact that the motivation of the trust is to limit tax or duty liabilities will not take a trust outside the scope of the Matrimonial Property Act.

### *Inconsistent with the policy of the minor beneficiary rule*

The rationale of the minor beneficiary rule is that families should not be able to gain a tax advantage simply because they are able to meet the costs of the family out of distributions of beneficiary income to a minor from a trust, rather than out of their own after-tax income, as is the normal course.

There is no policy reason for this tax advantage being available to families that have set up a trust where the parents have separated or divorced, yet not to families where the parents are still together, which would be the result if an exception were provided.

Even if gaining a tax advantage was not their motivation for going through the court process, providing an exception in such a situation would still enable parents whose income-earning assets are placed in a court-ordered trust to meet the expenses of the children out of income taxed at the marginal rate of the children.  Had it not been for the trust they would have had to meet these same expenses out of the income taxed at their own marginal tax rate.  This gives them an advantage over families who have not broken up, and also an advantage over families who have broken up but who have been able to reach an agreement themselves and have voluntarily set up a trust without going through the court process.

An exception in this situation can be contrasted with the other exceptions that deal with situations where that income clearly would not otherwise have been earned by the parent or settlor.

### Recommendation

That the submission be declined.

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## Issue:  Exception for income derived from a group investment fund

### Submission

*(Matter raised by officials)*

An amendment should be made to the proposed section HH 3B(3) to provide that the exemption from the minor beneficiary rule for income derived by a minor from a group investment fund only applies to income derived directly by the minor from the group investment fund.

### Comment

Section HH 3B(3) currently provides that the minor beneficiary rule does not apply to beneficiary income derived by a minor from a group investment fund.

Ordinarily, category B group investment funds and designated group investment funds are taxed as qualifying trusts, and consequently distributions from such a fund to a minor would be subject to the rule.  However, given that these group investment funds operate more in the nature of investment entities from which income is earned directly by the child and which are not subject to the rule, it is appropriate that distributions from a group investment fund to a minor are specifically excluded from the rule.

The policy intention, however, was that while distributions of beneficiary income from a group investment fund to a minor should not be subject to this rule, the rule should still apply if a family trust invests in a group investment fund and the income earned by this trust from the fund is subsequently distributed to a minor by the family trust.

Given that income derived by a trust generally retains its character when distributed as beneficiary income, the current wording may not be sufficient to include such income within the scope of the rule. Therefore the legislation should be amended to make this intention clearer, by providing that the exemption applies only when the income is derived directly by the minor from a group investment fund.

### Recommendation

That the submission be accepted.

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## Issue: Exception for established fixed trusts

### Submission

*(5 – PricewaterhouseCoopers)*

A grandfathering provision should be introduced to ensure that the minor beneficiary rule does not apply to distributions of beneficiary income to a minor from a fixed trust established before the announcement of the Government's intention to tax minor beneficiary income at 33%. Otherwise, a minor's beneficiary income will be subject to the rules in circumstances where tax-motivated income splitting is not present, because there is no discretion or flexibility for fixed trusts to amend the level of distributions.

### Comment

Although discretionary trusts do tend to be favoured for tax-planning purposes, fixed trusts, where each beneficiary's share in the trust property is precisely defined, can still be used to gain a tax advantage. For example, if the trust deed includes a power of resettlement, once it is no longer advantageous to distribute a particular amount to particular beneficiaries, the assets of the trust can be resettled on another trust. It is therefore appropriate that the minor beneficiary rule apply to fixed trusts as well as discretionary trusts.

Whilst many established fixed trusts may not have been motivated by gaining a tax advantage, this will also be the case with some established discretionary trusts. It is not possible in applying the rule to differentiate between those established trusts which were tax motivated and those which were not. Consequently, officials consider that established fixed trusts should not be excluded from the minor beneficiary rule.

It is intended that the minimum threshold will exclude from the minor beneficiary rule a significant number of trusts where gaining a tax advantage was not the motivation.

### Recommendation

That the submission be declined.

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## Issue: Level of minimum threshold under which beneficiary income is exempt

### Submission

*(6 – National Council of Women, 7 – ICANZ, 5 – PricewaterhouseCoopers)*

The legislation provides for a de minimis exemption for beneficiary income of $200 or less. This de minimis level should be increased.

*(6 – National Council of Women, ICANZ)*
A more suitable level would be $1,000.

*(5 – PricewaterhouseCoopers)*
The de minimis exemption should be increased to $10,000.

### Comment

Officials consider that increasing to $1,000 the level of the threshold under which beneficiary income is exempt is consistent with the purpose of the minor beneficiary rule. The rule aims to limit the ability of families to gain a tax advantage by using a trust to meet the expenses of the family. The maximum amount of tax a person would save by distributing $1,000 of income to a minor would be approximately $200 per child. A saving of this amount is unlikely to motivate a taxpayer to establish a trust, given the compliance costs of establishing and managing a trust. By raising the threshold, those trusts that are unlikely to have a tax motivation are removed from the compliance costs imposed by the minor beneficiary rule.

However, officials consider that it would be inappropriate to raise the minimum level to $10,000. At this level, the maximum tax saving would be nearly $2,000 per child, which may easily be sufficient to motivate a taxpayer to establish a trust.

A further purpose of the exemption is to minimise any uncertainty that exists amongst taxpayers as to whether a child's bank account operated by his or her parents might be considered to be a trust and therefore come within this rule. In the majority of situations involving a bank account, it is unlikely that there will be any division of legal and beneficial ownership of the trust property – the essential element of a trust relationship. Rather, the income will be earned directly by the child, in which case the minor beneficiary rule will not apply. Given that in the majority of cases the income from a child's bank account is unlikely to exceed $1,000, increasing the minimum threshold to $1,000 effectively eliminates any uncertainty as to whether the rule applies to such income.

### Recommendation

That the minimum threshold be increased from $200 to $1,000.

## OPERATIONAL ISSUES

### Issue: Tax payable by trustee on behalf of the beneficiary

**Submission**
*(7 – ICANZ)*

Taxing minor beneficiary income to the trustee, rather than each beneficiary is a cost-effective way of taxing beneficiary income at 33%. However, the legislation should be amended to specifically provide that the tax payable by the trustee is paid on behalf of the beneficiary.

**Comment**

For the purposes of the proposed rule, beneficiary income of a minor is taxed as if it was trustee income. However, because this income is for all other purposes beneficiary income, officials agree that the legislation should specifically provide that the tax is paid on behalf of the beneficiary. This enables the trustee to debit the beneficiary's current account within the trust.

**Recommendation**

That the submission be accepted.

### Issue: Use-of-money interest on minor beneficiary income

**Submission**
*(5 – PricewaterhouseCoopers)*

As a consequence of taxing minor beneficiary income as if it was trustee income, trustees will be liable for use-of-money interest on this income if they underpay their provisional tax. Currently, use-of-money interest is not charged on underpayments of provisional tax where those payments are made by a trustee on behalf of a beneficiary.

Consistent with this existing practice, use-of-money interest should not apply to underpayments of provisional tax by trustees in respect of minor beneficiary income.

**Comment**

Interest is not charged or paid when a trustee pays provisional tax on behalf of a beneficiary. Only the tax on a trust's trustee income is subject to use-of-money interest. Use-of-money interest is calculated separately for beneficiaries. Many beneficiaries are "safe-harbour" taxpayers, by whom use-of-money interest is not normally payable.

Because minor beneficiary income is taxed as if it was trustee income, and is deemed not to be gross income of the beneficiary, all of the aspects of taxation of trustee income will apply to this minor beneficiary income. That is, it will be taxed at 33%, it will be included in the trustee's provisional tax calculations along with other trustee income and, consequently, if the trustee underestimates their provisional tax, use-of-money interest will apply.

Significant compliance and administrative costs would be incurred if use-of-money interest was not applied to only that portion of the trustee's provisional tax obligation that related to minor beneficiary income. Trustees would be required to identify what portion of their provisional tax and what portion of the underestimation of provisional tax related to payments of tax on minor beneficiary income and Inland Revenue would be required to apply use-of-money interest only to that other portion.

In addition, not applying use-of-money interest to payments of minor beneficiary income would remove the incentive for trustees to estimate their provisional tax liability accurately in relation to minor beneficiary income.

### Recommendation

That the submission be declined.

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## Issue: Imposition of penalties and interest on the trustee

### Submission

*(5 – PricewaterhouseCoopers)*
Tax penalties and interest should not be imposed on trustees where they have made reasonable efforts to inquire as to the age and status of beneficiaries but have received inaccurate or misleading information.

### Comment

Trustees are subject to the same compliance and penalties legislation that applies to other taxpayers.

If the trustee underestimates the amount of tax payable as a result of receiving inaccurate or misleading information from the beneficiary, the trustee will not be liable for any shortfall penalties on that shortfall provided that they took reasonable care in reaching their tax position. In determining whether the trustee took reasonable care, the common law test for negligence (whether a person with ordinary skill and prudence would have foreseen a tax shortfall) is relevant.

However, the trustee will still be liable for a late-payment penalty. Currently, a late payment penalty of 5% applies on the failure to meet the due date. This is followed by a monthly incremental penalty of 2% until the date of payment. From 1 April 2001 the incremental penalty will be reduced to 1%. Under proposed amendments to the late payment penalty included in this bill, from 1 April 2002 the initial late payment penalty will be staggered so that a 1% penalty applies on the failure to meet the due date and a further 4% penalty applies if the payment is not made within a week of the due date. Late payment penalties will not be charged if the unpaid tax does not exceed $100.

It is appropriate that the late payment penalty should apply if the trustee underestimates the amount of provisional tax payable as a result of receiving the wrong information from the beneficiary, because the late-payment penalty applies to all provisional taxpayers who underestimate their liability, regardless of fault.

If the trustee is not a provisional taxpayer, the trustee will generally not be liable to a late payment penalty. If the Commissioner reassesses the amount of tax payable after the original due date for payment, he must then set a new due date for the payment of the increased amount in the notice of reassessment. Consequently, in this situation the trustee will be liable for a late payment penalty only if he/she fails to pay by the new due date.

Use-of-money interest will also be payable by the trustee on any underpayment and will be payable by the Commissioner on any overpayment of provisional tax that results from the trustee receiving the incorrect information from a beneficiary. This is appropriate because use-of-money interest is not a penalty. Its purpose is to compensate the Government when tax is unpaid and compensate the taxpayer when tax is overpaid. Interest is imposed in every case where there has been an underpayment of tax. The Commissioner has no discretion to waive interest.

### Recommendation

That the submission be declined. Standard-based shortfall penalties do not apply where the trustee has used reasonable care in reaching his/her tax position. No-fault late payment penalties and use-of-money interest do apply.

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## Issue: Treatment of tax losses

### Submission

*(11 – Simpson Grierson Law)*

Minors will not be able to offset their existing tax losses against their beneficiary income that is subject to the proposed rule. This is retrospective disentitlement and is unjust.

### Comment

The inability of a minor beneficiary to deduct any losses or expenses against his or her beneficiary income is a result of taxing this income as if it was trustee income. As the submission notes, in the development of this policy two options were considered for ensuring that the beneficiary income of minors is taxed at 33%. Option 1 was to tax the beneficiary income as if it was trustee income. Option 2 would continue to tax this income as beneficiary income. Tax would be required to be deducted by the trustee at 33% as agent for the beneficiary, and the minor would include the full amount as income in his or her return with a credit for tax paid at the trustee level.

