Mass-marketed tax schemes

An officials' issues paper on suggested legislative amendments

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Policy Advice Division,
Inland Revenue

The Treasury

Mass-marketed tax schemes: an issues paper on suggested legislative amendments

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Chapter 1

INTRODUCTION

1.1 This paper addresses mass-marketed tax schemes that result in investors receiving more tax deductions than the amount of money they invest in the scheme. Typically, the tax benefit of these deductions occurs regardless of the success of the scheme. Over the last six years or so these schemes have generally been marketed to high-income individuals, although trusts and companies, both small and large, have also invested in them.

1.2 The schemes cover a range of projects, from films to forestry and the commercialisation of "concepts". There are also schemes that target GST refunds, often in association with an income tax-driven proposal.

The problem

1.3 Although schemes that exploit loopholes in the tax legislation are not new, the Government is concerned about their recent proliferation and wide-ranging consequences. Therefore officials have been asked to consider how they can be combated.

1.4 The New Zealand tax system can, in certain circumstances, allow deductions to be taken for expenditure in advance of the income associated with that expenditure. For example, the costs of growing timber are deductible as incurred, whereas the income usually will not arise until harvest. The mere use of this opportunity is not the subject of this paper.

1.5 Rather, this paper considers schemes that seem to overstate the investors' deductions. Such schemes typically include apparently artificial sales projections that result in high asset valuations, together with the use of money in respect of which the investor is not at risk.

1.6 The New Zealand tax system is largely founded on the concept of voluntary compliance. If taxpayers perceive that the system lacks integrity, they will be less likely to comply, which in turn compounds the difficulties faced by Inland Revenue. These schemes have a negative impact on the integrity of the tax system, thereby undermining taxpayer confidence in that system.

1.7 For investors in the schemes, the consequences can include exposure to use-of-money interest and penalties on any resulting unpaid tax, as well as the unexpected expense and stress of being part of an Inland Revenue audit. For the Government, there is a potential loss of revenue and an inefficient use of Inland Revenue's resources.

1.8 By the end of the 2000 income year, about $436 million in tax credits had been claimed in relation to the schemes that Inland Revenue is aware of. This is a significant amount, and it could continue to increase in the absence of a targeted response. To date, however, $100 million of this has been recovered by continuing audit activity.

Suggested solution

1.9 Targeting the solution is a key issue. The Government has indicated that it has no desire or intention to change the current legislative and administrative rules for genuine, everyday investments. For example, it is not anticipated that the standard forestry schemes involving multiple investors would face any change.

1.10 The suggested solution has two aspects:

- A new "deferred deduction" rule would defer an investor's net losses from a scheme against future income from the scheme to the degree they exceed the amount of money the investor has "at risk" in the scheme.
- Schemes that meet one of several criteria would have to register with Inland Revenue and disclose that fact in a specified format on their prospectuses or "invitations to invest".

Submissions

1.11 All aspects of the suggested solution are offered for comment. We are particularly concerned that the suggested deferred deduction rule may be broader than appropriate, so comments on targeting the rule are particularly welcome. Comments on the detail of the suggested change, including issues related to the application date, are also welcome.

1.12 Submissions, which close on 22 February 2002, should be addressed to:

Mass-marketed Tax Schemes
The General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Or email: policy.webmaster@ird.govt.nz

1.13 Submissions may be published on the website of the Policy Advice Division of Inland Revenue Department, in the interests of making the information widely available. Should you object to your submission being published in this way, please clearly specify this in your submission.

1.14 Whether published on the website or not, submissions may also be made publicly available if requested under the Official Information Act 1982. The withholding of particular submissions or parts of submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you feel that your identity and/or any part of your submission should be properly withheld under that Act, please indicate this clearly in your submission.

Chapter 2

THE FEATURES OF MASS-MARKETED SCHEMES

2.1 A common feature of the scheme targeted by this paper is that they provide tax deductions from which tax savings in early years exceed the amount of the investor's own money put into the scheme. The investor makes a cash return regardless of whether the scheme is a commercial success or not.

2.2 There is no concern about schemes financed by the investor or commercial borrowings in which the investor is at real risk of losing this money if the scheme fails.

2.3 The schemes in question vary in quality, with some clearly being a form of tax avoidance. A number of current schemes are structurally similar to some that appeared in the early 1980s and then disappeared, to re-emerge in the mid-1990s.

2.4 Inland Revenue is currently auditing 22 of these schemes, involving $376 million of income tax in the years 1995 to 2000. One scheme will, if it is found to meet the criteria of the Revenue Acts, produce a revenue loss of over $50 million per year for many years.