Owing to the significantly greater administrative and compliance costs of Option 2, it was decided that a minor's beneficiary income would be taxed as if it was trustee income.

It is unlikely that a significant number of minors will have tax losses to offset. Minors who do, however, are still able to use their existing tax losses to offset their tax liability that arises on all other income.

In addition, taxing as trustee income gives minors the advantage of not having this beneficiary income taken into account in determining whether they have income greater than $60,000 and thus whether the 39% tax rate applies.

### Recommendation

That the submission be declined.

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## Issue: Allocation of imputation credits on a minor's beneficiary income

### Submission

*(11 – Simpson Grierson Law)*

The legislation should be amended to clarify that when a distribution of beneficiary income to a minor includes dividends with imputation credits attached, these imputation credits are allocated to the trustee.

The legislation should also be amended to ensure that the fact that these distributions are taxed to the trustee does not adversely affect the allocation of imputation credits to a non-minor beneficiary under section LB 1(3).

### Comment

Officials agree that when a distribution of beneficiary income includes dividends with imputation credits attached, the trustee, who is taxed on this beneficiary income, should also be allocated the imputation credits. This intention can be clarified in the law by providing, for the purposes of determining the allocation of imputation credits, that beneficiary income is to be treated as if it was distributed to the trustee and that the credit is to be allocated to the trustee. As a consequence of such an amendment, the allocation of imputation credits to non-minor beneficiaries under section LB 1(3) will not be adversely affected.

### Recommendation

That the submission be accepted.

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## Issue: Mechanism to include beneficiary income of minors

**Submission**
*(7 – ICANZ)*

The proposed section HH 3A currently states that the section will apply when a "minor derives beneficiary income". However, beneficiary income is income that is first derived by a trustee of the trust. The beneficiary does not derive the income – the trustee does. This income may then become beneficiary income if it is paid or applied within six months after the end of the income year or vests in the beneficiary during the income year. It would be more consistent with the scheme of the trust rules to exclude beneficiary income of minors from the definition of beneficiary income in section OB 1.

**Comment**

Officials agree that income is first derived by a trustee of the trust and becomes beneficiary income if it is paid or applied to the beneficiary within six months after the end of the income year or vests in the beneficiary during the income year. However, this income is derived by the minor as beneficiary income at the point in time at which it becomes beneficiary income.

To refer to the minor deriving beneficiary income is consistent with the scheme of the trust rules. For example, section HH 3(2), which provides that the trustee is liable to tax on a beneficiary's income, specifically refers to the situation where a beneficiary derives beneficiary income.

The proposed rule applies only to that income of a minor that is beneficiary income as defined in section OB 1. Consequently, it would not be appropriate to exclude this income from the definition of "beneficiary income".

**Recommendation**

That the submission be declined.

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## Issue: Application date of the rule

**Submission**
*(7 – ICANZ)*

The legislation as introduced provides that the amendment applies to beneficiary income derived in relation to the 2001-02 and subsequent income years. This wording has created some confusion because beneficiary income can be distributed by the trust up to six months after the end of the trust's income year. This should be clarified by simply providing the application date is the 2001-02 and subsequent income years.

**Comment**

Income earned by the trustee of a trust in an income year will be beneficiary income if it vests in the beneficiary in that income year or is paid or applied to the beneficiary within six months of the trust's balance date.

Thus, as the submission notes, a trust with a 31 March 2001 balance date can pay or apply income of that year up to 30 September 2001, for the trust's income to be treated as beneficiary income. If this occurs, the beneficiary is taxed in the 2001 income year and not in the 2002 income year, which is the year in which the beneficiary actually receives the income.

Officials understand that there has been some uncertainty that the minor beneficiary rule might apply to beneficiary income of the 2000-2001 income year that is distributed within six months after the end of the income year. This is not the intention. Officials consider that the current wording that the rule applies to income derived "in relation to the 2001-02 and subsequent income years" makes this intention clear.

Rather, officials consider that this confusion relates to uncertainty as to whether beneficiary income is derived in the same income year as it was earned by the trust. This confusion will be best dealt with by clarifying this point in a *Tax Information Bulletin* when the legislation is enacted.

**Recommendation**

That the submission be declined.

# PART II

# Services-related payments: restrictive covenants and exit inducements

# SERVICES-RELATED PAYMENTS: RESTRICTIVE COVENANTS AND EXIT INDUCEMENTS

## Introduction

The bill proposes that restrictive covenant and exit inducement payments be made taxable. This follows the recommendations in 1998 of the Committee of Experts on Tax Compliance to make these payments taxable. As part of the generic tax policy process, the Government released a consultative issues paper proposing changes to the taxation of these payments in June 2000.

A restrictive covenant payment is the consideration given for a restriction on a person's ability to perform services. An exit inducement payment is the consideration given by a prospective employer or contractor to a person to give up a particular status or position.

These payments pose a risk to the personal services income tax base because they are non-taxable to the recipient and can be paid in substitution for taxable personal services income (such as salary and wages), and they may be deductible in some cases to the payer.

The bill proposes a number of associated amendments, which include:

- excluding restrictive covenant payments connected with the sale of a business from the charging provision;
- excluding expenditure on restrictive covenants and exit inducements from the rule prohibiting deductions for capital expenditure; and
- including restrictive covenant and exit inducement payments to employees within the PAYE rules.

The proposed amendments will apply to amounts derived on and after the date of enactment. This will include such amounts derived from arrangements made before the date of enactment.

## Overview of submissions

Six submissions on the restrictive covenant and exit inducement amendments in the bill were made. Three of these submissions were opposed, in principle, to the taxation of these payments.

The main technical issue submitted on was the exclusion for restrictive covenant payments connected with the sale of a business.

Submissions also expressed significant concerns on the application date, which means that arrangements entered into before the date of enactment are not "grandfathered", and on whether the operation of the general deductibility provisions in the Income Tax Act would be affected by the amendments.

Officials consulted with the makers of two of the most substantial submissions on the proposals, the Institute of Chartered Accountants of New Zealand and PricewaterhouseCoopers, to discuss aspects of their submissions.

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

- Widen the ambit of the sale of business exclusion so it can apply to different forms of business sales.
- Remove the use of the GST concepts of “taxable activity” and “going concern”.
- Allow the deduction-related amendments to apply to expenditure incurred on restrictive covenant payments before the date of enactment if the payments are derived after the date of enactment and are taxable under the new charging provisions.

## WHETHER RESTRICTIVE COVENANT AND EXIT INDUCEMENT PAYMENTS SHOULD BE TAXED

### Issue: General opposition to proposals to tax restrictive covenant and exit inducement payments

**Submissions**
*(3 – New Zealand Employers' Federation, 5 – PricewaterhouseCoopers, 7 – ICANZ)*

Three submissions are opposed, in principle, to the taxation of restrictive covenant and exit inducement payments. This opposition arises because such payments are capital receipts under current law and taxing them would result in a shift of the existing capital/revenue boundary.

The New Zealand Employers' Federation considers that the current tax rules for capital and revenue-related payments should be maintained. Where disputes occur the Courts should continue to be the ultimate arbiter of whether payments are of a non-taxable compensatory nature or whether they are income-related and therefore taxable in the hands of the recipients.

PricewaterhouseCoopers was opposed to the proposed shifting of the capital/revenue boundary and considered that the amendments should be better directed towards income payments which are "disguised" as capital payments rather than adopting a blanket approach of taxing all services-related payments (other than restrictive covenant payments made on the sale of a business).

ICANZ is opposed to the amendments because they "seek to tax capital receipts as if they were revenue". At the most, the amendments should target only those payments that are substitutes for taxable receipts.

**Comment**

Officials do not consider that the amendments to tax restrictive covenant and exit inducement payments should be removed from the bill in light of these submissions. These services-related payments are non-taxable in the hands of recipients, but may be deductible in some cases to the payers. There is a risk to the personal services income tax base resulting from the potential for these non-taxable capital receipts to be substituted for taxable personal services income such as salary and wages.

The Government's position is that it is necessary to shift the current capital/revenue boundary in the case of restrictive covenant and exit inducement payments to protect the personal services income tax base.

Officials consider that the proposals to target only payments of an income nature that are disguised as capital receipts would amount to little more than the current law which itself has given rise to the current tax base concern. Such proposals would be too subjective to be effective. They could be circumvented by taxpayers arguing that there had been no reduction in amounts received from the performance of services. It would be very difficult for Inland Revenue to prove that a person would have received an amount in the absence of an arrangement involving a restrictive covenant or exit inducement.

Although Inland Revenue can query the amount of any capital receipt, in practice, challenging these payments is problematic because valuation of the underlying rights or property transferred is extremely difficult. It is, therefore, not practicable to distinguish between payments which are not in substitution for taxable income and those that are.

### Recommendation

That the submissions be declined.

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## Issue: Proposals should be referred to the Tax Review

### Submission

*(7 – ICANZ)*

ICANZ considers that the proposals to tax restrictive covenant and exit inducement payments amount to a fundamental change that should instead be referred to the Tax Review.

### Comment

The Tax Review is more concerned with a high level review of the whole tax system rather than a specific base maintenance measure such as the present. Also, the revenue risk to the personal services income tax base needs to be addressed as soon as practicable. This revenue risk could worsen if consideration of this issue were deferred until it could be considered as part of the work of the Tax Review. The Committee of Experts on Tax Compliance has already considered the tax treatment of restrictive covenant and exit inducement payments and recommended legislation to make these payments taxable.

### Recommendation

That the submission be declined.

# RESTRICTIVE COVENANT CHARGING PROVISION

## Issue: Ambit – application to non-individuals

### Submission

*(9 – New Zealand Law Society)*

The charging provision is intended to be targeted at individuals but is capable of affecting undertakings given by other entities such as companies by the use of the wide term "person". Accordingly, the term "person" should be changed to "individual".

### Comment

The restrictive covenant charging provision is intended to apply to all persons and not just individuals. Although the main target of the amendment is individuals, it is necessary for the charging provision to apply to all persons because otherwise the charging provision could be readily circumvented. For example, individuals could set up personal services companies and arrange for their companies to provide restrictive covenants to the purchasers of their services, thereby converting what would otherwise be taxable income from services into non-taxable capital receipts.

### Recommendation

That the submission be declined.

## Issue: Ambit – taxing restrictive covenant provider instead of recipient of payment

### Submission

*(9 – New Zealand Law Society)*

The amount derived should remain income of the recipient of the amount, rather than the person who gives the restrictive covenant.

### Comment

It is appropriate that the person who provides the restrictive covenant derives any amount given in consideration for that undertaking. If the legislation targeted only the recipient of the restrictive covenant payment this would open up avoidance opportunities whereby the provider of the restrictive covenant could arrange for an associated person such as a family member who is on a lower marginal tax rate to receive the payment.

Clearly, it is within the control of the provider of the restrictive covenant as to who is the recipient of the payment given in consideration for the restrictive covenant by the purchaser. Arguably, that recipient has not derived the payment in his or her own right and instead receives it as agent on behalf of the provider. The legislation puts the issue beyond doubt by providing that the person who gives the restrictive covenant always derives any consideration given for it.

Officials do not agree that the example given by the submissioner, involving an employee giving an undertaking to a third party with the payment being received by the employer who pays the amount to the employee, would result in double tax. In the example the employer would seem to have received the amount as agent for the employee and, therefore, it is the employee who has already derived the amount and there is no second layer of taxation when the employer on-pays the amount to the employee. Also, section BD 3(4) of the Income Tax Act 1994 provides that a particular amount of gross income may be allocated only once.

### Recommendation

That the submission be declined.

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## Issue: Ambit – targeting only amounts specifically agreed to be paid

### Submission

*(9 – New Zealand Law Society)*

Instead of having the restrictive covenant charging provision based on any amount derived by a person in respect of the restrictive covenant, it should be based on the amount agreed to be paid in respect of the undertaking.

### Comment

Basing the charging provision on the amount specifically agreed to be paid in respect of a restrictive covenant would allow the provision to be readily circumvented. As the submission notes, it could be possible for a restrictive covenant payment to be derived as part of a larger transaction. If the charging provision were dependant on an amount being specifically agreed on, it could be avoided by the parties deliberately choosing not to allocate specifically any part of the total payment under the larger transaction to the restrictive covenant.

### Recommendation

That the submission be declined.

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## Issue: Settlements made in employment disputes

### Submission

*(7 – ICANZ)*

The amendments should contain provision for settlements made in employment disputes and explicitly make them non-taxable. Under a settlement in an employment dispute an employee may agree to accept a termination package in full and final settlement of the dispute. As part of that settlement, the employee may agree not to commence, or, if already commenced, to cease legal proceedings in respect of the dispute. A financial settlement as part of a termination package may be caught by the charging provision because it is an undertaking on behalf of the employee restricting that person's ability to perform services as an employee for that employer.

### Comment

Officials do not agree that such settlements made in employment disputes would be caught by the charging provision. An employee's agreement not to commence legal proceedings as part of a termination package does not restrict that person's ability to perform services as an employee generally.

Officials note, in any event, that with the exception of payments for humiliation and injured feelings (made under section 123(c)(i) of the Employment Relations Act 2000), all payments received by an employee as part of a settlement made on termination of an employment relationship would come within the definition of "monetary remuneration". This definition is drafted in very wide terms and, in particular, includes all compensation for loss of office or employment (other than payments for humiliation and injury to feelings). Given that this bill is not aimed at taxing injury to feelings payments, the amendments do not, therefore, alter the tax treatment of the remaining amounts of any financial settlements made in employment disputes as these are already taxed.

### Recommendation

That the submission be declined.

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## Issue: Application date

### Submission

*(11W – Simpson Grierson)*

The bill proposes to change the taxation consequences of existing binding contracts entered into, in many cases years ago, where amounts are to be paid in terms of those contracts after the date of enactment. The legislation is therefore unfairly retrospective.

The submission refers to the situation where purchasers of restrictive covenants provide consideration in the form of share options. Because the share options do not involve the purchaser in any expenditure, the recipient will be taxable on the value of what is received but the purchaser of the restraint will not obtain a deduction for its opportunity cost. Although it is likely that in future restrictive covenants will not use this type of consideration, existing restrictive covenant contracts will be affected by changing the balance of non-deductibility/non-assessability that underpinned those existing contracts' pricing.

The amendments should therefore apply only to arrangements entered into after the date of enactment. This will remove their present retrospective nature.

**Comment**

The restrictive covenant charging provision applies to amounts derived on and after the date of enactment. This will include such amounts derived in respect of arrangements made before the date of enactment.

The Government made a decision not to grandfather existing arrangements. Grandfathering would mean that payments made under restrictive covenants entered into before the date of enactment would remain non-taxable in the hands of the recipient. Such agreements could last for many years after the date of enactment. Payments made under such contracts should not remain non-taxable as there is a risk to the personal services income tax base resulting from such payments being substituted for taxable income from services.

These amendments have been foreshadowed for a considerable period. Restrictive covenants have been listed as a revenue risk in several recent budgets. In 1998, the Committee of Experts on Tax Compliance recommended legislation to make restrictive covenant payments taxable. The issues paper stating the Government's intention to tax these payments was issued on 30 June 2000. The bill will probably not be enacted until near the end of March 2001.

If the amendments applied only to arrangements entered into after the date of enactment, taxpayers would have a significant window of opportunity to enter into long-term restrictive covenant arrangements thereby ensuring a tax-free flow of receipts to the detriment of the personal services income tax base.

As the submission itself notes, the issue of restrictive covenants involving share options would probably be a transitional one only as in future restraints will be provided in a form involving the purchaser in making expenditure that would be allowed as a deduction under new section DJ 20. For the reasons set out above, the Government was not in favour of existing arrangements being grandfathered.

There is ample precedent for application date provisions to be expressed in terms of applying to amounts derived after the date of enactment. The provisions of the Income Tax Act 1994 are often expressed in terms of applying to amounts derived. Although charging provisions may be expressed to apply to arrangements entered into after the date of enactment this need not always be the case, and often is not.

### Recommendation

That the submission be declined.

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## Issue:  Placement of charging provisions in the Income Tax Act 1994

### Submission

*(7 – ICANZ)*

The restrictive covenant and exit inducement charging provisions, proposed to be contained in new subpart CHA, should instead be located at the end of Part C or, alternatively, included in existing subpart CH.

### Comment

New provisions should be located where they best fit the scheme of the Income Tax Act 1994. Officials consider that this is best achieved in the case of the new restrictive covenant and exit inducement charging provisions by locating them in a new subpart (subpart CHA) immediately following subpart CH, which deals with employment-related income.  This location better fits the scheme of the Income Tax Act than placing the provisions at the end of Part C following subpart CN (which mainly relates to certain income derived by non-residents).  It would also not be appropriate to place the provisions within subpart CH (employment-related income) as the new provisions can also apply to non-employees such as independent contractors and office holders.

### Recommendation

That the submission be declined.

# EXCLUSION FOR RESTRICTIVE COVENANT PAYMENTS CONNECTED WITH THE SALE OF A BUSINESS

New section CHA 1(2) contains a specific exclusion for restrictive covenant payments made in connection with the sale of a business. This exclusion applies only if a number of conditions are satisfied.

Submissioners raised a number of issues with the drafting of the exclusion such as the use of GST terminology, not catering for certain forms of business sale, and being unduly restrictive in certain respects. Officials consider that these concerns can be addressed while still preventing the sale of business exclusion being exploited so as to undermine the reform to tax restrictive covenant payments that can be substituted for income from services.

## Issue: Whether GST concepts should be used

### Submission

*(9 – New Zealand Law Society, 10W – Rudd Watts & Stone)*

The sale of business exclusion should be reworded to remove references to the GST concepts of "taxable activity" and "going concern" and instead simply refer to amounts derived on the sale of a business.

Both submissioners were concerned with whether it was intended to use GST time of supply rules for determining the time of the sale of a taxable activity.

Even after the 1995 amendments to the Goods and Services Tax Act 1985 (GST Act), the going concern concept had caused considerable confusion in the GST arena resulting in substantial litigation.

### Comment

Officials consider that the use of the GST concepts of "taxable activity" and "going concern" in the sale of business exclusion in the restrictive covenant charging provision has resulted in unnecessary confusion. Submissioners are concerned that whether or not a sale of a business is zero-rated for GST purposes (as a sale of a taxable activity as a going concern) could determine whether the sale of business exclusion in the restrictive covenant charging provision is applicable.

It was not intended that the sale of business exclusion would employ the zero-rating tests in section 11(1)(m) of the GST Act for the supply of a taxable activity as a going concern. These zero-rating tests require that the supplier and the recipient agree in writing that the supply is of a going concern and that they intend that the supply is of a taxable activity that is capable of being carried on as a going concern by the recipient. Instead, section CHA 1(2) refers only to the "going concern" and "taxable activity" definitions contained in sections 2 and 6 respectively of the GST Act.

Officials consider that in order to remove confusion about the application of GST concepts in the sale of business exclusion, the GST concepts of “taxable activity” and “going concern” should be replaced with a simple requirement that the restrictive covenant be connected with the sale of a business.

New section CHA 1(3)(a), which provides that, for the purposes of the sale of business exclusion, the sale of a taxable activity as a going concern includes the sale of part of a taxable activity as a going concern, should be amended to provide that the sale of a business includes the sale of part of a business if that part is capable of separate operation.

Replacing the GST concepts “taxable activity” and “going concern” with that of the income tax concept of a “sale of a business” addresses a number of the submissioners’ concerns and allows the legislation to be considerably simplified. This can be achieved without allowing the sale of business exclusion to be exploited so as to undermine the reform to tax restrictive covenant payments that can be substituted for income from services.

### Recommendation

That the submissions to remove the GST concepts from the sale of business exclusion and replace them with references to the “sale of a business” be accepted.

## Issue: Expanding forms of business sale qualifying for exemption

### Submission

*(5 – PricewaterhouseCoopers, 9 – New Zealand Law Society)*

The forms of business sale qualifying for the sale of business exclusion from the restrictive covenant charging provision should be expanded.

The New Zealand Law Society refers to sale structures involving chains of companies, for example, where the business is being carried on by a subsidiary of a holding company whose shares are being sold, and to sales of businesses that are in trust ownership.

PricewaterhouseCoopers refers to the example where a company sells its business but the restrictive covenant is given by its shareholder, the vendor of the business (the company), and the provider of the restrictive covenant (the shareholder) are different persons.

### Comment

The current sale of business exclusion in new section CHA 1(2) caters for two forms of business sale. These are the direct sale by a person of their business and a sale by a person of a company directly owned by them which carries on the business.

Officials agree that, subject to certain modifications, the sale of business exclusion from the restrictive covenant charging provision should cater for the forms of business sale referred to in submissions. This can be achieved by making certain minor modifications to the existing provisions.

Two amendments are necessary to cater for sale situations involving chains of companies, for example, the sale by a shareholder (who gives the restrictive covenant) of a holding company which owns a subsidiary which carries on the relevant business.

First, subsection (3)(b), which provides that the sale of a business includes the sale of all of the shares in a company that is carrying on a business, should be amended so that the company carrying on a business may include another company directly or indirectly wholly owned by the company whose shares are being sold.

Secondly, subsection (4), which modifies the application of certain of the conditions in subsection (2) in the case of a sale of shares, and which currently refers to the company whose shares have been sold by person A, will need to be amended to refer to the company in subsection (3)(b) which carries on the relevant business.

In relation to the Law Society submission that the sale of business exclusion should also cater for trustee-owned businesses, officials note that this is already the case. In terms of the legislation, there is nothing in section CHA 1(2) that excludes a vendor of a business who is a trustee.

Two amendments are necessary to new section CHA 1(2) to cater for the sale of business form submitted on by PricewaterhouseCoopers involving a sale of a business by a company whose shareholder gives a restrictive covenant to the purchaser.

First, section CHA 1(2)(a) should be amended to refer to an amount derived by person A in connection with the sale of a business by person A or a person associated with person A. PricewaterhouseCoopers submits that the sale of the business should be allowed to be by any person. Officials consider that the provision would be drafted too widely in this case and the example submitted on would be catered for by allowing the sale of the business to be by an associate of person A. Changing the current reference to person A deriving the amount “as part of the consideration for the sale” to person A deriving the amount “in connection with the sale” is also necessary because the paragraph will provide that the sale can be by an associate of person A as well as by person A itself. (PricewaterhouseCoopers also recommended a change to this “in connection with” terminology but for different reasons that officials do not agree with.)