2.5 The schemes are not restricted to income tax, as some also have GST implications. For example, GST refunds have been claimed on the purchase of second-hand goods such as intangible property rights, at prices Inland Revenue considers are well in excess of apparent market values. About $60 million in GST input credits were claimed in respect of these schemes for the four years from June 1996 to June 2000.

2.6 The schemes usually have some of the following features:

- They involve participation in a high-risk activity with apparently optimistic or unrealistic future sales projections.
- They include a transfer of property, including intangible and intellectual property, that is difficult to value with precision. Transfer at an excessive price magnifies the available tax deductions, which are usually by way of a depreciation deduction. Sometimes GST input credits are also claimed.
- They make use of non-residents, tax-exempt organisations like charities, tax loss companies, or entities that are not registered for GST. The use of such entities can give rise to income that is effectively exempt from New Zealand income tax and/or GST.
- Their finance is arranged so that the investor is not at real risk of ever having to repay the loans. This can create inflated interest deductions and/or provide support for a higher transfer price.

- Their projected income is well into the future and may or may not materialise.
- Sometimes the arrangements detailed in the accompanying invitation to invest are not implemented.

2.7 The tax system presumes that transactions between non-associated persons are at arm's length market values. Vendors attempt to maximise their return and purchasers attempt to minimise their cost. The end agreement as to value may or may not be what a valuer would agree, but arm's length bargaining is conceptually acceptable for taxation purposes.

2.8 The schemes that are the subject of this paper generally revolve around obtaining tax deductions for assets whose valuation is based on potential future income. The techniques for valuing these assets are not usually in question. It is the credibility of the forecasts of future income that underpin these valuations that is usually the issue.

2.9 If purchasers are not actually at risk of having to dispose of their own assets to acquire scheme assets, however, it is reasonable to suggest that the arm's-length presumption does not hold. At this stage both parties' interest in the value focuses, at least to a significant extent, on the size of the associated tax deductions.

How the schemes work

2.10 The schemes in question are generally similar in structure, and usually vary only in detail.

2.11 Typically, investors put a relatively small amount of money into a joint venture or partnership. This can be by way of scheme-specific, loss attributing qualifying companies (LAQCs) or it can be direct.

2.12 The joint venture or partnership undertakes an activity. Most of this money goes into the activity, with the balance going to the promoter.

2.13 The promoter arranges for the investors to have access to loan money. The loan money is used to purchase high-value assets that diminish in value, at least for tax purposes, over time. The higher the purchase value, the greater the tax deductions.

2.14 The investors are not at risk of having to repay the loan even if the scheme is commercially unsuccessful. A variety of mechanisms are used to ensure this. They range from the loan being provided on limited or non-recourse terms, to it being lent to a scheme-specific company and only secured over the assets of and perhaps the shares in the company. Other mechanisms include the use of put or call options over scheme assets or the use of "insurance policies".

2.15 The lending is frequently arranged so that the effects of the financial arrangement rules – in particular, the rules that produce gross income when debt is remitted – can be circumvented, as such income would reduce the positive tax benefits caused by the scheme.

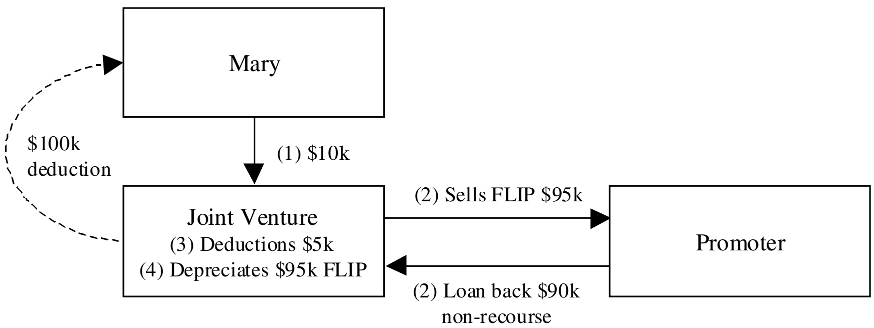
Example

2.16 Mary puts $10,000 into a joint venture (JV) that forecasts losses of $100,000 over the first three years. It forecasts income of $150,000 in year four, which in fact does not arise.

2.17 The promoter of the scheme sells fixed life intangible property to the JV for $95,000. This is depreciable over three years. The JV pays $5,000 cash (from Mary's investment) for the property, with the balance of $90,000 funded by a non-recourse loan from the promoter. The JV spends the remaining $5,000 in a fashion that causes it to be deductible.

2.18 Mary receives tax deductions of $100,000 over three years, saving her $39,000 if the 39% marginal tax rate applies to her income. This is $29,000 more than she has or will invest. She has made a substantial gain even though the JV has been unsuccessful.

2.19 The cash flows and loss transfers are as follows:



2.20 Chapter 5 gives more detailed examples of these schemes and illustrates the effect of the deferred deduction rule suggested in chapter 3.

Why is a legislative response required?

2.21 Some investors who appear in a number of these schemes are presumably aware of the potential consequences if, upon audit by Inland Revenue, the supposed tax benefits do not materialise. However, a number of investors are surprised when Inland Revenue not only suggests that deductions should be disallowed under either technical or anti-avoidance grounds, but that penalties might also apply. The compliance costs and stress faced by investors when a scheme is audited should not be underestimated.

2.22 As at August 2001, 32 Inland Revenue auditors were working full time on the 22 schemes then being audited. This was in addition to the litigation management and adjudication staff involved. One scheme alone has led to over 500 tax returns (covering multiple years) that are potentially subject to reassessment by Inland Revenue. This is clearly not the most efficient use of the department's scarce resources.

2.23 These tax schemes reduce the integrity of the tax system, thereby undermining taxpayer confidence in that system as a whole. The New Zealand tax system is largely founded on the concept of voluntary compliance, so if taxpayers perceive that the system lacks integrity, they will be less likely to comply. This in turn compounds the difficulties faced by Inland Revenue.

2.24 Although Inland Revenue is taking and will continue to take operational action to counter the use of such tax schemes, it is also appropriate to consider specific legislation to target them.

2.25 The legislation would aim to:

- reduce the number of such schemes, therefore reducing investors' compliance costs and Inland Revenue's administrative costs;
- inform potential investors that investment in such schemes should be considered carefully;
- confirm the policy intent of the law;
- increase taxpayer confidence in the tax system; and
- support the general anti-avoidance provisions in the law.

Overseas approaches

2.26 Canada and the United States also experienced significant revenue losses from such schemes marketed to individuals in the 1980s and early 1990s. Their experience indicates that a legislative response based on deduction limitation has the intended effect of limiting these schemes.

2.27 Both Canada and the United States have rules that identify money in respect of which the investor is "not at risk" and limit deductions accordingly. Canada does this by reducing the cost base of assets that give rise to tax deductions by the amounts "not at risk". The United States also defers deductions to the extent that an investor is "not at risk" in relation to an interest in specified assets or activities.

2.28 Both countries have tax shelter (a defined term) registration rules similar to, but more widely targeted than those suggested in this paper.

Chapter 3

SUGGESTED DEFERRED DEDUCTION RULE

3.1 The valuation of assets used in the schemes in question is the most problematic feature, so it should ideally be the target of any legislative response. Targeting valuation, however, is very difficult because the forecasts of income that underpin valuations of the assets involved are inherently difficult to determine and are very subjective. Therefore an alternative approach is needed.

3.2 Our suggested approach focuses on whether investors have used their own money or put their own assets at risk in the scheme. Such an approach would result in investors being unable to claim a greater deduction than the amount of money they are "at risk" of losing if the scheme in which they have invested is unsuccessful. Excess deductions arising from amounts the investor is "not at risk" of losing would be deferred against future income from the scheme or future contributions by the investor.

Deferred deduction rule

3.3 Our suggested criteria for the application of the rule are as follows:

- an investor enters into an arrangement that has a promoter, and
- incurs or expects to incur aggregate net tax losses in the first three years of the arrangement, and
- has money "not at risk" in the arrangement.

3.4 If the criteria are met, the net tax losses available for offset against other income or for transfer to another taxpayer will be reduced by the amount of money that is "not at risk" in the arrangement. This balance will be deferred until it can be released, either by the arrangement generating net income in future years for the investor or through reduction of money "not at risk".

3.5 The deferral may be permanent if the arrangement is not commercially successful.

3.6 These tests will have to be applied by treating the investor and any associated persons as one to ensure that, if companies are part of the scheme, transactions are aggregated. This associated persons test will obviously have to include interests in LAQCs that are involved in schemes.

3.7 Whether the expectation test is met at the time the investment is made may often be easy for potential investors to ascertain.

3.8 More difficulty arises when the “invitation to invest” contains the suggestion that there may be significant income in the three-year period, but does not in any way guarantee this. In this circumstance, investors may choose to apply the deferred deduction rule from year one to ensure they are not significantly disadvantaged by a backdated application of the rule several years later.

3.9 Should the deferred deduction rule apply because forecast income is not realised and the investor has not voluntarily applied the rule, an adjustment would be required to the investor’s tax position taken in earlier years.