Secondly, section CHA 1(2)(e) should be amended by changing the person A reference to the person referred to in subsection (2)(a) who undertakes the sale of the business.

### Recommendation

That the submissions be accepted in part.

## Issue: Requirement that restrictive covenant amount is paid by purchaser to vendor

### Submission

*(5 – PricewaterhouseCoopers)*

The requirement in new section CHA 1(2)(c) that the restrictive covenant amount is paid by the purchaser of the business (person B) to the person who gives the restrictive covenant is too restrictive. The requirement does not cover the number of possible permutations of a business sale, for example, the restrictive covenant payment could be sourced from an associate of the purchaser of the business. It is inappropriate for vendors and purchasers to be forced to transact differently in order to bring themselves within the exclusionary criteria for tax purposes.

### Comment

Officials agree that the requirement in new section CHA 1(2)(c) that the purchaser must make the payment to the person who gives the restrictive covenant is unnecessarily restrictive. The other conditions in the sale of business exclusion in section CHA 1(2) are sufficiently robust to prevent the exclusion being exploited. Accordingly, this requirement can be omitted.

### Recommendation

That the submission be accepted by omitting new section CHA 1(2)(c).

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## Issue: Requirement that services not be provided to purchaser after sale of business

### Submission

*(5 – PricewaterhouseCoopers, 7 – ICANZ, 9 – New Zealand Law Society)*

The requirement in new section CHA 1(2)(d), which limits the services that the person who gives the restrictive covenant undertaking may provide to the purchaser of the business after its sale, is too restrictive. The provision should be either widened or omitted altogether.

### Comment

New section CHA 1(2)(d) provides that the person who gives the restrictive covenant must not provide any services to the purchaser after the sale of the business, other than services that are incidental to the sale and are temporary in nature. Officials consider that this requirement is crucial to preventing the sale of business exclusion being exploited so as to undermine the reform to tax restrictive covenant payments that can be substituted for income from services.

PricewaterhouseCoopers submits that new section CHA 1(2)(d) should not preclude the existence of an “earn out” clause in sale and purchase agreements “which requires the vendor to work in the business for a period of time with a view to transitioning the business to the new owners”.

Officials consider that the exception in new section CHA 1(2)(d) applying to services that are incidental to the sale and are temporary in nature already allows such earn out clauses whose focus is to facilitate the transfer of the business to the new owners. This exception should also take account of the other concerns expressed by the submissioner such as the sale price for the business being affected by the profit earned during the transition period and the vendor being a principal participant during the transition period. In particular, the “incidental” reference in the exception relates to the transition period and does not restrict the quantum of services that can be provided during that period.

PricewaterhouseCoopers also submits that the exception in new section CHA 1(2)(d) should be widened to allow the purchaser of the business to use the vendor’s services within the business after the sale for an indeterminate period of time. Officials consider that widening the exception in this manner would deny section CHA 1(2)(d) any effect. It would allow the sale of business exclusion to be exploited to undermine the reform.

PricewaterhouseCoopers notes that the sale of business exclusion should allow for “genuine” restrictive covenant payments that are not in substitution for a salary. However, it is for the very reason that in practice it is very difficult to distinguish between restrictive covenant payments that are in substitution for taxable income from services and those that are not, that the capital/revenue boundary is being shifted in this particular area to protect the personal services income tax base.

The New Zealand Law Society considers that new section CHA 1(2)(d) is too restrictive for two reasons. First, section CHA 1(2)(d) raises the question of whether the GST time of supply rules should be used. This concern has been addressed by the recommendation to remove GST concepts from the sale of business exclusion.

Secondly, although limited assistance in the transitioning may have been contemplated by the parties at the outset of the sale, it may subsequently transpire that substantial assistance is in fact required. Accordingly, the Law Society considers that section CHA 1(2)(d) should be drafted on the basis of intention so that it can apply to situations where it was intended at the time of granting the undertaking that only limited services would be provided. Officials are not in favour of such an intention-based test as this would be too subjective in practice. Officials also consider that the Law Society’s concerns are addressed by the current drafting, which allows for substantial assistance to be provided by the vendor so long as it is provided in the context of transitioning the business to the new owner.

ICANZ submits that new section CHA 1(2)(d) should be omitted altogether on the basis that an avoidance opportunity does not arise on the sale of a business. As previously noted, officials consider that section CHA 1(2)(d) is crucial to prevent the sale of business exclusion being exploited to undermine the reform to tax restrictive covenant payments that can be substituted for income from services.

### Recommendation

That the submissions be declined.

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## Issue: Agreement in writing requirement

### Submission

*(9 – New Zealand Law Society)*

The requirement in new section CHA 1(2)(e) that the vendor and purchaser agree in writing that the transaction is a sale of a taxable activity as a going concern is too restrictive and should be omitted. The requirement gives rise to two problems. First, the parties may not wish to reach an agreement, as it will impact on their GST position. Secondly, the parties may not be New Zealand residents familiar with our GST system. If they fail to insert such a clause, at present merely timing/cash flow implications arise (pay GST on acquisition and obtain a subsequent refund). Having this written requirement for income tax purposes will additionally expose them to a permanent cost.

### Comment

The submissioner's concerns arise from the present use of GST concepts of "taxable activity" and "going concern" in the sale of business exclusion and would seem to be addressed by the earlier recommendation that these GST concepts be removed and replaced with sale of a business terminology.

The written agreement requirement in new section CHA 1(2)(e) reduces the possibility of there being, in practice, a mismatch of tax treatment between the parties to a restrictive covenant agreement. The result of a mismatch would be that no tax is collected on the payment and a deduction is taken by the purchaser of the restrictive covenant.

For instance, in the absence of an express agreement the recipient may return the restrictive covenant payment as non-taxable on the basis that the sale of business exclusion applies. However, the purchaser might claim a deduction on the basis that the exclusion does not apply. That is, both parties are interpreting and applying the law differently to the one transaction. This situation could arise despite the requirement in new DJ 20(1) that a deduction is available only for expenditure that is gross income under new section CHA 1.

The agreement in writing requirement should prevent such a mismatch occurring. It also provides some evidential support that there has been a bona fide sale of a business.

### Recommendation

That the submission be declined.

# RESTRICTIVE COVENANT ANTI-AVOIDANCE PROVISION

## Issue: Whether anti-avoidance rule in new section GC 14F is too extensive

### Submission

*(9 – New Zealand Law Society)*

The anti-avoidance rule is too extensive in that it applies whenever there is an avoidance “effect”, whether or not the parties have intended that effect. Such a broad rule is capable of striking down transactions even though no avoidance was intended. Accordingly, the provision should be either omitted (as any arrangement would be subject to the general anti-avoidance rule in section BG 1) or amended so that it applies only where an arrangement has the “purpose or effect” of avoidance.

### Comment

Officials consider that it is sensible for the anti-avoidance rule in new section GC 14F to apply to an arrangement which simply has an effect (before the application of the anti-avoidance rule) of avoiding the restrictive covenant charging provision.

In the case where an arrangement involved a purpose or intention to avoid the charging provision but did not, in fact, have that effect, and the charging provision continued to apply, there would be no reason to apply the anti-avoidance rule.

It should not be a requirement before the anti-avoidance rule can apply that the parties must have entered into the transaction with an intention to avoid the restrictive covenant charging provision. The fact that an arrangement has an effect (before the application of the anti-avoidance rule) of avoiding the charging provision should be the main criterion in the application of the anti-avoidance rule. An arrangement that has an effect of avoiding the restrictive covenant charging provision means essentially an arrangement that is contrary to legislative intent.

In relation to the comment that any arrangement would be subject to the general anti-avoidance rule in section BG 1 of the Income Tax Act 1994, officials consider that specific anti-avoidance provisions such as new section GC 14F are generally easier for taxpayers and Inland Revenue to interpret and apply than the general anti-avoidance provision. Their application is, therefore, more certain.

### Recommendation

That the submission be declined.

## Issue:  Application of anti-avoidance rule to sales of companies

**Submission**
*(7 – ICANZ)*

The specific anti-avoidance provision should not be retained because it will minimise the ability of shareholders to receive appropriate value from the sale of their shares.

**Comment**

The submission is concerned with the application of the proposed anti-avoidance rule to a specific situation which the rule is designed to address.  The situation involves an employee making a restrictive covenant agreement with a wholly-owned company, the shares in which the employee subsequently sells to his or her employer.

The submission considers that this situation supports the view that a restrictive covenant of trade is a valuable right that can be validly given and paid for.  The existence of a restrictive covenant over employees means that a company is worth more, but the anti-avoidance rule could minimise the ability of shareholders to receive appropriate value from the sale of their shares.

Officials consider that the company sale situation involves a non-arm's-length arrangement whereby an employee enters into a restrictive covenant with his or her own company.  If an anti-avoidance rule did not apply, the employee, by subsequently selling the shares in the wholly-owned company to the employer, could transform a payment for a restrictive covenant that substituted for income from services into a payment for shares which may not be taxable under the other provisions of the Income Tax Act 1994.

It is necessary, therefore, for a specific anti-avoidance rule to apply to this share sale situation to prevent the restrictive covenant charging provision being avoided with a consequent erosion of the personal exertion income tax base.

**Recommendation**

That the submission be declined.

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## Issue:  Making application of anti-avoidance rule dependent on application of service attribution rules

**Submission**
*(7 – ICANZ)*

If the proposed anti-avoidance rule proceeds it should apply only where the service attribution rules in sections GC 14B to GC 14E apply.

**Comment**

Officials do not consider that there is any relationship between the proposed anti-avoidance rule and the service attribution rules in sections GC 14B to GC 14E.  The application of the former provision should therefore not be dependent on the application of the latter provisions.

**Recommendation**

That the submission be declined.

## EXIT INDUCEMENT CHARGING PROVISION

### Issue: Specific exclusion for injury to feelings payments

**Submission**
*(5 – PricewaterhouseCoopers)*

A specific exclusion should be made to the exit inducement charging provision to provide that injury to feelings payments relating to employment disputes and made under section 123(c)(i) of the Employment Relations Act 2000 are not caught by the charging provision.

**Comment**

Officials do not consider that a specific exclusion from the exit inducement charging provision for employment-related injury to feelings payments is necessary because such payments are not caught by the charging provision in the first place. The charging provision will tax any amount derived by a person for a loss of a vocation, position or status, or for leaving a position. The provision does not tax payments for injury to feelings referred to in section 123(c)(i) of the Employment Relations Act 2000 (which is based on former section 40(1)(c)(i) of the Employment Contracts Act 1991).

The wording of the draft exit inducement charging provision contained in the issues paper released in June 2000 was specifically amended, in the light of submissions, to ensure that injury to feelings payments were not inadvertently caught by the provision (it never being the intention for such payments to be taxed by this charging provision). This wording change involved replacing the reference to an amount derived "in connection with" a loss with a reference to an amount derived "for" a loss.

**Recommendation**

That the submission be declined.