3.10 This backdated application of the rule, however, would cause use-of-money interest to apply. Inland Revenue would have to set a new due date[1] for the reassessments for the payment of any tax. The reassessments would not be subject to the four-year time bar, given there generally will be only limited time after year three for the reassessment to be completed.

3.11 Given that some existing schemes will produce deductions for some years, we suggest that the deferred deduction rule should apply to future deductions of existing schemes as well as any future schemes that fall within the criteria. Thus, for present schemes, its effect would be retroactive. The detail of any transitional rules has yet to be worked through.

Money “not at risk”

3.12 The term “not at risk” will need to be carefully defined. Given the various schemes Inland Revenue has sighted to date, we suggest that money “not at risk” be defined to include:

- Loans that are explicitly limited or non-recourse.
- Loans that are economically limited recourse because they have been lent to scheme-specific entities and are not secured against other non-scheme assets of the investor[2], except for loans that are demonstrably on arm’s length terms and conditions.
- Put and call arrangements that function to relieve funding risk if the value of the put or call does not necessarily bear any relationship to market value of the assets subject to it. This will be carefully worded so as to exclude forward sales of homogenous products at values that relate to market values. For example, the forward sale of logs at a value that relates to expected market values if the forester still has the risk of delivering logs of a certain quality should not result in money being “not at risk”.

[1] For example, the date could be the terminal tax due date for year three of the arrangement if the expected income does not arise.
[2] A loan to an individual generally puts all of the individual’s assets at risk. Likewise, a loan to a top tier holding company puts all of the assets of that company at risk. In both cases the funding would be regarded as “at risk”.

- Insurance arrangements, except for policies issued by a New Zealand insurance company, or that are demonstrably on arm's length terms and conditions and are not arranged by the promoter.

3.13 Given the nature of the schemes and the pattern of their development, it is also necessary to consider whether there should be a further provision along the lines of "any other arrangement that has the same effect".

3.14 In light of the suggested associated persons rule, any loans to scheme-specific entities by the investor or associated persons would not be "not at risk" unless the holder is "not at risk" in respect of the loan.

Location of rule

3.15 We suggest the legislation for the deferred deduction rule be located in Part E of the Income Tax Act 1994. This rule would not, by itself, deem the arrangement to be an avoidance arrangement or otherwise cause penalties to apply. It merely acts as a timing rule for the scheme's tax deductions. This adjustment would be made outside the tax return.

Chapter 4

SUGGESTED SCHEME REGISTRATION

4.1 The tax administration's current information-gathering process has a number of problems in relation to these mass-marketed schemes:

- When a return is provided the information in the return is often not of sufficient detail for Inland Revenue to determine the tax impact of an investment.

- Inland Revenue frequently has to review large numbers of tax returns before a scheme is identified. This imposes administrative costs as well as a risk that such schemes might not be detected.

- Audit activity may not begin until two or three years after the end of the income year in which the investment was made. This means:

  - a revenue loss to the Government as the investment erodes the tax base until audit action begins;

  - increased administrative costs through resolving an issue over multiple years rather than when the investment was first made; and

  - the potential for taxpayers to face several years of shortfall penalties.

4.2 Incentives for investors to provide the information to Inland Revenue voluntarily are limited. Investors generally enter these types of schemes to minimise their tax, so they are naturally inclined not to draw attention to the scheme.

Scheme registration

4.3 We suggest that a scheme registration system, similar to that currently in operation in the United States and Canada, would be the most efficient and fairest way of obtaining information on schemes. It would put the focus on the origin of the problem instead of dealing with the consequences of lack of information. If done well this would benefit both investors and Inland Revenue.

4.4 Registration would not necessarily mean Inland Revenue would begin an investigation into the scheme at that time. It would simply mean the department would be made aware of the existence of the scheme, its ambit, and potentially its investors. This would allow it to plan its audit activity more efficiently, in contrast to the current situation, where Inland Revenue may become aware of the scheme only when the first related return is filed.

4.5 Registration would not prevent a promoter applying for a binding ruling in respect of the scheme, or remove any rights under the tax dispute resolution process.

4.6 The registration system could consist of the promoter or anyone else associated with the scheme filing with Inland Revenue a copy of the offer documents and a simple standard form notifying Inland Revenue that the scheme had one or more of the features requiring registration and identifying the promoter. It would, therefore, be both quick and simple. If Inland Revenue then wanted more details the promoter would be obliged to provide details of investors.

Registration criteria

4.7 Given that registration, by itself, would not impose any sanctions, and given the obvious need for information, the criteria could be somewhat wider than those required for deferred deduction. The criteria set would also have to be both simple and certain in application. It would not be in the interests of promoters, investors or Inland Revenue for debates about whether registration was required to take place after the event. This would need to be balanced, however, by the need to ensure that forcing an undue number of investments to be registered did not impair the efficiency of New Zealand's capital markets.

4.8 We suggest the following registration criteria:

The promoter must sell or anticipate selling the arrangement, or arrangements with the same generic features, to five or more investors and:

- the arrangement results in the deferred deduction rule applying because the expected income in the first three years is insufficient to cover tax deductions; or
- if the arrangement is commercially unsuccessful, net tax losses available to the investor could exceed the money the investor has risked in the arrangement; or
- a tax-exempt person, as part of the arrangement, sells an asset other than in the ordinary course of its business that it acquired in anticipation of or as part of the arrangement that causes the investors to derive tax deductions; or
- the investor claims GST input credits if the vendor is not registered for GST in respect of the transaction.

4.9 The types of schemes that can be used to erode the tax base change constantly. For this reason Inland Revenue would monitor the types of features that are commonly indicative of certain tax schemes. This is likely to lead to the criteria being updated if necessary.

Encouraging registration

4.10 It would be important to provide promoters with an incentive to notify Inland Revenue of their participation in a scheme that met the criteria for registration. This could be achieved in two ways: by measures targeted directly at the promoter and by measures that make unregistered schemes ineffective.

4.11 The Government discussion document *Taxpayer compliance, standards and penalties: a review*, published in August last year, raises the prospect of penalties being levied on promoters of certain tax schemes. However, such measures targeted solely at the promoter are unlikely to create a sufficient incentive to ensure registration. For example, if Inland Revenue becomes aware of an unregistered scheme several years after it has been promoted, it may no longer be possible to track down a promoter on whom sanctions can be applied.

4.12 Instead, it may be possible to make unregistered schemes ineffective, thus causing tension between the promoter and investors. To this end, we believe it may be appropriate to defer all tax deductions claimed by investors until a scheme that should be registered is registered.

4.13 Deferring the deductions would have a substantial impact on investors in schemes that, while otherwise satisfying the requirements of the Revenue Acts, have not been registered. Again, this could lead to new due dates being set and the investor being exposed to use-of-money interest. However, we believe the incentive would be sufficient to ensure registration.

4.14 This rule would also have an effect on schemes to which the main deferred deduction rule outlined in chapter 4 applies. The deferral for non-registration would apply to all deductions arising from the scheme, rather than only those up to the “not at risk” amount. Therefore the total deductions deferred would be greater if the scheme had not been registered.

4.15 Any deferred deduction of this kind would need to address the situation where a promoter advises potential investors that a scheme had been registered, when in fact it had not.

4.16 A similar deferral would apply to GST input credits until the scheme is registered.

Notification

4.17 To alert investors that Inland Revenue may know the details of such schemes, we suggest that registered schemes contain a statement notifying potential investors that the scheme is registered, such as the following:

"This proposal is registered with Inland Revenue as required by tax law. Registration conveys no assurance that this proposal complies with the current tax legislation. Investors should seek independent tax advice."

4.18 We acknowledge that if schemes that use existing law in a legitimate manner are required to register and use the registration notice this could act as a real impediment to commercial investments because potential investors could view the registration notice as a warning. Investors would need to understand that registration in itself did not mean that a proposal amounted to tax avoidance. Both targeting and the form of the statement made to prospective investors are key factors in ensuring that scheme registration works as intended.

4.19 Inland Revenue is also considering the merits of mounting an advertising campaign to draw potential investors' attention to the types of scheme required to carry a registration notice and the possible implications and risks of such a notice. Such a campaign would have to consider the effects of any inappropriate targeting.

Chapter 5

DETAILED EXAMPLES

5.1 This chapter presents three examples of how the deferred deduction rule would apply in practice. In the first two examples the rule applies to the schemes involved. The third example is of a structure to which neither the deferred deduction nor the scheme registration rules would apply, even though it incorporates scheme-specific finance.

Example 1

5.2 Under current law and presuming the scheme will yield the tax results the promoter suggests, Bill puts $10,000 of his own money into a joint venture (JV). The JV uses this for a computer development activity that produces deductions of $10,000 in the first year. The scheme does not amount to tax avoidance.