### Issue: Specifying payer of exit inducement

**Submission**
*(10W – Rudd Watts & Stone)*

The proposed section CHA 2 should be amended to clarify that exit inducement payments constitute the consideration given by a prospective employer or contractor to a person for giving up a particular status or position.

**Comment**

As the submissioner notes, the issues paper released in June 2000 described an exit inducement payment as the consideration given by a prospective employer or contractor to a person to give up a particular status or position. Although this is a correct description of the main target of the charging provision, the decision was made not to identify the payer of the exit inducement in the legislation itself because such specification could result in an unintended narrowing of the provision. Specifying the source of the payment could encourage such payments to be routed through third parties. Also, at the time of derivation of the exit inducement payment the recipient may have begun the new employment or services contract so that the employer or contractor payer could no longer be described as prospective.

Therefore, while a reference to a prospective employer or contractor as the source of an exit inducement payment would be an accurate description of the intended policy, such a reference is not necessary to make the charging provision work and could result in an unintended narrowing of the charging provision.

**Recommendation**

That the submission be declined.

## EXPENDITURE INCURRED ON RESTRICTIVE COVENANTS AND EXIT INDUCEMENTS

### Issue: Whether new section DJ 20 affects general deductibility provisions

**Submission**
*(5 – PricewaterhouseCoopers)*

There may be certain circumstances where a deduction is available to the payer, irrespective of whether the amount is gross income under either section CHA 1 or section CHA 2. The submissioner asks for confirmation that their analysis of the relationship between the income and deductibility provisions accords with the intention of the proposed provisions.

**Comment**

The submissioner sets out an example involving an exit inducement payment made to a non-resident and asks for two questions to be answered.

First, is the amount derived by the non-resident still considered to be gross income if it is included within gross income under section BD 1(1) but is subsequently excluded under section BD 1(2)(c) (because it is a foreign-sourced amount and the recipient is a non-resident when it is derived), so that the express relief under new section DJ 20(1) from the capital prohibition rule in section BD 2(2)(e) will be accorded to the payer?

Secondly, if the amount is not gross income within the terms of the proposed section DJ 20, do taxpayers default to general principles to determine deductibility?

The answer to the first question is "no". The amount is not gross income for the purposes of qualifying for relief from the prohibition on deductions for capital expenditure under section DJ 20(1).

The answer to the second question is "yes". Although section DJ 20(1) provides a specific relief from the general prohibition for deductions of capital expenditure, it does not constitute a code in relation to whether expenditure on restrictive covenants and exit inducements is expenditure of a capital nature. In particular, the general deductibility rules in section BD 2 are not excluded and still operate normally.

Officials can therefore confirm the submissioner's analysis of the relationship between the income and deductibility provisions.

**Recommendation**

That the officials' response to the submissioner's questions be noted.

## Issue: Minor clarification in new section DJ 20(1)

**Submission**
*(10W – Rudd, Watts & Stone)*

To ensure that the intent of new section DJ 20(1) is clear on the face of the legislation it should be amended to refer to expenditure incurred by a taxpayer that is gross income of another person.

**Comment**

Officials agree with the submissioner that it would be a worthwhile minor clarification of section DJ 20(1) for the provision to refer to "gross income of another person". Although this is the intent of the provision, the proposed amendment would make this clear on the face of the legislation.

**Recommendation**

That the submission be accepted.

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## Issue: Expenditure on services which is of a capital nature

**Submissions**
*(7 – ICANZ, 9 – New Zealand Law Society)*

ICANZ considers that the restriction on the deduction allowed under section DJ 20(1) that is contained in subsection (2) is flawed for two reasons. First, because the reforms generally involve shifting from a non-deductible/non-assessable model to a deductible/taxable model, there is no valid reason for restricting deductibility. Secondly, if payments are made for services rendered they will be taxable and subject to the normal rules of deductibility.

The New Zealand Law Society considers that the wording of section DJ 20(2) should be amended so that section DJ 20(1) applies only to the percentage extent to which the employee's monetary remuneration is otherwise deductible. The Law Society also considers that an arbitrary period may need to be stated as to what period is the focus of the enquiry under the provision.

**Comment**

The ICANZ submissions do not seem to take into account the policy rationale for new section DJ 20(2), which is to ensure that the deductibility treatment of restrictive covenant and exit inducement payments is not concessionary in comparison with salary and wages. Salary and wages are non-deductible capital expenditure to the extent they relate to work of a capital nature undertaken by recipient employees. If outright relief from the exclusion for capital expenditure was provided under new section DJ 20(1) for restrictive covenant and exit inducement payments, these payments could never be characterised as capital expenditure, even when the work was of a capital nature. Employers could, therefore, prefer to make these payments instead of payments for services if capital works were involved. This rationale – stated in the commentary to the bill – explains why providing for deductibility of restrictive covenant and exit inducement payments in all cases would not be the correct treatment in policy terms.

The New Zealand Law Society submission seems to have misconstrued the meaning of section DJ 20(2). The Law Society has difficulty with the wording of the provision because it considers that payments made under sections CHA 1 and CHA 2 are not for services rendered but respectively for restrictions on a person's ability to perform services or for loss of employment.

The focus of new section DJ 20(2) is not on the particular services whose performance is restricted under the restrictive covenant. Instead, the focus is on restrictive covenant and exit inducement payments being substituted for income from services in cases where expenditure on those services would have been of a capital nature because, for example, the services relate to capital works. The provision is anti-avoidance in nature and not expected to have a significant application. However, the provision is necessary to act as a deterrent to employers preferring to make restrictive covenant and exit inducement payments instead of salary and wage payments if capital works are involved.

Officials will provide a more detailed explanation of this provision in the *Tax Information Bulletin* item on these amendments so that it is better understood.

### Recommendation

That the submissions be declined.

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## Issue: Application date for new section DJ 20

### Submission

*(5 – PricewaterhouseCoopers, 10W – Rudd, Watts & Stone)*

A transitional rule should be enacted to allow taxpayers to deduct expenditure incurred on restrictive covenant and exit inducement payments before the date of enactment of the bill if those payments are subsequently taxed as gross income to another taxpayer under either section CHA 1 or section CHA 2.

### Comment

Clause 8(2) of the bill provides that new section DJ 20 – which contains express relief from the capital prohibition rule for expenditure on restrictive covenant and exit inducement payments – applies to expenditure incurred on and after the date of enactment of the bill. Clause 7(1) of the bill provides that the restrictive covenant and exit inducement charging provisions apply to amounts derived on and after the date of enactment.

As the submissions noted, these application date provisions could result in a mismatch in situations where payers incur expenditure on restrictive covenant and exit inducement payments before the date of enactment (and therefore not currently entitled to the relief under section DJ 20) but the payments are derived by recipients after the date of enactment and are gross income under either section CHA 1 or section CHA 2.

Therefore payments may be taxable to the payee under either section CHA 1 or section CHA 2 but be non-deductible by the payer.

Officials agree with submissioners that this transitional issue should be addressed by amending clause 8(2) of the bill to provide that new section DJ 20 also applies to expenditure incurred on restrictive covenant and exit inducement payments before the date of enactment if those payments are gross income to another person under either section CHA 1 or section CHA 2.

### Recommendation

That the submissions be accepted.

# DEDUCTION FOR REFUND OF RESTRICTIVE COVENANT PAYMENT

## Issue: Application of section DJ 21

### Submission

*(10W – Rudd, Watts & Stone)*

New section DJ 21 should apply to employees only. The provision is only necessary to provide a deduction in respect of refunds of restrictive covenant payments made by employees because section BD 2(2)(c) – which prohibits a deduction for expenditure incurred in deriving income from employment – would otherwise deny employees such a deduction. However, independent contractors and office holders would be able to claim a deduction for the cost of refunding a restrictive covenant payment under the general deductibility provisions in section BD 2(1)(b)(i) and (ii) without recourse to section DJ 21. It is more appropriate for independent contractors and office holders to claim deductions under the general deductibility provisions and a specific deduction provision such as section DJ 21 is unnecessary for such persons.

### Comment

New section DJ 21(1) allows a deduction to persons who have been taxed on a restrictive covenant payment if they are required to refund part or all of that payment because they do not comply with the terms of the restrictive covenant.

Officials agree with the submissioner that it is only necessary for section DJ 21 to apply to employees. Independent contractors and office holders can have recourse to the general deductibility provisions to claim a deduction for the amount of any refund of a restrictive covenant payment that they are required to make because of breach of a term of the restrictive covenant.

### Recommendation

That the submission be accepted.

## Issue: Minor amendment to section BD 2(2)(c)

### Submission

*(Matter raised by officials)*

Section BD 2(2)(c) should be amended to include an exception for the deduction allowed to employees under new section DJ 21(1) for a refund of a restrictive covenant payment.

**Comment**

Section BD 2(2)(c) in the core provisions of the Income Tax Act 1994 prohibits a deduction for expenditure incurred in deriving income from employment. By virtue of the amendment made by clause 24(2) of the bill to the definition of "extra emolument", restrictive covenant and exit inducement payments derived by employees constitute income from employment for the purpose of section BD 2(2)(c).

It is desirable to amend section BD 2(2)(c) to include an exception for the deduction allowed to employees under new section DJ 21(1).

**Recommendation**

That an amendment be made to clarify the relationship between section BD 2(2)(c) and section DJ 21(1).

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## Issue: Restrictions on deductions allowed under new section DJ 21(1)

**Submissions**
*(7 – ICANZ, 9 – New Zealand Law Society, 10W – Rudd, Watts & Stone)*

The restrictions contained in subsections (2) and (3) of section DJ 21 on the deduction allowed under subsection (1) for a refund of a restrictive covenant payment should be removed or apply only to employees.

**Comment**

Section DJ 21(2) provides that the deduction allowed under subsection (1) is limited to the lesser of the amount that is refunded and the amount that was taxed under the restrictive covenant charging provision. Section DJ 21(3) provides that a deduction is also not allowed under subsection (1) for any payment in respect of punitive or exemplary damages, interest or the legal costs or other expenses of the person who paid the restrictive covenant amount to the person claiming the deduction.

It is important to note that the restrictions contained in section DJ 21(2) and (3) only limit the deduction allowed under subsection (1) for any refund of a restrictive covenant payment. Submissioners were concerned that the restrictions may limit the deductions allowed to an independent contractor under the general deductibility provisions in section BD 2(l)(b)(i) and (ii). This view misconstrues the effect of those restrictions because they do not, in fact, affect the operation of the general deductibility provisions. This non-derogation should address most of the concerns expressed by submissioners.

Limiting the application of the deduction allowed under section DJ 21(1) to employees, as recommended above, should also help to address submissioners' concerns because it makes it even clearer that the operation of the general deductibility provisions is not affected by the restrictions contained in section DJ 21(2) and (3).

**Recommendation**

That the submissions be declined.

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## Issue: Timing of deduction for refund made when restrictive covenant breached

**Submission**
*(5 – PricewaterhouseCoopers)*

New section EO 6, which governs the timing of the deduction allowed under section DJ 21, should be amended to allow the defaulting person to claim a deduction in either the income year in which the restrictive covenant payment was returned or the income year in which the payment is refunded.