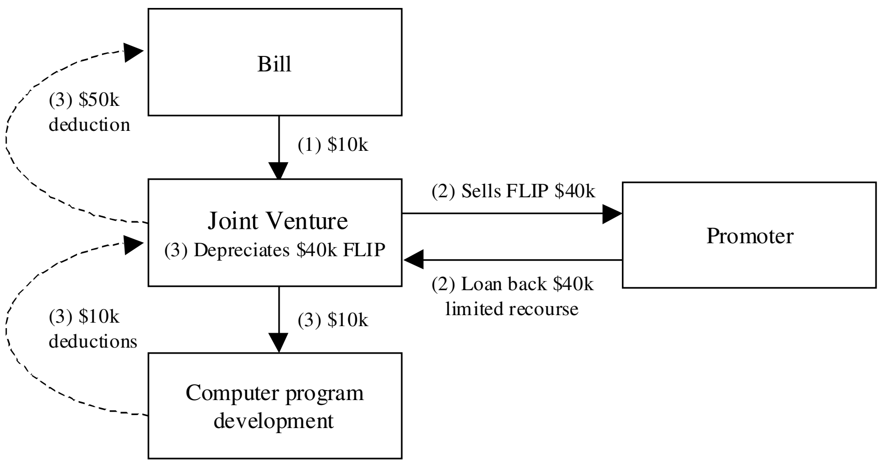
5.3 The scheme also provides that the promoter will sell to the JV fixed life intangible property that is depreciable over the first two years for taxation purposes. Each venturer's share of this is $40,000. Because the JV cannot afford to pay for it, the promoter will arrange finance. To ensure that Bill is not actually at risk of having to repay this finance, the loan is limited recourse.

5.4 The "invitation to invest" suggests that income of $55,000 will arise in year four. Tax payable on this income will be Bill's responsibility as the JV is "looked through" for tax purposes. In fact, income of only $10,000 arises.

5.5 Bill receives tax deductions of $50,000 over two years (JV activity of $10,000 together with depreciation of $40,000). At a marginal tax rate of 39%, under current law Bill receives tax refunds of $19,500 within two years.

5.6 The scheme has a mechanism in place to ensure that Bill is not exposed to any taxation consequences of the accrual rules if the project is unsuccessful.

5.7 The cash flows and tax deductions are summarised diagrammatically below.



Cash flows and taxable income under existing law

5.8 The *forecast* return over years one to four for Bill can be summarised as:

Forecast	*Taxable income/ (loss)*	*Refund/ (Tax to pay)*	*Return/ (Investment made)*	*Net cash position*[3]
Year one	(30,000)	11,700	(10,000)	1,700
Year two	(20,000)	7,800	0	7,800
Year three	0	0	0	0
Year four	55,000	(21,450)	15,000	(6,450)
Total	5,000	(1,950)	5,000	3,050

5.9 The income is first used to repay the limited recourse loan of $40,000, with the balance being passed from the JV to Bill.

5.10 If the forecast income is realised, Bill has received a timing benefit only. In net terms over four years, Bill has paid tax of $1,950 on a return of $5,000, an effective tax rate of 39%.

5.11 The *actual* return over years one to four for the investor is significantly different. It can be summarised as:

Actual	*Taxable income/ (loss)*	*Refund/ (Tax to pay)*	*Return/ (Investment made)*	*Net cash position*
Year one	(30,000)	11,700	(10,000)	1,700
Year two	(20,000)	7,800	0	7,800
Year three	0	0	0	0
Year four	10,000	(3,900)	0[4]	(3,900)
Total	(40,000)	15,600	(10,000)	5,600

5.12 Note that this net cash gain of $5,600 arises even though the scheme was not commercially successful. If the scheme actually made no income, Bill's net cash gain would be even better, at $9,500. Supposedly, Bill would make a 95 percent gain (solely at the expense of the tax base) even though the scheme was totally unsuccessful.

[3] Sum of tax to pay/(refund) and investment made/(return) for year.

[4] Income of $10,000 is firstly put towards repayment of the limited recourse loan of $40,000. There are no proceeds to be returned to Bill.

Cash flows and taxable income under the deferred deduction rule

5.13 The proposed deferred deduction rule will apply because the "invitation to invest" does not expect income until year four. Net losses will be incurred within three years. The total amount "not at risk" subject to the deferred deduction rule is $40,000, with the result that the first $40,000 of tax losses are deferred. The following arises from the application of the deferred deduction rule:

Deferred deduction rule	*Allowable taxable income/(loss)*	*Deferred taxable loss*	*Refund/ (Tax to pay)*	*Return/ (Investment made)*	*Net cash position*
Year one	0	(30,000)	0	(10,000)	(10,000)
Year two	(10,000)	(40,000)	3,900	0	3,900
Year three	0	(40,000)	0	0	0
Year four	0	(30,000)[5]	0	0	0
Total	(10,000)	(30,000)	3,900	(10,000)	(6,100)

5.14 It can be seen that the deduction generated by the "not at risk" money is not available until the scheme generates income in the fourth year. The $30,000 balance of deferred deductions will only be useable against further income or if the amount "not at risk" is reduced.