**Comment**

In the light of the recommendation above that the deduction allowed under new section DJ 21(1) should apply only to employees, it is the appropriate income tax treatment that the deduction is allowed only in the income year that the refund is paid, and not in an earlier period if the restrictive covenant payment was returned in that earlier period. This is because employees are taxed on a cash basis under the Income Tax Act. Accordingly, because employees have to return income only in the year that it is paid to them, it is appropriate that a deduction is allowed only in the year that refunds are made by them.

This treatment for employees has the advantage of not having to re-open prior year returns. Also, employees are generally not exposed to the provisional tax and use-of-money interest rules because the tax on their employment income (including restrictive covenant and exit inducement payments by virtue of the proposed amendment to the “extra emolument” definition in section OB 1) has been deducted at source.

The precedent for re-opening previous year returns in the foreign investor tax credit rules cited by the submissioner applies only to companies which are taxed on an accruals basis and is, therefore, not relevant to employees.

**Recommendation**

That the submission be declined.

# PART III

# Other changes to Income Tax Act 1994

## OVERSEAS STAKE MONEY

### Submission

*(Matter raised by officials)*

The exemption of overseas stake money from income tax should apply retrospectively from the 1995-96 income year.

### Comment

The amendment to section CB 9 of the Income Tax Act exempts stake money won from a horse race, trotting race or dog race held outside New Zealand with effect from the 2001-02 income year.

The racing industry has voiced concern regarding the application date of the amendment. It is concerned that there is uncertainty around whether Inland Revenue would require income tax to be paid on overseas stake money won in the recent past. After consultation with the Industry, Inland Revenue has determined that the application date that would alleviate the concerns of the racing industry would be the income year beginning on 1 April 1995.

Backdating the amendment would bring the legislation into line with past practice and as this practice is continued there are no revenue or compliance implications.

### Recommendation

That the amendment apply from the 1995-96 income year.

## TREATING EXCEPTED ARRANGEMENTS AS FINANCIAL ARRANGEMENTS

### Submission

*(Matter raised by officials)*

Section EH 13 should be amended, with application from 20 May 1999, so that the right to treat certain excepted financial arrangements as financial arrangements applies to all arrangements entered into between the taxpayer’s last balance date and 20 May 1999.

### Comment

When the new accrual rules were introduced, some financial arrangements (such as an interest-free loan) were listed as excepted financial arrangements with retrospective effect. The retrospective effect was considered unfair if taxpayers had entered into these arrangements under the old accrual rules with the expectation that they would be treated as financial arrangements. Section EH 13 was introduced, therefore, to allow these taxpayers to continue treating these arrangements as financial arrangements.

It appears, however, that the right of election does not currently apply to arrangements entered into between the taxpayer’s last balance date and the filing date. This is contrary to the policy intention, which allows the right of election to apply to arrangements entered into before 20 May 1999, the date of enactment of the new accrual rules.

As this is a minor amendment needed to reflect the original policy intention, it should apply with retrospective effect from 20 May 1999.

### Recommendation

That the submission be accepted.

## TREATY OF WAITANGI FISHERIES COMMISSION

**Submission**
*(7 – ICANZ)*

The wording of clause 14 should be clarified to exclude distributions that are not in relation to the allocation of assets but are made in the course of managing the Commission until all of its assets are allocated.

**Comment**

Officials consider that the Commission would not be making distributions of assets as part of the normal course of managing the operations of its business. The fisheries assets can only be distributed as part of the fisheries allocation process and not as part of managing the Commission's operations. Accordingly, we do not see the need for this change.

**Recommendation**

That the submission be declined.

## Issue: Technical drafting issues

### Submission

*(10W – Rudd Watts & Stone)*

The proposed amendment to section NG 9(1)(b) does not achieve its intended result that conduit relieved non-cash taxable bonus issues are only subject to 15% NRWT.

### Comment

In particular, the submissioner notes that:

- The portion of the taxable bonus issue which carries conduit tax relief credits should be excluded from item (e)/. By including the portion of the dividend which is conduit relieved in both item (e) and item (g) of that formula, the amendments actually impose a rate of NRWT in excess of 30%.
- The formula in clause 23(2) should be amended to *(a x e) + (c x (f + g))* to ensure that the NRWT treatment of bonus issues is the same as the treatment accorded the equivalent cash dividend.
- Item ‘g’ in the formula in proposed section NG 9(1)(b) should read:

> “g is the amount of the dividends, to the extent fully conduit tax relief credited **plus the** conduit tax relief additional dividends paid **in respect of the taxable bonus issue** as a result of Part LG.”

Officials agree with the submissioner’s comments and, to achieve the desired outcome, have consulted with them on alternative drafting of the amendments.

### Recommendation

That the submission be accepted.

## DEFINITION OF "QUALIFYING PERSON" FOR FAMILY ASSISTANCE – REMEDIAL AMENDMENT

### Submission

*(Matter raised by officials)*

The definition of "qualifying person" in section KD 3 should reflect the changes in the bill to the definition of "qualifying person" in section OB 1.

### Comment

The bill amends the definition of "qualifying person" in section OB1 to ensure that a qualifying person is tax resident in New Zealand before they qualify for family assistance. This change will stop a potential loophole whereby full family assistance could be claimed by a non-resident who had been in New Zealand for a period of 12 months some years ago.

The equivalent change should also be made to the definition of "qualifying person" in section KD 3(1) for family tax credit purposes. Amending section KD 3 will also close the loophole with respect to the family tax credit.

### Recommendation

That the definition of "qualifying person" in section KD 3 be amended in the same way as the definition in section OB1.

## Issue: Income statements for all taxpayers

### Submission

*(7 – ICANZ)*

All taxpayers should receive an income statement for each income year.

### Comment

ICANZ states that automatically issuing an income statement to every taxpayer would:

- give them reassurance that they had paid the right amount of tax;
- reduce anxiety for those who would have to contact the Inland Revenue Department to confirm their statement; and
- decrease administration costs by reducing the number of telephone calls received by the department.

ICANZ made the same submission in 1999 to the Finance and Expenditure Committee as part of the committee's deliberations over the Taxation (Simplification and Other Remedial Matters) Bill.

Issuing income statements to all eligible taxpayers would bring many more taxpayers into the system than are currently in it, increasing compliance costs for many and administrative costs for Inland Revenue. The compliance costs include the psychological costs incurred by many people when they receive correspondence from Inland Revenue and must actively consider their tax affairs.

In the past Inland Revenue issued around 1.45 million annual IR 5 tax returns, of which 1.2 million were returned. To date around 460,000 income statements have been issued, of which only around 135,000 were requested by taxpayers. About one million taxpayers would have to be contacted by Inland Revenue if this recommendation were implemented.

Inland Revenue considers that the newness of the process has resulted in a higher number of contacts by taxpayers than was planned for, but expects the number of contacts to diminish over time as taxpayers become familiar with the new system. This change in behaviour has been evidenced in recent studies.

### Recommendation

That the submission be declined.

## Issue: Direct crediting of refunds of excess tax

### Submission

*(Matter raised by officials)*

The application date for the new definition of "tax" in section 184A(5) of the Tax Administration Act as implemented by the Taxation (GST and Miscellaneous Provisions) Act 2000 should be changed to on and after 1 April 2000.

### Comment

The definition of "tax" in section 184A of the Tax Administration Act was replaced to allow refunds for rebates to be paid directly into taxpayers' bank accounts. That amendment incorrectly applies to the 1999-2000 and subsequent income years and therefore can apply from 1 April 1999 for standard balance taxpayers. However, section 184A was originally inserted into the Tax Administration Act with application on and after 1 April 2000.

The change suggested by the submission corrects an oversight and does not amend policy.

### Recommendation

That the submissions be accepted.

**Submission**
*(Matter raised by officials)*

Section ED 4(3)(a) of the Income Tax Act 1994 should be amended to update its reference to previous section 21(3) of the Goods and Services Tax Act 1985.

**Comment**

Section ED 4(3)(a) still contains a reference to previous section 21(3). This should be changed to refer to section 21I(1) – (3).

**Recommendation**

That the reference to previous section 21(3) in section ED 4(3)(a) be changed to a reference to section 21I(1) – (3).

**Submission**
*(Matter raised by officials)*

The definition of "excepted financial arrangement" in section EH 14(d) of the Income Tax Act 1994 should be amended to refer to section EH 12, instead of to EH 10.

**Comment**

The definition of excepted financial arrangement in section EH 14(d) refers to an election in accordance with section EH 10 to treat a short-term trade credit as a financial arrangement to which the qualified accruals rules apply. Before the enactment of the Taxation (Accrual Rules and Other Remedial Matters) Act 1999, this election was contained in section EH 10, but is now contained in section EH 12. Owing to an omission at the time, this section reference was not changed accordingly.

**Recommendation**

That the submission be accepted.

**Submission**
*(Matter raised by officials)*

Paragraph (a) of the definition of "partner" and "partnership" should be repealed.

**Comment**

Section OB 1, paragraph (a) of the definition of “partner” and “partnership” contains an incorrect cross-reference to section DZ 4. The correct reference, section DZ 6, applies the definitions of “partner” and “partnership” to shares or an interest in an asset, rather than containing actual definitions of “partner” and “partnership” itself. Officials therefore consider that paragraph (a) should be repealed from the date of the bill’s enactment.

**Recommendation**

That paragraph (a) of the definition of “partner” and “partnership” be repealed.

# PART IV

# Changes to Tax Administration Act 1994

## REMEDIAL CHANGE TO SECTION 25(6)

### Submission

*(Matter raised by officials)*

An amendment should be made to section 25(6) of the Tax Administration Act to provide clarification that Inland Revenue can require payers of resident withholding tax (RWT) to provide their tax file numbers on RWT Deduction Certificates.

### Comment

As part of changes under the Taxation (Simplification and Other Remedial Matters) Act 1998, section 25(6) was replaced with an amended section. This change removed a paragraph that could require payers of RWT such as banks and other financial institutions to provide their tax file number on a RWT Deduction Certificate along with the required tax file number of the recipient of the interest such as a bank account holder. Owing to this change, there is some confusion over the requirement on payers to provide their tax file number on such certificates. In practice, payers have continued to provide this information. However, some have queried the legislative authority for the information to be required.

Payers of RWT often have multiple entities and tax file numbers, and therefore it is important for matching and processing purposes to require the payer to note the appropriate number. For example, this allows more timely processing of refunds or queries from taxpayers as the RWT payer can be quickly identified.

### Recommendation

That section 25(6) be amended to legitimise current practice and clarify that RWT payers are required to provide their tax file numbers on RWT Deduction Certificates that they provide.

## Issue: Phased application of the initial late payment penalty

**Submission**
*(9 – New Zealand Law Society)*

The reference in clause 28(3) to section 139(2A) should be section 139B(2A).

**Recommendation**

That the submission identifies a typographical error and should be accepted.

**Submission**
*(7 – ICANZ, 9 – New Zealand Law Society)*

The implementation date of the new staggered application date of the initial late payment penalty should be brought forward to:

- 1 July 2001 (Law Society);
- 1 April 2001 (ICANZ).

**Comment**

The planned application date is 1 April 2002. Considerable systems changes are required to implement this initiative. In order to bring forward the implementation date for this proposal it would be necessary to reprioritise Inland Revenue’s existing commitments to implement other proposals considered more urgent, such as the changes for student loan borrowers, and the introduction of the optional fringe benefit tax multi-rate rules.

**Recommendation**

That the submission be declined.

**Submission**
*(7 – ICANZ)*

The initial late payment penalty should be reduced from being a 5% penalty to a 3% penalty, and use-of-money interest should not apply until the whole penalty is applied.

**Comment**

The initial late payment penalty is designed to provide a clear incentive to pay tax on the due date. The quantum of the penalty is set so that it is significant enough to create a preference for paying Inland Revenue over trade creditors, and complying taxpayers can see that non-compliance is punished. However, penalties should not exceed the levels necessary to achieve their objectives.

The penalty structure proposed in this bill is designed to support the original due date while not overly penalising those who inadvertently pay just a few days late. Reducing the quantum of the second phase of the penalty would undermine the objectives of the penalty.

Use-of-money interest is not charged as a penalty but instead compensates the Government for not having the use of the overdue tax payment and to encourage taxpayers to pay the right amount at the right time. Delaying the exposure to interest until the time that the second phase of the initial late payment penalty is imposed may make it simpler for taxpayers to calculate the total amount owed. However, it will remove the incentive on taxpayers who miss the due date not to delay their payment further. It would also prevent the Government from being adequately compensated for the loss in the use of its money.

**Recommendation**

That the submission be declined.

**Submission**
*(Matter raised by officials)*

Section 139B should be amended to:

- prevent the second phase of the initial late payment penalty from applying if taxpayers meet the terms of their instalment arrangement; and
- enable taxpayers who are subject to compulsory deductions, whether in one or more payments, to be eligible for cancellation of penalties, as are those with instalment arrangements.

As a consequential change to the above, section 183B should be repealed, and amendments made to sections 3(1), 125 and 138E of the Tax Administration Act.

Section 183B should be consequentially amended to follow changes that mean instalment arrangements can be for one instalment.

**Comment**

If a taxpayer enters into an arrangement to pay a debt or if the Commissioner has exercised powers to have the debt repaid by compulsory deductions, the taxpayer is entitled to have 60% of the initial late payment penalty and incremental late payment penalties cancelled under this section 183B. The arrangement must have been agreed to before the tax was due, and all its terms must be met before this cancellation can take place.

The proposals in this bill to cancel incremental penalties make parts of section 183B that address the cancellation of incremental penalties redundant.

It was also intended that taxpayers on behalf of whom compulsory deductions are being made should be eligible for the cancellation of penalties, similarly to those who have entered into instalment arrangements.

The phasing of the initial late payment penalty would mean that taxpayers would be entitled to a 60% cancellation of each phase of the penalty. Preventing the application of the second phase of the initial late payment penalty would be a simpler alternative that would also create a larger incentive for taxpayers who anticipate not being able to meet a tax payment to enter into an instalment arrangement before the tax is due.

The current drafting of the provision anticipates that two or more instalments will be payable under an arrangement. However, some taxpayers enter into arrangements to repay overdue tax in one instalment. It would create inequities if these taxpayers had penalties imposed before they are required to pay the debt.

**Recommendation**

That the submission be accepted and the redrafted consequential amendment apply from the same time that the primary changes take effect.

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## Issue: Serious hardship and financial difficulty

**Submission**
*(Matter raised by officials)*

The application date for the new definition of "tax" for the purposes of sections 176 and 177 of the Tax Administration Act as amended by the Taxation (GST and Miscellaneous Provisions) Act 2000 should be changed to on and after 1 April 2001.

**Comment**

The types of taxes that are eligible for relief under sections 176 and 177 of the Tax Administration Act were extended from income tax and fringe benefit tax to include all taxes by the Taxation (GST and Miscellaneous Provisions) Act.

At introduction, this proposal was intended to apply to tax payable on or after the 2001-2002 income year. Following submissions it was decided that the extension should apply to all applications for relief made after 1 April 2001. This submission addresses potential confusion over the application date of the new definition to ensure that tax debt incurred before 1 April 2001 can be the subject of relief.

The application date for the new definition of "tax" for the purposes of the provisions that provide relief in the case of serious hardship or financial difficulty is for the 2000 – 2001 and subsequent income years. This has the potential to create confusion over whether tax debt incurred before 1 April 2001 can be the subject of relief . The changes suggested by the submission clarify the legislation to ensure that taxpayers with tax debt incurred before 1 April 2001 will be eligible to apply for relief.

**Recommendation**

That the submission be accepted.

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## Issue: Aligning tax payment dates

**Submission**
*(7 – ICANZ)*

Tax payment dates should be aligned to the seventh day of the month. If it is decided not to align payment dates, the reasons for not doing so should be reported.

**Comment**

ICANZ points out that a number of reviews of compliance costs have made recommendations to investigate the merits of aligning payment dates. It considers that aligning payment dates will reduce the number of dates that taxpayers must remember and separate the time that tax is paid from the time that trade creditors are generally paid. It also points out that not aligning payment dates because of the effect on poorly organised taxpayers penalises well-organised taxpayers.

Options to align payments were considered in the discussion document *Less Taxing Tax*. The response to the proposal was mixed. While the proposal was favoured by large, well organised businesses, small businesses were strongly opposed to aligning payment dates. They were concerned that the effect on cash flow of large consolidated payments would jeopardise the viability of their businesses or impose extra budgeting costs.

Other options to reduce the compliance costs caused by multiple payment dates will be outlined in a discussion document planned for release later this year.

**Recommendation**

That the submission be declined.

## SHORTFALL PENALTIES ON REFUNDS

**Submission**
*(Matter raised by officials)*

Sections 141E(1)(d), (e) and 141E(3) should be corrected to apply in cases where the taxpayer attempts to obtain a refund or payment of tax.

**Comment**

Section 141E(1)(d) of the Tax Administration Act 1994 imposes a shortfall penalty for evasion of 150 percent in cases where taxpayers obtain a refund or payment of tax knowing that that they are not lawfully entitled to it. Section 141E(1)(e) imposes a similar penalty if a taxpayer enables another person to obtain the refund or payment of tax knowing that that they are not lawfully entitled to the refund or payment.

However, if, for example, someone attempts to obtain a refund knowing that they are not entitled to it, but the refund is halted by Inland Revenue, a penalty for evasion is not imposed simply because Inland Revenue does not make the refund.

The position that a taxpayer may attempt evasion and not be subject a penalty if Inland Revenue detects that evasion represents a significant deficiency in the tax legislation. All taxpayers who knowingly seek to obtain a refund or payment to which they are not lawfully entitled should be subject to the evasion penalty. Taxpayers should not benefit from the department's actions which result in the refund or payment not being made.

The legislation as currently presented does not reflect its underlying intent. Penalties for attempted evasion have always been part of the tax system. Sections 141E(1)(d), (e) and 141E(3) should be corrected to re-establish that in cases where the taxpayer attempts to obtain a refund or payment of tax, an evasion penalty can be imposed.

The amendment should apply from 1 April 1997, the date the compliance and penalties legislation took effect, apart from cases where the taxpayer has been advised by the Commissioner that a penalty for evasion cannot be imposed.

**Recommendation**

That the submission be accepted.

# PART V

# Changes to Stamp and Cheque Duties Act 1971

# APPROVED ISSUER LEVY

## Issue: Registered securities held by residents

### Submissions

*(9 – New Zealand Law Society, 10W – Rudd Watts & Stone)*

Approved issuer levy (AIL) should not be payable on interest paid in respect of a registered security, which is held by a New Zealand resident.

### Comment

The submissions note that the proposed amendments require an approved issuer to pay AIL on any interest payments to a non-associated person in respect of a registered security, regardless of whether the payee is a New Zealand resident or non-resident. As a result, an interest payment made to a New Zealand resident holder of a registered security would be subject to AIL as well as resident withholding tax.

The intention of the proposed amendments was simply to allow the compliance and penalty rules to apply to late payments of AIL. It was never the intention to subject a resident holder of a registered security to AIL, as a deduction of resident withholding tax is the correct treatment in that case. Officials agree, however, that the current amendments do have the unintended effect of requiring AIL to be paid on interest paid in respect of a registered security, which is held by a New Zealand resident.

Officials have consulted with the submissioners on an alternative drafting of the amendments. Both officials and submissioners are now happy that the new amendments will result solely in late payment of AIL being subject to the compliance and penalty rules and not make residents with registered securities liable for AIL.

### Recommendation

That the submission be accepted.

## Issue: Mandatory payment of AIL on registered securities

### Submissions

*(9 – New Zealand Law Society, 10W- Rudd Watts & Stone)*

AIL should not be mandatory if a security is registered. Investors should have the choice between having AIL paid or NRWT deducted in respect of interest paid to them on registered securities.

### Comment

The submissioners note that while the intention of AIL was that it was a choice subject to strict conditions, it was a choice nonetheless. They note that the current amendments remove this choice and require AIL to be paid on all registered securities.

The intention of the proposed amendments was simply to allow the compliance and penalty rules to apply to late payments of AIL. While it was never the intention to make the payment of AIL obligatory, officials agree that the proposed amendments do have this unintended effect.

Officials have consulted with the submissioners on an alternative drafting of the amendments. Both officials and submissioners are now happy that the new amendments will simply result in late payment of AIL being subject to the compliance and penalty rules and not make the payment of AIL obligatory if a security is registered.

### Recommendation

That the submission be accepted

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## Issue: Extension of the $500 annual threshold for six-monthly payments of approved issuer levy

### Submission

*(12W – MS and MA Douglas)*

Even with a $500 annual threshold, the compliance costs for monthly payments of small sums are still extremely high. The submission recommends that either the threshold level be increased to $2500 or the basis on which the threshold is set be based on the value of the registered security. The threshold value recommended is $1.5 million at current interest rates.

### Comment

Both the resident and non-resident withholding tax rules allow six-monthly payments when the expected annual payments are less than $500. As AIL is set at 2% versus 19.5/33/39% for RWT or 10/15/30% for NRWT, the proposed amendments will allow six-monthly payments on a much higher underlying principal than is the case for RWT or NRWT.

Thus although the $500 threshold for AIL was set to be consistent with provisions in the RWT and NRWT rules, it is in fact already more generous than the $500 thresholds in those rules. Officials are, therefore, unable to support any extension of the $500 threshold currently proposed in the bill.

**Recommendation**

That the submission be declined.

# Part VI
# Changes to GST Act 1985

# MINOR REMEDIAL AMENDMENTS

A number of changes are proposed to the Goods and Services Tax Act 1985 to correct minor drafting errors and oversights in the reforms to the GST Act recently enacted by the Taxation (GST and Miscellaneous Provisions) Act 2000. These changes apply from the date of enactment of the original amendments, to ensure that the policy intent of the changes is achieved.

## Issue: Vouchers

A number of minor remedial amendments are required to rules concerning the treatment of tokens, stamps, and vouchers (vouchers). The legislation in the Goods and Services Tax Act 1985 allows taxpayers the option to recognise GST on the supply of a voucher either when it is issued or when it is redeemed. In designing the rules officials consulted with retail groups to ensure the efficacy of the rules. The intention was to simplify the treatment of voucher transactions by aligning the treatment of voucher transactions with the general time of supply rule, being the earlier of invoice or payment. However, where the change created significant compliance costs such as in multi-party retail arrangements involving the supply of vouchers, the legislation allowed the option for those taxpayers to maintain those arrangements. Officials have since been informed that some aspects of the legislation in the GST Act are not achieving their policy intent. Officials recommend that the following minor remedial amendments be made to sections 5(11D) – 5(11G) of the GST Act. The amendments will apply from 10 October 2000, the date when the original amendments (as contained in the Taxation (GST and Miscellaneous Provisions Act) 2000) came into effect. Officials recommend a retrospective date because it is clarifying the original intent and is taxpayer friendly.