5.15 If the scheme actually made no income Bill's net cash cost would still be $6,100. This is the correct result, as Bill has lost his investment of $10,000 and is, in the circumstances, entitled to a tax deduction for this loss.

5.16 Note that the scheme would also have to be registered under the scheme registration rule, as the deferred deduction rule will apply because the expected income in the first three years is insufficient to cover tax deductions.

Example 2

5.17 Kay puts $20,000 of her own money into a scheme-specific LAQC, which in turn invests into a partnership of LAQCs. The partnership uses this money to make a film and obtains a deduction for it in year 1.

5.18 The scheme provides that the promoter will sell to the partnership fixed life intangible property that is depreciable for taxation purposes. Each partner's share of this deduction is $70,000, also in year 1.

[5] Taxable income of $10,000 is offset by deferred deductions that are now available for release.

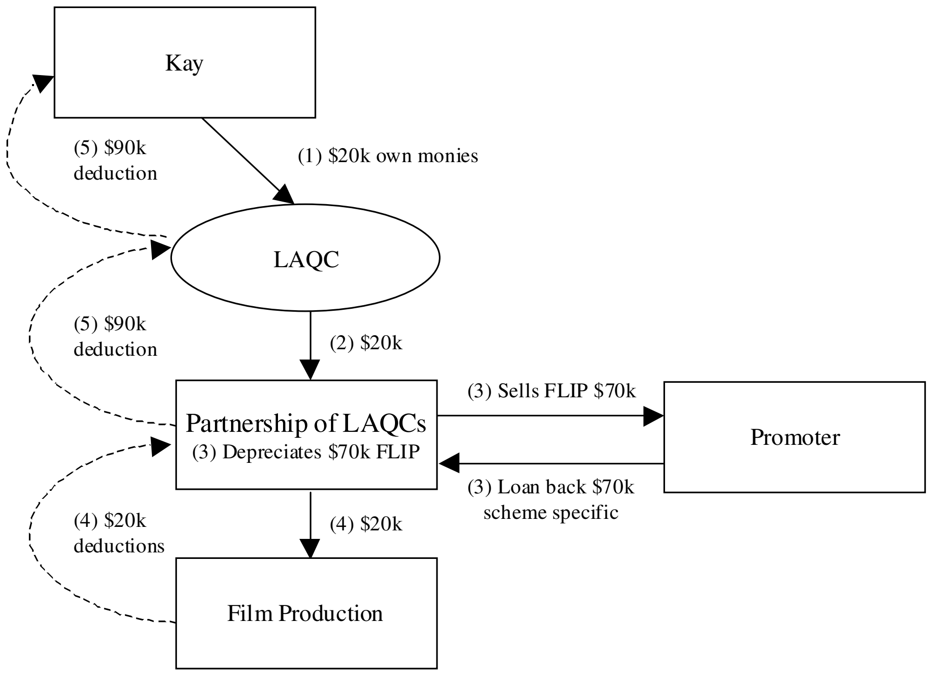
5.19 Because the partnership cannot afford to pay for it, the promoter will arrange finance. This finance is secured over the assets of and shares in the LAQCs, with the result that investors are not actually at risk of having to repay this finance from their non-scheme assets. In economic terms the loan is limited recourse against the scheme's assets and income. The scheme does not amount to tax avoidance.

5.20 The "invitation to invest" indicates that in year three the income of $120,000 per investor is expected. Tax payable on this income will be the responsibility of the LAQC, with a shareholder guarantee over the LAQC tax liability. The scheme in year three, in fact, produces income of only $30,000.

5.21 Kay receives tax deductions of $90,000 in year 1 (partnership activity $20,000 together with depreciation of $70,000). At a marginal tax rate of 39%, under the current law she receives tax refunds of $35,100 within 12 months.

5.22 The scheme has a mechanism in place to ensure that Kay is not exposed to any taxation consequences of the accrual rules if the project is unsuccessful.

5.23 The cash flows and loss transfers are summarised diagrammatically below:



Cash flows and taxable income under existing law

5.24 If the positions of Kay and the special purpose LAQC are consolidated, the anticipated result is similar to that shown in example 1. The *forecast* return over years one to three for Kay can be summarised as:

Forecast	*Taxable income/ (loss)*	*Refund/ (Tax to pay)*	*Return/ (Investment made)*	*Net cash position*
Year one	(90,000)	35,100	(20,000)	15,100
Year two	0	0	0	0
Year three	120,000	(46,800)	50,000[6]	3,200
Total	30,000	(11,700)	30,000	18,300

5.25 If the forecast income is realised, Kay has received a timing benefit only. In net terms over four years, she has paid tax of $11,700 on a return of $30,000, an effective tax rate of 39%.

5.26 The *actual* return over years one to three for Kay is significantly different. It can be summarised as:

Actual	*Taxable income/ (loss)*	*Refund/ (Tax to pay)*	*Return/ (Investment made)*	*Net cash position*
Year one	(90,000)	35,100	(20,000)	15,100
Year two	0	0	0	0
Year three	30,000	(11,700)	0[7]	(11,700)
Total	(60,000)	23,400	(20,000)	3,400

5.27 Note a net cash gain of $3,400 arises even though the scheme was not commercially successful. If the scheme actually made no income, Kay's net cash gain would be even better at $15,100. Kay then would have made a 75.5 percent gain[8] (solely at the expense of the tax base) even though the scheme was totally unsuccessful.

Cash flows and taxable income under the deferred deduction rule

5.28 Assuming that the expected return of $120,000 is realistic at the time the investment is made, Kay will not be required to apply the deferred deduction rule at the outset of the investment. However, should Kay so choose – for example, if she is uncertain as to the outcome of the investment – the rule can be applied from the year in which the investment is made. The total amount "not at risk" subject to the deferred deduction rule is $70,000, with the result that the first $70,000 of tax losses are deferred as soon the rule is applied.

[6] Proceeds are used first to repay limited recourse loan of $70,000. The balance of $50,000 is passed from the partnership to the LAQC and then on to the investor.
[7] Income of $30,000 is first put towards repayment of the scheme-specific loan of $70,000. There are no proceeds to be returned to the investor.
[8] $15,100/$20,000 (amount originally invested) x 100= 75.5%

5.29 Kay is not confident that the expected return of $120,000 in the third year will eventuate. To avoid use-of-money interest and the possibility of shortfall penalties applying if the expected return does not eventuate in year three she decides to apply the deferred deduction rule in year one, with the following results:

Deferred deduction rule	*Allowable taxable income/(loss)*	*Deferred taxable loss balance*	*Refund/ (Tax to pay)*	*Return/ (Investment made)*	*Net cash position*
Year one	(20,000)	(70,000)	7,800	(20,000)	(12,200)
Year two	0	(70,000)	0	0	0
Year three	0	(40,000)[9]	0	0	0
Total	(20,000)	(40,000)	7,800	(20,000)	(12,200)

5.30 The deductions generated by the "at risk" money are, in this example, available in year one. None of the deductions generated by the "not at risk" money are available until the scheme generates income in the third year, at which time they are released to the extent they cover net income from the scheme. The $40,000 balance of deferred deductions will only be useable against further income or if the amount "not at risk" is reduced.

5.31 If the scheme actually made no income Kay's net cash cost would also be $12,200. This is the correct result as Kay has lost her investment of $20,000 and is, in the circumstances, entitled to a tax deduction for this loss.

5.32 Note that the scheme would also have to be registered under the scheme registration rule, since the net losses available to Kay could otherwise have exceeded the money she has risked in the event that the scheme is not commercially successful.

Example 3

5.33 Tom puts $10,000 of his own money into a scheme-specific LAQC which in turn invests into a partnership of LAQCs. The partnership uses $7,000 of this to plant trees and obtains a deduction for it in year one. The balance is used as part payment for the land on which the trees are grown.

5.34 The "invitation to invest" indicated that in year 25 the income would be $150,000 per investor.

5.35 The scheme provides that the promoter will sell to the partnership land on which to grow trees. This land will cost $12,000 per partner.

[9] Taxable income of $30,000 is offset by deferred deductions that are now available for release.

5.36 Because the partnership cannot afford to pay for the land in full, the promoter arranges a loan of $9,000 per partner from a New Zealand bank. The finance is secured by mortgage over the land. This results in the investors actually not being at risk of having to repay this finance from their non-scheme assets. In economic terms, the loan is limited recourse against the scheme's assets and income.

5.37 However, the loan is from a New Zealand bank and interest is payable monthly. The investors pay this by way of automatic payments to the partnership, which in turn pays the bank. The bank loan is not "not at risk" because it is arm's length on fully commercial terms and conditions.

5.38 Because there is no money that is "not at risk", the deferred deduction or scheme registration rules do not apply. Tom receives, via the LAQC, tax deductions of $7,000 plus interest. The cashflows and tax deductions, ignoring interest, are summarised below.