### Submission

*(Matter raised by officials)*

Potential double taxation of voucher transactions

### Comment

If a taxpayer elects to recognise GST on the supply of a voucher at the time of redemption, the issue of a voucher is disregarded by the Act. GST is payable when the voucher is redeemed for goods and services. The rules were designed to ensure that GST was only payable once. Concerns have been raised that the wording of the recent amendments may create the situation where, although the issue of a voucher maybe disregarded, a subsequent sale of the voucher by the person to whom the voucher was issued will be treated as a supply and subject to GST. This potential for double taxation was not intended.

**Recommendation**

That sections 5(11D) to 5(11G) be amended, with effect from 10 October 2000, to ensure that there are only two alternative points at which the supply in relation to a voucher is recognised – either at the time the voucher is supplied to a customer for the purpose of redemption or at the time the voucher is redeemed for goods and services.

**Submission**
*(Matter raised by officials)*

Meaning of the word “redemption”.

**Comment**

If a taxpayer elects to recognise GST on the supply of a voucher at the time of redemption, the issue of a voucher is disregarded by the Act. GST is therefore due when the voucher is redeemed for goods and services. The legislation, however, does not qualify the reference to “redemption” with the words “for goods and services”. There is a possible argument, therefore, that the legislation could require GST to be paid again when the participating retailer who supplied the goods and services in exchange for the voucher returns the voucher for reimbursement from the person who issued the voucher (or other person, depending on the arrangement).

**Recommendation**

That reference to the word “redemption” in section 5(11G) be clarified, with effect from 10 October 2000, by adding the words “for goods and services”.

**Submission**
*(Matter raised by officials)*

Meaning of the words “not practical”.

**Comment**

The preferred treatment of transactions involving the supply of vouchers is to recognise GST when the voucher is issued. Consultation with interested parties at the time that the policy was being developed highlighted that it would be difficult for some arrangements involving the retail sale of vouchers to comply with the preferred treatment. These concerns were addressed by allowing taxpayers the option to recognise GST when a voucher was redeemed. However, this option may only be used if it is “not practical” to comply with the preferred treatment. Concerns have been raised regarding the interpretation of the words “not practical” and whether in some cases it could unjustifiably require taxpayers to change longstanding arrangements and account for GST when a voucher is issued.

### Recommendation

Amend section 5(11G), with effect from 10 October 2000, to ensure that the words "not practical" do not unreasonably prevent taxpayers from accounting for GST at the time of redemption when a voucher is redeemed for goods and services. The amendment clarifies that when the issuer of a voucher and the person supplying the goods and services in exchange for the voucher are not the same, the taxpayers may elect to recognise GST at the time of redemption rather than issue. The application of the amendment will still require that there be an agreement between the taxpayers to this effect or that they are party to such an agreement.

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## Issue: Amendment to section 2A of the GST Act

### Submission

*(Matter raised by officials)*

The test for associating a trustee and a settlor of a trust in section 2A of the GST Act should be amended not to apply if the trustee is a charitable or non-profit body.

### Comment

Section 2A of the GST Act contains the definition of "associated persons" which applies for the purposes of various operative provisions in the GST Act. Subsection (1)(g) contains a new test which associates a trustee of a trust and a settlor of the trust.

A settlor of a trust is widely defined to include any person who provides anything to a trust for less than market value. The wide ambit of this definition is necessary to prevent the trustee-settlor associated persons test being circumvented. However, the definition of "settlor" could result in a donor to a trust which is a charitable or non-profit body being associated with that body. This could also affect the application of the tripartite test in subsection (1)(i), which associates two persons who are each associated with the same third person.

This result was not intended and it is therefore appropriate to amend the trustee-settlor associated persons test so that it does not apply if the trustee is a charitable or non-profit body. This would be consistent with a similar exception applying for charitable and non-profit bodies in the test in subsection (1)(f) which associates a trustee and a beneficiary of a trust.

### Recommendation

That the test associating a trustee and a settlor of a trust in the definition of "associated persons" in section 2A of the GST Act be amended not to apply if the trustee is a charitable or non-profit body.

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## Issue:  Amendment to 5(13A) of the GST Act

**Submission**
*(Matter raised by officials)*

Section 86(7) of the Taxation (GST and Miscellaneous Provisions) Act 2000 should be retrospectively repealed.

**Comment**

Section 86(7) incorrectly amended section 5(13A) of the Goods and Services Tax Act 1985 to replace the words "by that registered person's taxable activity" with the words "by the person in the course or furtherance of their taxable activity".

Section 5(13A) actually contained the words "by that registered person in the course or furtherance of that person's taxable activity".  The amendment was therefore both incorrect, in that it purported to replace non-existent words, and unnecessary, and should be retrospectively repealed.

**Recommendation**

That section 86(7) of the Taxation (GST and Miscellaneous Provisions) Act 2000 be repealed with effect from 10 October 2000.

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## Issue:  Amendment to section 11(1)(f) of the GST Act

**Submission**
*(Matter raised by officials)*

The word "or" in section 11(1)(f) should be replaced with "and" and the word "either" should be omitted.

**Comment**

Section 11(1)(f) is intended to zero-rate goods that would have been exported but for their death, destruction and so forth under circumstances outside the control of both the exporter and the purchaser – for example, by an "act of God" such as a landslide.

The provision currently refers to circumstances "…beyond the control of *either* the supplier *or* the recipient…".  This should be retrospectively changed to circumstances "…beyond the control of the supplier *and* the recipient…".

### Recommendation

That section 11(1)(f) be retrospectively amended, with effect from 10 October 2000, to remove the word "either" and replace the word "or" with the word "and".

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## Issue: Amendment to section 21A(2) of the GST Act

### Submission

*(Matter raised by officials)*

Section 21A(2) should be amended to ensure that any allocation between taxable and exempt supplies is fair and reasonable.

### Comment

Section 21A sets out the methods for allocating between taxable and other non-taxable uses of goods and services. Section 21A(1) sets out the two general methods of allocation – actual use (direct attribution), and a Commissioner-approved alternative method if the method results in a fair and reasonable allocation.

Section 21A(2) allows the use of either the two methods in section 21A(1) or the turnover method for ascertaining the proportion of exempt use of goods or services.

This implies an unrestricted ability to use the turnover method to ascertain the proportion of exempt use of goods or services. This was not intended – any method used should give a fair and reasonable result.

Section 21A(1) and (2) should therefore be clarified to ensure that the method adopted gives a fair and reasonable result.

### Recommendation

That a new subsection be added to section 21A, with effect from 10 October 2000, to ensure that the method used to allocate between taxable and exempt supplies results in a fair and reasonable allocation.

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## Issue: Amendment to section 21B(3) of the GST Act

### Submission

*(Matter raised by officials)*

Section 21B(3) should be amended to apply to all goods and services acquired or produced for which there is no pattern of use as intended, not just replacement goods and services.

### Comment

Section 21B(3) provides that when section 21C(1)(a) is applied to goods and services acquired or produced to replace goods and services without an existing pattern of use, a provisional output tax adjustment must be made on acquisition followed by a recalculation, and adjustment if necessary, after 12 months.

Section 21B(3) was intended to apply to all goods and services acquired or produced for which there is no pattern of use – replacement goods and services and new goods and services. A reference to new goods which are not replacement goods and services should, therefore, be inserted in section 21B(3), and the title of section 21B should be changed to reflect the wider scope of the section (Methods of allocation for new and replacement goods and services).

There is also inconsistent use of the term "produced" (goods "acquired or produced") in the section and it should be amended so that "produced" is used throughout the section in conjunction with the term "acquired".

### Recommendation

That section 21B(3) be amended to refer to all new goods and services and goods and services which are produced, as well as those acquired.

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## Issue: Amendment to section 21E(2)(b) of the GST Act

### Submission

*(Matter raised by officials)*

Section 21E(2)(b) should be amended to add the words "of this Act" after the reference to section 12(1).

### Comment

The words "of this Act" should be inserted after the reference to "section 12(1)" in section 21E(2)(b), as there is a reference to another Act in that provision (the Customs and Excise Act 1996). This minor amendment would be consistent with the drafting of the new definition of "input tax" in new section 3A(1)(b).

### Recommendation

That section 21E(2)(b) be amended to add the words "of this Act" after the reference to section 12(1).

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## Issue: Amendment to section 21E(3)(a) of the GST Act

**Submission**
*(Matter raised by officials)*

The reference to “section 12(1) of the Custom and Excise Act 1996” in section 21E(3)(a) of the Goods and Services Tax Act 1985 should be replaced by a reference to section 12(1) of the GST Act.

**Comment**

Section 21E(3)(a) contains an incorrect reference to “section 12(1) of the Custom and Excise Act 1996”. The reference should instead be to section 12(1) of the GST Act. This amendment could be made by simply repealing in new section 21E(3)(a) the words “of the Customs and Excise Act 1996” with retrospective effect. The current reference is taxpayer unfriendly.

**Recommendation**

That the reference to “section 12(1) of the Custom and Excise Act 1996” in section 21E(3)(a) of the Goods and Services Tax Act 1985 be retrospectively replaced by a reference to “section 12(1)”, with effect from 10 October 2000.

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## Issue: Amendments made by section 106 of the Taxation (GST and Miscellaneous Provisions) Act 2000

**Submission**
*(Matter raised by officials)*

Section 106(2) and (3) of the Taxation (GST and Miscellaneous Provisions) Act 2000 should be repealed. Section 42(2)(c) of the GST Act should be amended by replacing “a body (as defined in section 57(1) of this Act)” with “an incorporated body” and omitting “pursuant to any order by the Court”. New section 42(5) (which has not yet come into force) contained in Schedule 1 of the Personal Property Securities Act 1999 should also be amended by replacing “a body” with “an unincorporated body”.

**Comment**

Section 106(2) and (3) was intended to amend certain references in section 42 of the GST Act applying to the recovery of tax in respect of unincorporated bodies. These references, however, do not appear in section 42 – they appear in amendments to section 42 made by Schedule 1 of the Personal Property Securities Amendment Act 1999 which have not yet come into force. The purported amendments made by section 106(2) and (3) are therefore ineffective. It is, therefore, necessary to repeal these amendments and instead make the correct amendments to existing section 42(2)(c) of the GST Act. It is also necessary to make a minor amendment to new section 42(5) (which has not yet come into force) contained in Schedule 1 of the Personal Property Securities Act 1999.

## Recommendations

That section 106(2) and (3) be repealed.

That section 42(2)(c) of the GST Act be amended by replacing “a body (as defined in section 57(1) of this Act)” with “an unincorporated body” and omitting “pursuant to any order by the Court”.

That new section 42(5) contained in Schedule 1 of the Personal Property Securities Act 1999 be amended by replacing “a body” with “an unincorporated body”.

The amendments should have effect from 10 October 2000.